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CLIENT ALERT

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**BORROWER AND GUARANTORS PERSONALLY LIABLE FOR DEFAULT
UNDER NON-RECOURSE CARVE-OUT CLAUSE**

By: Arnold D. Litt, Esq.

Dear Clients and Friends:

In a case of first impression in New Jersey, the Superior Court of New Jersey, Appellate Division, in the case of CSFB 2001-CP-4 Princeton Park Corporate Center, LLC vs. SB Rental I, LLC, et al. decided August 11, 2008 (Docket No. A-6397-07T2), held that a borrower and guarantors of a non-recourse loan are personally liable for repayment of the loan where the borrower placed a second mortgage on the property without the prior written consent of the lender in breach of a carve-out provision in the note which imposed personal liability on the borrower in the event of violation of the carve-out provision.

The facts of the case are simply stated. Plaintiff's predecessor-in-interest, Credit Suisse First Boston Mortgage Capital, LLC, loaned \$13,300,000.00 to SB Rental, secured by a first mortgage encumbering the commercial property located on Cornwall Road, South Brunswick, New Jersey. The loan was guaranteed by the principals of SB Rental. The loan was a non-recourse obligation, but the mortgage note contained a carve-out clause providing that the debt would be fully recourse in the event borrower failed to obtain the lender's prior written consent to subordinate financing encumbering the property.

Notwithstanding the provision SB Rental procured a \$400,000.00 subordinate loan secured by a second mortgage on the property. While the second mortgage was fully satisfied seven months later and thereafter discharged of record, the non-recourse carve-out provision had been triggered, rendering the loan fully recourse as to the borrower and the guarantors. Eighteen months later the borrower defaulted in the payment of principal and interest and the loan was

foreclosed in an uncontested foreclosure action. Plaintiff instituted the present action against the borrower and guarantors seeking recovery of the deficiency on the balance of the mortgage note. Plaintiff moved for summary judgment seeking full recourse against both the borrower and the guarantors, and the motion judge granted summary judgment in favor of the plaintiff. From that determination, this appeal was brought by the defendants.

Defendants argued that the non-recourse carve-out clause was unenforceable because it represented a liquidated damages provision due to the fact that the penalty of full recourse bears no relationship to any harm suffered by the lender.

The Court recognized that "this was a commercial transaction negotiated between business entities having comparable bargaining power". *Id.* at 7. The parties agreed upon the carve-out because it affected the value of the collateral and constituted a material term in acquiring the \$13,000,000.00 loan in the first instance. Recognizing that the parties were sophisticated and that the terms of the documents were "carefully crafted terms", *Id.* at 8, the Court held that it would give full force and effect to the unambiguous language that the parties had agreed upon.

The Court rejected the defendants' argument holding that a non-recourse carve-out clause was not a liquidated damages provision because it operated "to define the terms and conditions of personal liability, and not to affix probable damages". *Id.* at 9. The Court recognized that "the non-recourse nature of the loan operates as an exemption", while the "carve-outs exist to implicate personal liability". *Id.* at 9. It was also recognized that the carve-out provision was not a liquidated damages provision because it provided for actual damages as opposed to speculative or incalculable damages.

Defendants' argument that the breach which triggered personal liability was eventually cured, and, therefore, there was no harm to the plaintiff, was similarly rejected by the Court, which held that it did not matter whether or not the default was cured. By adding another mortgage lien, the harm was created in that it adversely affected the value of the collateral securitizing the loan. Even though the subordinate financing was paid off, the Court held that itself "does not alter the fact that defendants breached the very obligation identified by both parties as posting a special risk to plaintiff, and therefore requiring the covenant's special protection. By further encumbering the property, even if only temporarily, defendants' action had the potential to affect the viability and value of the collateral that secured the original loan." *Id.* at 13.

Based on this decision, it is critical that borrowers and guarantors alike pay special attention to the carve-out clauses in an otherwise non-recourse loan. A default, even if a technical one, may irreparably generate full recourse to the borrower and the guarantors, which will not be rescinded merely because the default has been cured. Consideration should be given to negotiating specific cure periods regarding carve-out defaults, so that the draconian events of the subject case are not triggered.