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New Jersey Appellate Division Holds Material Adverse Change to Borrower's Financial Condition Sufficient to Invoke Cross-Default Provisions

By Michael R. O'Donnell, Michael Crowley and Kevin Hakansson*

Banks should take note of a recent New Jersey Appellate Division decision, which gives detailed guidance on what courts look at in determining to enforce non-monetary defaults and particularly material adverse changes and debt service coverage ratios. The authors discuss the decision and its implications.

The New Jersey Appellate Division recently affirmed the trial court's grant of summary judgment in favor of a bank, holding that the bank had the right to refuse prepayment on two of its loans based on non-monetary defaults on a third loan when the loan documents contained cross-default provisions.[1] This case is of interest as it reaffirms the enforceability of cross-default provisions and that courts will indeed recognize and enforce non-monetary defaults such as a material adverse change in a borrower's financial condition and debt service coverage ratios.

BACKGROUND

Paul V. Profeta ("Profeta") owned the LLCs LVP Associates ("LVP"), 349 Associates ("349") and 769 Associates ("769" and collectively "Defendants") that received multi-million dollar commercial mortgage loans from the Bank of China ("the Bank") in 2007. The loans matured on July 1, 2017, and Defendants did not pay the balance due on the loans. One month before the maturity date, however, the Bank had refused to permit Defendants to prepay the LVP and 349 loans and to secure the release of the mortgage liens on those properties.

In doing so, the Bank invoked the loan agreements' cross-default provisions, which made it an event of default by one borrower if there is an event of default by one of the two other borrowers. The Bank argued that multiple non-

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[1] *See Bank of China v. L.V.P. Assocs., et al.*, 2021 N.J. Super. Unpub. LEXIS 3184 (App. Div. Dec. 30, 2021). Copy of the decision on file with authors.

monetary, pre-maturity defaults by 769 constituted defaults by all Defendants, justifying the Bank's refusal to release the other two mortgage liens upon prepayment.

The Bank alleged that (1) there was a "material adverse change" in 769's "financial condition or results of operations . . . or . . . the value of [its] Property"; (2) the Bank "in the exercise of its sole reasonable discretion, deem[ed] itself insecure"; and (3) the ratio of 769's net operating income to its debt service—the "Debt Service Coverage Ratio" or "DSCR"—had fallen below the required 1.25 to 1. The trial court agreed that 769's pre-maturity defaults justified the Bank's actions and granted the Bank summary judgment, striking Defendants' answers and counterclaims and deeming the Bank's foreclosure complaint as uncontested, later entering final judgments of foreclosure.

ON APPEAL

In appealing the orders against 349 and LVP, Defendants contended, among other things, that there were genuine issues of material fact regarding the Bank's allegations of "material adverse change," insecurity, and 769's DSCR. After first noting that the loan agreements did not define "material adverse change" and there was no subjective standard for determining if a materially adverse change has occurred, the court disagreed with Defendants.

With regard to 769's "material adverse change," the court found that the drop in 769's property value from nearly $16 million to $8 million, as well as the steady rise in the vacancy rate of third party tenants from 27 percent to 62 percent in 769's property, affected the Bank's financial risks associated with making and holding the loan and were thus material. The fact that the Bank did not obtain an appraisal until after it declared default "matters not" because the Bank "relied on the expertise of its employees who opined, based on the rent rolls and general economic conditions, the property's value had fallen."

The court also rejected Defendants' argument that if the adverse changes to 769's finances were material, the Bank would have acted sooner, stating that "a creditor's temporary forbearance in exercising its remedies upon its debtor's default does not preclude the creditor from subsequently exercising those rights."

Regarding the Bank's insecurity, the court found that the same developments that gave rise to the "material adverse change," along with the threat of 769 filing for bankruptcy and 769 representative Steven Coleman's ("Coleman") statement that 769 would not be able to repay the loan, gave rise to the Bank's insecurity. The court held that these facts were so one-sided that a reasonable jury would not find against the Bank's claim of insecurity, and refused to allow

Defendants to create a dispute of material fact by claiming there was "confusion" about Coleman's statement. It dismissed Coleman's contradiction after a break in his deposition of his earlier deposition testimony admitting that 769 could not pay the loan as a violation of the sham affidavit doctrine.

Regarding the DSCR, the court acknowledged that there may have been a genuine issue of material fact as to whether 769's DSCR did fall below 1.25 to 1.00, but held that because there existed the other pre-maturity defaults by 769, the Bank was justified in invoking the cross-default provisions and declaring 349 and LVP in default.

Defendants also claimed that the Bank breached the loan documents and violated the implied covenant of good faith and fair dealing by refusing Defendants' offer to prepay the loans. While the court acknowledged that the Bank misinterpreted some terms of the loan agreements, including incorrectly informing Defendants that they had to pay 115 percent of the outstanding principal in order to prepay the loans and sending unsupported default notices, the misinterpretations did not constitute material breaches of the loan agreements because, even if the Bank had interpreted all provisions correctly, Defendants still would not be entitled to the release of the lien if it prepaid the two loans.

The court also rejected Defendants' covenant of good faith and fair dealing arguments, stating that both Defendants and the Bank were sophisticated parties seeking to exploit their contractual rights to maximum benefit, and that the Bank was entitled to enforce the contracts as written.

Finally, the court held that Defendants could not argue that the Bank violated its own internal loan guidelines as a defense:

> we are unaware of any authority—and defendants point to none—that a borrower may defend a default on the ground that the lender did not follow its own internal guidelines, even if the default was justified under the borrower's agreement with the lender. Defendants lack standing to object to the bank's compliance with its own internal practices.

CONCLUSION

Banks should take note of this decision, which gives detailed guidance on what courts look at in determining to enforce non-monetary defaults and particularly material adverse changes and DSCRs. The court reenforced that significant shifts in property value and in a property owner's third-party vacancy rate constitute materially adverse changes and grounds for a bank's insecurity that will justify calling a loan.

As the court held, to be considered materially adverse, the change "must have been enduring and of significant proportion," and that in the context of a loan transaction and a bank's decision-making process, the adverse change "had to affect the financial risks associated with making and holding the loan."