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Decisions bring cheers and jeers from lenders

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With the work out and foreclosure era winding down, many of the cases filed during that era have now been decided. In recent months, there has been a flurry of decisions of interest to lenders. The decisions represent a "mixed bag" of results, some favorable for lenders, some unfavorable.

It is difficult to generalize whether any particular pattern has emerged, but certain trends seem clear. In particular, lenders may be less susceptible to borrower claims of an oral agreement to alter, amend or extend the terms of a loan. This flows directly from the amendment in 1991 of the Statute of Frauds, which was specifically intended to eliminate the ability of borrowers to allege that the lender orally agreed to modifications and extensions to loan documents. In considering the rights of guarantors, however, the courts have scrupulously honored the particular language of guaranty agreements and, to the chagrin of lenders, allowed guarantors either to escape from their guaranty or limited the guaranty in circumstances in which liability might otherwise have been expected.

A brief review follows of several recent cases on various issues that are representative of the activity of the New Jersey courts in these areas over the past year or so.

Positive for lenders

In a decision of significance for lenders, the Appellate Division in *Glenfed Financial Corp. v. Pennick Corp.,* 276 N.J. Super. 163, considered the following facts: The borrower had breached its financial covenants contained in the loan agreement and was in default. Glenfed had the ability under the loan agreement to accelerate amounts due as a result of those covenant defaults. The borrower requested that Glenfed not accelerate the loan immediately and, in exchange, the borrower would agree to an earlier maturity date. Glenfed ultimately agreed to shorten the maturity by approximately 13 months. Upon reaching the new maturity nonpayment by the borrower, Glenfed attempted to exercise its rights. It was met with a defense that the entire extension arrangement was extracted by Glenfed

under economic duress.

The court rejected this contention and found a creditor's exercise of its rights to declare a loan default or to forebear from taking such action, only upon agreeing to certain modification in the agreement, is not "wrongful conduct and therefore, does not constitute economic duress." Further, the actions by Glenfed did not violate its implied duties of good faith and fair dealing, since such duties "may not be invoked by a commercial debtor to preclude a creditor from exercising its bargained for rights under the loan agreement." Finally, the failure by Glenfed to call a default immediately after the breach of the covenants did not preclude Glenfed from exercising its rights at a later date.

While it is difficult to generalize from the case, it does appear that Glenfed represents a significant acknowledgement by the court that sophisticated commercial borrowers cannot have things both ways. When the lender has immediate rights against the borrower, it may trade its ability to exercise those rights in exchange for an earlier maturity date and other modification of the terms and provisions of the loan documents without being accused of duress or otherwise being in breach of its duty of good faith.

That the particular terms of an agreed-upon restructuring will be precisely honored by the courts was demonstrated in *Charles Klatskin Company, Inc. v. Erez Levy & Gershon Levy*, App. Div. A-2180-93T2. The Appellate Division concluded the failure by the Levys to pay on a promissory note, which contained an explicit provision stating the failure to make payment within five days of the payment due date or to have an envelope contained the payment post-marked by the third day following the payment date, would be an event of default. The court permitted the lender to accelerate the loan and exercise remedies despite the fact the late payment was inadvertent and ultimately was offered and made by the borrower. Whether the same result would have flowed had the parties been involved in a consumer transaction rather than a commercial arrangement, is uncertain. However, the case represents further evidence that between presumably sophisticated parties, contractual arrangements will be upheld in the strictest sense.

Was duty breached?

In Artic Petroleum, Inc. v. Bank of Mid-Jersey, App. Div., A-283-93T5, the Appellate Division considered whether the bank breached its duty of good faith and fair dealing by failing to provide notice of its intention not to renew a loan that it had extended to the borrower. As was true in Glenfed, the borrower argued the failure to provide notice of nonrenewal breached the implied duty of good faith and fair dealing. The court rejected this argument and held "the common law duty of fear dealing cannot modify the clear terms of the documents themselves to create duties not bargained and agreed to by the parties."

Accordingly, since the loan documents did not require the lender to give the borrower notice of its intention not to

renew, the bank was not obliged to do so and breached no duty. Further, the court held the alleged oral agreement by the lender to extend the loan was unenforceable since the extension allegedly promised it would carry the loan beyond a 12-month period and therefore violate the Statute of Frauds. The case is significant because it again represents a judicial rejection of an argument by a borrower that some implied duty should be imposed beyond the express terms of the loan documents.

Lien Law Interpretation

A case that interpreted the New Jersey Priority of Lien Law was *First Fidelity Bank, N.A., N.J. v. George A. Bock, et al.*, 279 N.J. Super. 172. First Fidelity extended a loan in 1987 to the borrower that was secured by a mortgage. The loan matured in 1992, and the bank agreed to extend for one year. A new promissory note was executed. The same thing happen in 1993. In both instances, the new promissory notes indicated the prior notes had been satisfied.

When the borrowers defaulted and foreclosure was begun by First Fidelity, a subsequent creditor asserted it should be granted priority over the original filed mortgage. The creditor argued the original mortgage should not be deemed to secure the subsequent notes because the original mortgage only secured the original note, which had been satisfied by the subsequent notes. The court rejected this argument and held that despite the fact that subsequent notes were denominated as new notes in satisfaction of the prior notes, the transaction, taken as a whole, was actually a modification of the original 1987 obligation, with the new notes simply serving to extend the maturity of the original loan. Since the new notes were considered a mere "modification," the court concluded the Priority of Lien Law should protect the seniority of First Fidelity's original mortgage.

This result seems appropriate since it is apparent that in each case the restructured loan was a continuation of the original 1987 note. However, the lender would have been well-advised to recite in the subsequent documentation that the prior obligation was not satisfied or repaid by the new notes, but rather was simply continued and restated.

A final case that may be characterized as favorable for lenders is *United Jersey Bank/Central N.A. v. Albert Pinhas, et al.* , App. Div. A-440-93T2. The borrowers took a $162,000 loan from the bank to purchase a condominium. The note was secured by a mortgage on the condominium. Upon default, the bank brought suit on the promissory note, but did not foreclose on the mortgage. The trial court held the borrowers were entitled to a fair-market value credit against the debt obligations equal to the value of the mortgaged property. The Appellate Division reversed, concluding the statutory provisions that permit a fair-market value credit only apply in situations in which the mortgage is on owner-occupied property or property on which the borrower and immediate family reside. Since these were not the facts in this case, the fair-market value credit rights were not applicable. Accordingly, a fair-market value credit would only be applicable to the borrowers in this case after the foreclosure had been concluded and the mortgaged property had been sold in foreclosure.

The jeers

In a group of cases involving the relative rights of guarantors, the courts demonstrated an extreme willingness to protect the rights of guarantors in circumstances during which events occurred between the borrower and the lender which, under common law, might result in release or diminution of the guaranteed obligation.

In Danni Corp. v. Arlene Doviak, App. Div. A-3667-93T, the Appellate Division considered whether a guaranty could be enforced in a situation in which the creditor did not file a financing statement and thereby failed to perfect its security interest in the underlying property of the borrower. The guaranty purported to be an absolute guaranty and stated that "no act or omission of any kind on the part of the holder of the note shall in any event effect, impair or terminate this guaranty." The guaranty, however, also contained language to the effect that the creditor could not claim such a waiver unless it had fully performed its obligations under a contract of sale.

The court concluded the failure by the lender to perfect its security interest represented a breach of its required obligation to fully perform its obligations under the contract for sale. Accordingly, the court held the waiver language contained in the guaranty was not applicable. When limited to the facts, the case may not be an extreme result, but rather simply reflect a strict and proper reading of the particular provisions of the guaranty involved. Because the guaranty required full compliance with the contract of sale by the creditor, the court held the parties could reasonably have expected such compliance would include perfection of the security interest.

While the case may be limited to its facts, it is better practice to include language in a guaranty that affirms the continuing obligations of the guarantor notwithstanding any nonperfection of lien.

The Appellate Division in The Valley Hospital Corporation v. Gerald F. Juliano, et al., App. Div., A-4154-93T1, considered whether a "dragnet" provision in a guaranty should be enforced under the circumstances of that case. The guaranty was provided primarily as additional support for a $100,000 annually renewable line of credit. In addition to describing the line of credit as being a guaranteed obligation, the guaranty also stated the guarantor guaranteed "the payment, when due, of each and every obligation... owing to Midlantic by [the borrower]." It was unclear why this language was included, and there was no evidence the lender could establish that it was specifically agreed to at the time the guaranty was executed. Because it was not established the parties actually intended the guaranty to extend beyond the line of credit, the court rejected the lender's attempt to include within the guaranteed obligations certain warranties relating to prior endorsements of negotiable instruments in addition to the guaranty of the line of credit.

Bad faith by lender

Finally, in National Westminster Bank, N.J. v. James Lomker, et al., 277 N.J. Super. 491, the Appellate Division was

faced with a defense by a guarantor that the guaranty should not be enforced because the lender allegedly had engaged in practices that resulted in an impairment of the collateral of the borrower. The guaranty contained language purporting to make it an absolute and unconditional obligation of the guarantor irrespective of any circumstances that might exist between the borrower and the lender.

However, the facts in the case suggested there might have been some legitimacy to the defense that the lender acted improperly. The court held that in order for a waiver of such action in a guaranty to be enforceable, "it should only be by the most unequivocal language in the guaranty agreement." According to the court, in order for a defense of bad faith or other misconduct by the lender to be subject to waiver, "a guaranty must do so expressly."

Based on this case, it may be advisable for lenders to include in their standard guaranty forms an express waiver of bad faith or other misconduct. Naturally, such an attempt will be met with resistance by the guarantor as it will argue that the guarantor should not be held liable in situations where the lender clearly acts in bad faith.

The best that can be said for these cases is that in certain specific areas there is now further judicial guidance. The body of law applicable to lenders continue to evolve and one will have to simply continue to adjust both lending practices and loan documents to conform to these emerging decisions.

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