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Are Deficiency Actions Now Dead In North Carolina?

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On February 17, 2015, the North Carolina Court of Appeals handed down a decision that, if not reversed by the North Carolina Supreme Court, will radically alter the process by which lenders pursue post-foreclosure deficiency actions against guarantors. Deficiency actions may not be dead *per se*, but they will be much more involved and expensive for lenders.

The case involved the application of Section 45-21.36 of the North Carolina General Statutes—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 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 foreclosed on collateral securing a $1 million loan and acquired 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. The borrower, however, could assert that the collateral was actually worth $1 million and, if a jury agreed, the borrower would owe no deficiency.

Historically, North Carolina courts have consistently held that the offset defense was available only to the mortgagor, trustor, or other maker of the obligation. In other words, you had to sign the promissory note or the deed of trust to avail yourself of the statutory defense. Over the years, 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 issued a ruling that allowed an end-run around the rule that the offset defense did not apply to a mere guarantor. In that case, High Point Bank & Trust Co. v. Highmark Properties, LLC, 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. The decision seems to stand for the proposition that a guarantor can do indirectly what the guarantor cannot do directly.

On February 17, 2015, in BB&T v. Smith, a third panel of the North Carolina Court of Appeals dispensed with the "have the borrower assert the defense for the guarantor" concept and held that the guarantor now can

assert the offset defense directly, even if the borrower is not a party to the action. The Court of Appeals held that a 77-year-old decision from the North Carolina Supreme Court compelled this result.

If the High Point Bank and BB&T decisions stand, they 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 you had to do was get your math right, subtracting the bid price (less expenses) from the debt. But now, in every deficiency action, the value of the collateral and whether the bank bid 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 appraiser to show evidence of value or to discredit the lender's appraiser. Absent settlement, it will be almost impossible to resolve a deficiency action short of a full-blown trial.

The High Point Bank case is presently before the North Carolina Supreme Court. The Supreme Court heard oral arguments in November 2014 and a decision could come any day. Perhaps the BB&T decision will spur the Supreme Court to immediate action. In the meantime, if you have any pending or potential foreclosure deficiency actions, please contact our Creditors' Rights Practice Group for more information on how best to advocate your position.

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