

News & Types: Commercial, Competition & Trade Update

Borrower Escapes, But Guarantor Does Not, on \$17 Million Debt

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In a recent Risk Management Update, we reported on an Illinois case in which Michael Finley, former NBA star, avoided liability on his personal guaranty because the lender had inserted an incorrect closing date in the guaranty. The error was clearly inadvertent and could be called a technicality. But it was enough to let Mr. Finley off the hook. (*Ringgold Capital IV, LLC, as Assignee of Old Second National Bank, v. Finley*, 2013 Illinois Appellate (1st) 121702, June 19, 2013). In that case, the Illinois appeals court called guarantors a "favorite of the law" and stated that guaranties are to be strictly construed in favor of the guarantor.

So one might think that it's easy for guarantors to avoid the obligations they have guaranteed. But it's not always so, as illustrated in a recent 7th Circuit Court of Appeals decision authored by Judge Posner. (*Inland Mortgage Capital Corporation v. Chivas Retail Partners, LLC*, No. 12-3648, Seventh Circuit Court of Appeals, January 29, 2014)

In 2007, Inland Mortgage Capital Corporation (IMCC) agreed to lend \$60 million to a company called Harbins Crossing TC (Harbins) to buy land in Georgia. The plan was for the land to be developed into a shopping center anchored by a Wal-Mart. IMCC obtained a guaranty from Chivas Retail Partners, LLC (Chivas), along with other guarantors. The guaranty contained the usual verbiage that Chivas "absolutely, unconditionally and irrevocably" guaranteed Harbins obligations. The guaranty also included the following language, which turned out to be critical:

" . . . if Lender [IMCC] forecloses on any real property collateral . . . the amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price; and Lender may collect from Guarantor [Chivas] even if Lender, by foreclosing on the real property collateral, has destroyed any rights Guarantor may have to collect from Borrower or anyone else" (emphasis added by the court)

Wal-Mart never opened a store in the shopping center. Fourteen months after Harbins borrowed from IMCC the money guaranteed by Chivas, Harbins defaulted.

IMCC foreclosed on its mortgage on the land. By way of the foreclosure, the land was auctioned off by the local sheriff after a public notice. IMCC bid \$7 million for the land, a bid characterized by the court as a credit bid (a bid financed by the debt IMCC was owed by Harbins, rather than a cash bid). It was the only bidder, so IMCC succeeded in becoming the owner of the land in exchange for reducing Harbins's indebtedness by \$7 million.

So IMCC had the land, for which it had reduced Harbins' indebtedness by the bid of \$7 million. But clearly IMCC was a long way from being made whole, with an unpaid balance of \$24 million, reduced by the \$7 million bid. Before IMCC tried to collect this unpaid balance of \$17 million, it encountered a big obstacle in the form of an unusual Georgia law.

Georgia law required IMCC to file a petition with a Georgia court to confirm that the auction had conformed to Georgia law. (Ga. Code Sec. 44-14-161) If the petition is not granted, a mortgagee, such as IMCC, which obtains property in a nonjudicial foreclosure (which this foreclosure was) cannot obtain a deficiency judgment. The Georgia court "shall not confirm the sale [i.e., the auction] unless it is satisfied that the property so sold brought its true market value on such foreclosure sale." (Ga. Code Sec. 44-14-161(b))

The peculiarities of the Georgia law can be shown by contrasting it with Article 9 of the Uniform Commercial Code, which also deals with enforcement of security interests (similar to mortgages for real property). Under Article 9, the sale of property covered by a security interest must be "commercially reasonable." (UCC 9-610) A low price does not void the sale, but may cause a court to scrutinize the sale more carefully. (UCC 9-610, Comment 10) "The fact that a greater amount could have been obtained . . . is not of itself sufficient to preclude the secured party from establishing that the [sale] was made in a commercially reasonable manner." If the sale is not commercially reasonable, the secured party can still show that even a commercially reasonable sale would not have satisfied the entire obligation and, therefore, a deficiency remains which the debtor should satisfy. In other words, even in a sale which is not commercially reasonable, market value can still be established and the debtor may not be completely off the hook.

Contrast this with the Georgia statute. Under the Georgia statute, the sole issue is whether the property sold brought its true market value. The mortgagee (in this case, IMCC) has no opportunity to show it acted in a commercially reasonable manner. If the court does not agree that the property brought its true market value, then the sale cannot be confirmed and the lender loses its right to claim a deficiency, or any amount, from the borrower.

Unfortunately for IMCC, the Georgia court denied confirmation finding that IMCC has not satisfied "statutory requirements." There was no further explanation, but the parties concluded that the court thought the land was worth more than the \$7 million that IMCC had bid. IMCC appealed in the Georgia courts, but lost.

So IMCC naturally went after the guarantor, Chivas. But Chivas refused to honor the guaranty, citing IMCC's inability to confirm the sale in Georgia. So IMCC sued Chivas in federal court in Illinois. Chivas lost and the district court awarded IMCC the \$17 million it was claiming. Chivas appealed. The 7th Circuit Court of Appeals had to decide whether IMCC's inability to confirm the judgment in Georgia enabled Chivas to escape its guaranty.

Judge Posner clearly did not think highly of the Georgia statute that defeated IMCC's deficiency claim, calling it a "bit of Southern populism left over from the 1930s depression" and a "legislative fossil." The problem with the Georgia statute was that, in its strict application, the creditor was denied the right to claim any of the deficiency if the court felt the sale price was below the market value. Said Judge Posner,

"The Georgia courts have determined that the land is worth more than \$7 million. . . . We don't know how much more. There is no evidence of the land's value in the record. It could be only \$7,000,001. . . ."

But even if the land was worth just \$1 more than IMCC's credit bid of \$7 million, under Georgia law, IMCC loses its entire claim for a deficiency. As a result, said Chivas, IMCC should also lose its right to collect under the guaranty. But Judge Posner was no more receptive to this claim than the district court had been.

"But IMCC is not seeking a deficiency judgment. Such a judgment is sought against a borrower, usually and in this case a mortgagor. The borrower, the mortgagor, is Harbins. Harbins is not a defendant in this suit; Chivas, the guarantor, is. By virtue of the Georgia judgment, IMCC can't obtain a deficiency judgment, which is to say [it] can't sue Harbins for the balance of Harbins's debt to it. But there is nothing to prevent it from suing the guarantor."

Judge Posner then cited Georgia cases that upheld the right of a creditor to pursue other contractual remedies, including guaranties, even if the foreclosure sale was not confirmed. So even Georgia courts would not release guarantors in cases where the primary borrower escapes liability because of the inability of the creditor to confirm the sale. As further reinforcement, Judge Posner cited the language in the guaranty, quoted above, in which the guaranty remains in effect even if the land is worth more than the sale price and even if IMCC, in its foreclosure, destroys "any rights Guarantor [Chivas] may have to collect from the Borrower [Harbins] or anyone else."

It is interesting to contrast the guaranties in the Finley case, referenced above, and this case. In the Finley case, the bank made a costly error in the guaranty. The guaranty stated that it was a guaranty for a loan to be closed on a specified date but the loan was delayed and closed on a different date. So the guaranty, technically, covered a loan that did not exist. In the Finley case, the technical error in the date of the guaranty cost the bank its right to enforce the guaranty.

But in this case, the guaranty did not contain such an error. In fact, the guaranty seemed to contemplate the risk that the borrower (Harbins) could escape its obligation if the court failed to confirm the foreclosure sale. The failure to confirm the sale was not a reason to permit Chivas to escape the guaranty. Based on the language of the guaranty, it was actually the eventuality that IMCC contemplated when it obtained the guaranty. So IMCC prevailed in its effort to enforce Chivas' guaranty.