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North Carolina Supreme Court Extends 'Offset Defense' to Guarantors in Foreclosure Deficiency Actions

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On September 25, 2015, the North Carolina Supreme Court handed down a landmark decision that will radically alter the process by which lenders pursue post-foreclosure deficiency actions against guarantors. In a victory for guarantors of real estate-secured loans, the Supreme Court ruled that guarantors are permitted to stand in the shoes of the principal borrower and raise the North Carolina General Statute Section 45-21.36 anti-deficiency defense in their own right. Consequently, deficiency actions may not be dead against guarantors *per se*, but they will be much more involved and expensive for lenders.

The case, High Point Bank & Trust Co. v. Highmark Properties, LLC, involved the application of Section 45-21.36—the so-called "offset defense"—which provides a defense for certain loan obligors in post-foreclosure deficiency actions. It provides that when the lender acquires the collateral at foreclosure and then sues to collect the deficiency, certain obligors may defeat the action or reduce the amount of a potential judgment against them, by showing that the collateral was worth the amount of the debt at the foreclosure sale or that the lender bid substantially less than the collateral's true value.

For example, if a lender forecloses on collateral securing a $1 million loan and acquires the property for a credit bid of $750,000 at the sale, the lender would typically have a valid deficiency claim for $250,000 against the borrower and any guarantors. But under Section 45-21.36, the borrower can assert that the collateral was actually worth $1 million and, if a jury agrees, the borrower would owe no deficiency. Alternatively, if the jury decides the collateral was worth $850,000, the borrower would owe only $150,000.

Historically, North Carolina courts have consistently held that the offset defense was available only to the borrower or other maker of the obligation or owner of the collateral. In other words, you had to sign the promissory note or the deed of trust to avail yourself of the statutory defense. For decades, the courts have repeatedly held that the offset defense did not apply to a mere guarantor. A panel of the North Carolina Court of Appeals affirmed this position as recently as March 2013.

In December 2013, however, a different panel of the North Carolina Court of Appeals, in deciding the initial appeal of the High Point Bank case, allowed an end-run around the rule that the offset defense did not apply to a mere guarantor. In that case, the Court of Appeals held that once a *borrower* obtains an offset or reduction of the debt under the statute, then the guarantors of that debt can be held responsible only for the reduced amount of the borrower's debt. In other words, the guarantor did not have the personal right to assert the offset defense, but could use the borrower to assert the defense for the guarantor. In practice, even if a lender sued only the guarantors, then the guarantors could seek to join the borrower in the action and assert the defense.

High Point Bank sought review in the North Carolina Supreme Court. The Supreme Court agreed to review the

decision, and not only affirmed, but expanded the holding of the Court of Appeals. The Supreme Court held that guarantors indeed may assert the offset defense just like a borrower or collateral owner. Moreover, the Supreme Court dispensed with the "have the borrower assert the defense for the guarantor" concept and held that the guarantor can assert the offset defense directly, even if the borrower is not a party to the action.

Lenders can be forgiven if they find the decision frustrating. Even though Section 45-21.36 specifically refers to the "defense" being available to a "mortgagor, trustor or other maker of such an obligation," the Supreme Court held that it is "not a 'defense' in the usual sense." Instead, the Supreme Court held that it is "an equitable method of calculating the (post-foreclosure) indebtedness." The Supreme Court stated that "[t]he statute protects a debtor by calculating the debt based upon the fair market value of the collateral instead of the amount bid by the creditor at the trustee's sale."

The opinion does not acknowledge the decades-worth of decisions from the Court of Appeals holding that the offset defense did not apply to a mere guarantor (including cases going back to at least 1979 that the Supreme Court explicitly declined to review on appeal). The Supreme Court also did not discuss the fact that lenders use guaranty agreements as separate, independent, and additional sources of security for repayment of a loan. This omission is perplexing since the Supreme Court has previously recognized that a guaranty obligation is separate and independent of the obligation of the principal borrower. Finally, the Supreme Court stated that it had to interpret Section 45-21.36 broadly because it was part of a group of "depression era laws designed to protect debtors." But the Supreme Court made no distinction between commercial loans and consumer loans secured by principal residences. High Point Bank, in fact, involved a multi-million dollar commercial real estate development project, not the image that comes to mind when we think about The Great Depression.

To make matters worse for lenders, the Supreme Court ended its opinion by holding that the offset defense is not subject to waiver and that "waiver of this statutory protection as a prerequisite to receipt of a mortgage or as a condition of a guaranty agreement would violate public policy." In other words, lenders will not be able to avoid this holding by re-drafting their loan documents.

The ruling will have a profound impact on lenders in North Carolina, both in underwriting and collection. The rulings will almost certainly increase the time and expense associated with deficiency actions. Under the law before High Point Bank, in the absence of lender liability claims, a deficiency judgment could be obtained by summary judgment. Essentially, all the lender had to do was get the math right, subtracting the bid price (less expenses) from the debt. But now, in every deficiency action, the actual fair market value of the collateral and whether the bank bid not just less, but "substantially less" than that value will be questions of fact to be resolved by a jury. Guarantors will use the discovery process to obtain copies of the lender's appraisals and bid strategy, and then use that information against the lender in the action. Guarantors will be able to use their own appraisers -- or even just their own opinion -- to show evidence of value or to discredit the lender's appraiser and get the matter to a jury. Absent settlement, it will be almost impossible to resolve a deficiency action short of a full-blown trial.

The High Point Bank decision raises many questions that are beyond the scope of this article, including this one: If a lender has already obtained a judgment against a guarantor, may the guarantor now file an action against the lender for relief from the judgment?

Our Creditors' Rights Practice Group is available to provide you with additional information and answer any questions you have about the decision and how it may affect you.

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