

# LOWENSTEIN SANDLER NEWSLETTER REAL ESTATE

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## NEW JERSEY NEWS AND DEVELOPMENTS

July 2010

### **Springing Recourse Liability for Limited Recourse Obligor—No Good Deed Goes Unpunished**

CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, 410 N.J. Super. 114 (N.J. Super. Ct. App. Div. 2009) ("*SB Rental I*").

Common in real estate lending is a variety of loan in which personal liability of the borrower or guarantor is triggered only if the borrower commits certain identified malfeasance, such as fraud upon the lender or misapplication of operating funds. This variety of liability is formally referred to as non-recourse or limited recourse and the loan provisions that give rise to personal liability of the borrower or guarantor are colloquially known as a "bad boy" provisions. In a case of first impression in New Jersey, the Appellate Division found in SB Rental I that the provisions that triggered recourse to the obligors (in this case, a borrower and a guarantor) pursuant to a bad boy provision are valid and enforceable. The holding in SB Rental I is particularly compelling because the conduct that led to the trigger of the recourse provisions wasn't an act that would be generally recognized as wrongful and didn't cause any loss to the lender.

The facts of SB Rental I are as follows: the lender made a \$13,300,000 mortgage loan, with a guaranty from the borrower's principals. The loan and the guaranty were non-recourse to the borrower and its principals, except upon the occurrence of certain events. Typically, bad boy events might include acts that we'd all recognize as wrongful conduct, such as fraud as mentioned above. There are categories of bad boy events that are less obvious and are intended to make it difficult for a mortgagor's principals to allow the mortgagor to file bankruptcy or put the entity in a position where another party could force the entity into bankruptcy. These events might include, most directly, the mortgagor filing a bankruptcy petition, but could also include a failure by the mortgagor to maintain its status as a single purpose entity or to refrain from adding subordinate financing to the mortgaged property. In SB Rental I, it was the latter prohibition that tripped the guarantor's liability. During the term of the loan, the borrower obtained \$400,000 in subordinate financing secured by a second mortgage on the property without obtaining its first lender's consent. The \$400,000 mortgage was satisfied without event seven months later. Beginning 18 months after the second

mortgage was repaid, the borrower stopped making payments on its first mortgage loan. This resulted in an uncontested foreclosure action and a sale, leaving a deficiency to the lender.

Following completion of the uncontested foreclosure action, the lender claimed that the second mortgage financing sprung the full recourse provision, and sought recovery for its losses against the borrower's principals. The principals argued that because the borrower cured the very breach that triggered their personal liability 18 months prior to the default that led to foreclosure, no harm accrued to lender as a result.

The Court decided that it was unimportant that the subordinate financing was paid off well before the borrower's ultimate default on payment of the loan. The fact the Court focused upon was that the borrower breached an obligation that the parties agreed posed a special risk to the lender. By granting the second mortgage lien, the obligors' action, according to the Court, "had the potential to affect the viability and

value of the collateral that secured the original loan," for which the parties had already agreed upon contracted-for consequences, which were the springing of the full recourse provisions of the loan agreement and the guaranty. The Court concluded that the obligors "may not now escape the consequences of their bargain," and imposed liability against the guarantors for the deficiency. The Court distinguished the imposition of this liability from damages that constitute a penalty on the grounds that the lender suffered a loss in fixed sum, which loss was imposed on the guarantors as "actual damages."

The enforcement of many bad boy triggers would not give anyone pause — fraud, misappropriation of revenues and similar malfeasance are all to be avoided. However, the trigger in [SB Rental I](#) was not an intrinsically bad act. For example, the \$400,000 second lien loan might have been applied to benefit or preserve the property. The Court noted that on the other hand, the burden of repaying the second mortgage might have caused the eventual default on the first loan. In the end, the reason for the departure from the non-recourse standard is not relevant to the existence of liability. Although the Court characterized the liability that is imposed on the guarantors as actual damages, no proof requirement was imposed to show that the departure from the non-recourse standard led to the loss. As a result, the holding of the case is akin to creation of strict liability. To paraphrase the Court, the parties' bargain, once made, is unavoidable.

An important point to highlight in this case is the fact that the foreclosure was uncontested. In essence, the borrower and its principals agreed to cooperate with the lender for a quick and orderly transfer. A contested foreclosure could have taken two or three times as long and cost the lender much more in legal fees and administrative expenses. What they got in return, after the conclusion of the foreclosure action, is a suit for springing recourse on the guaranty for an act that happened two years before that caused no loss or damage to the lender. To this the adage, "no good deed goes unpunished" seems to fit best. Defaulting borrowers in a similar position should take the facts of this case as a cautionary tale and seek to condition their cooperation on a release of recourse liability under the guaranty. Please contact Edward J. Hunter, Esq. at [ehunter@lowenstein.com](mailto:ehunter@lowenstein.com) to discuss ways that we can help structure these arrangements for you.

#### **New Jersey Controlling Interest Transfer Tax Imposed on Transfer of Ownership Interests Even if Ultimate (Beneficial) Control Remains the Same**

The New Jersey Division of Taxation ("Division") recently published an amendment to N.J.A.C. 18:16A that specifically addresses the application of the "Controlling Interest Transfer Tax" to transfers between second tier entities. Prior to this amendment, the Controlling Interest Transfer Tax did not apply to transfers of a controlling interest in a second tier entity owning Class 4A commercial property to an affiliated second tier entity (i.e.,

controlled by the same entity controlling the transferee entity). The amendment is a complete reversal of the Division's original position. The relevant example provided by the Division in the amended regulation now states, "*Corporation A directly owns 100 percent of both Corporation B and Corporation C. Corporation B is the [sole] member of [single member LLC ("SMLLC")], which owns a class 4A Commercial Property. Corporation B transfers the ownership interest in SMLLC to Corporation C for \$5,000,000.*" N.J.A.C. 18:16A. This transfer is now subject to the Controlling Interest Transfer Tax. The example further explains, "*[a]lthough ultimate control (beneficial control) of the property remains in Corporation A, direct control of the property has changed from Corporation B to Corporation C, which are two separate legal entities. The purchaser, Corporation C, pays a one percent tax on the consideration because it has acquired direct control of SMLLC and its commercial classified property.*" N.J.A.C. 18:16A. The Division cited its inadvertent oversight of the relationship between the Realty Transfer Fee and the Controlling Interest Transfer Tax laws when it originally promulgated NJAC 18:16A in July 2008 as the basis for eliminating the exemption for transfers between second tier entities because they are subject to common ownership by a third entity. It appears that the Superior Court's decision in [Mack-Cali Realty, LP v. Clerk of Bergen County](#), 25 N.J. Tax 243 (NJ Super. Tax 2009) may have motivated the Division to amend the Controlling Interest Transfer Tax in an effort to add consistency to the Division's position

that any transfer between separate legal entities via either a deed transfer of classified property or a transfer of ownership of an entity that owns classified property—regardless of whether the transferor and transferee are commonly owned entities—is a taxable transaction. In light of the implications of this new amendment on controlling interest transfers and the more favorable tax treatment afforded to certain deeded transfers among affiliated companies under the [Mack-Cali](#) decision, please contact Edward J. Hunter, Esq. at [ehunter@lowenstein.com](mailto:ehunter@lowenstein.com) for advice on how to structure your transactions.

### **Are Commercial Tenants Entitled to Notice of a Proposed Blight Designation Under New Jersey's Local Redevelopment and Housing Law?**

In [Iron Mountain Information Management Inc. v. The City of Newark, A-100-08](#), the New Jersey Supreme Court considered whether a long-term commercial tenant, with a limited right of first refusal to purchase the property being leased, is entitled to the same notice as the property owner when the property is subject to a potential blight designation pursuant to the Local Redevelopment Housing Law (LRHL), [N.J.S.A. 40A: 12A-1 to -49](#). On May 19, 2010, the Supreme Court held that the Legislature intended to limit the right to receive actual notice of blight designation to owners of record and those whose names are listed on the tax assessor's records, and as a result, Iron Mountain was not deprived of any due process protections afforded by the New Jersey or U.S. Constitutions.

In 2004, the Newark Municipal Council adopted a resolution authorizing the planning board to investigate whether a group of properties, including the building in which Iron Mountain is a tenant, qualified as "an area in need of redevelopment" pursuant to the LRHL. Following the publication of a notice of hearing and service of the notice upon the building owner, the planning board held a public hearing and concluded that the property met the applicable criteria to support a blight designation under the LRHL. A resolution was adopted designating the area as being in need of redevelopment and directing that a redevelopment plan be drafted. The planning board held another public hearing to consider the redevelopment plan, and adopted resolutions approving the redevelopment plan, and appointing the housing authority to serve as the redevelopment agency.

Iron Mountain challenged both the initial blight designation and the subsequent approval of the redevelopment plan. Iron Mountain argued that its status as a long-term commercial tenant amounted to a protected interest in the property that entitled it to the same notices that the LRHL affords to the property owner. The Supreme Court disagreed and concurred with the Appellate Division's reasoning that the Legislature intended, in the blight designation context, to limit the right to actual notice to owners of record and those whose names are listed on the tax assessor's records. The Appellate Division noted that when the Legislature adopted the LRHL, it chose not to impose upon a governing

body any obligation to provide commercial tenants with individual notice of a proposed blight designation and made a policy determination that the tenant's right to individual notice should not be recognized unless, and until, the condemnor proceeds to the condemnation stage. The Appellate Division further concluded that there are no due process violations because commercial tenants do not have an interest entitling them to individualized recognition and protection at the earlier redevelopment area designation stage, the condemnation stage affords the tenant a comprehensive and complete forum for the vindication of its rights, and the administrative burdens of requiring individual notice at the earlier blight designation state are enormous. Consequently, commercial tenants are not entitled to notice of a potential redevelopment area designation pursuant to the LRHL and may have no rights or remedies until there is a subsequent condemnation proceeding.

### **New Jersey's Time of Decision Rule Abolished**

On May 5, 2010, Governor Chris Christie signed Senate Bill S-82 into law abolishing the "Time of Decision" rule except where necessary to protect health and public safety. Before the new law was enacted, the "Time of Decision" rule provided that "the zoning ordinance in effect at the time the case is ultimately decided" is the standard that governs the municipality's decision. [Dinizo v. Planning Board of the Town of Westfield, 312 N.J. Super. 273, 277 \(Law Div. 1998\)](#). In effect, this

permitted a municipality to change the zoning for a property at any time during the entitlements process up until the time the appropriate land use board issued a final decision on the developer's application. The new legislation, which takes effect in 2011, amends the Municipal Land Use Law and creates a "Time of Application" standard. Under this new standard, the zoning ordinance in effect as of the date of submission of an application for development approvals will govern the land use board's decision; however, there is an exception for changes in law that relate to health and public safety. Under the old standard, developers could be forced to spend thousands of dollars continually changing their plans due to changes in zoning regulations enacted while their application was pending. Streamlining the application process through the use of a "Time of Application" standard will encourage development that will create more business and employment opportunities in the state. The new law can be viewed on the New Jersey legislature's site here:

[http://www.njleg.state.nj.us/2010/Bills/S0500/82\\_T1.pdf](http://www.njleg.state.nj.us/2010/Bills/S0500/82_T1.pdf)

**Do Purchasers of Tax Sale Certificates Under New Jersey State Law Qualify as Holders of "Tax Claims" Under Federal Bankruptcy Law?**

Chapter 11 of the United States Bankruptcy Code is intended to allow financially stressed debtors to restructure their debt obligations through a plan of reorganization. Typically, a Chapter 11 plan places different types of claims in different

classes and, subject to various requirements of the Bankruptcy Code, allows the debtor to pay only portions of the claims (and in certain circumstances not to pay certain claims at all). Moreover, the Bankruptcy Code allows a debtor the flexibility to structure a plan to defer the payment of certain claims.

In particular, as a general rule, the Bankruptcy Code requires a debtor to pay "tax claims" in full, but payment can be deferred if the plan offers to pay interest to the holder of the tax claim. Until 2005, however, the Bankruptcy Code was silent as to the method for calculating the rate of interest to be paid on account of tax claims. Courts generally held that the interest rate would be equivalent to the rate of interest a debtor would pay to borrow the same amount of funds on the same terms in the commercial marketplace. Unless the debtor and the holder of the tax claim agreed to the interest rate, courts would decide the appropriate interest rate after considering expert testimony offered by the parties.

In 2005, in an effort to establish uniformity in the methodology of calculating the interest rate paid on deferred tax claims, Congress enacted Section 511 of the Bankruptcy Code. Essentially, Section 511(a) directs that whenever the Bankruptcy Code requires the payment of interest on a tax claim, including under a plan of reorganization, "the rate of interest shall be the rate determined under applicable nonbankruptcy law."

Although Section 511 substantially reduced disputes concerning the appropriate interest rate to be paid on

account of tax claims, neither it nor any other provision of the Bankruptcy Code expressly defines what constitutes a "tax claim" for purposes of Section 511. This omission has resulted in differing views as to whether purchasers of tax sale certificates generated by municipal taxing authorities for unpaid real property taxes hold "tax claims" that fall within the purview of Section 511. In order to avoid the high rates of interest that are generally associated with tax sale certificates, debtors argue that claims represented by the certificates are claims for the redemption price of the certificate and, therefore, are not subject to the interest rate constraints imposed by Section 511. Investors who purchased the certificates, which in New Jersey accrue interest often at the rate of 18%, contend that since the underlying obligations were undoubtedly tax claims in the hands of the municipalities from whom the certificates were purchased, they should be characterized as tax claims.

In a recent published decision of first impression in New Jersey, Bankruptcy Judge Michael Kaplan determined that the purchaser of a tax sale certificate from the Township of Lawrenceville under the Tax Sale Law, N.J.S.A. 54:5-1 et seq., did not hold a tax claim and, therefore, was not entitled to receive 18% statutory interest as permitted by applicable nonbankruptcy law. See In Re: Princeton Office Park, L.P., 423 B.R. 795 (Bankr. D.N.J. 2010). Instead, the Bankruptcy Court concluded that once the purchaser paid the tax obligation to the municipality, the purchaser held a lien on the real estate but that the claim secured by the lien

was not for taxes but "for the redemption price owed as a result of . . . having paid the Debtor's tax obligation to the Township." Consequently, the debtor was permitted to propose and confirm a plan of reorganization that offered deferred payments to the tax sale certificate holder with interest payable at rates substantially below 18%.

Not surprisingly, given the alternative and reasonable characterizations of claims held by holders of tax sale certificates, the Princeton Office Park ruling has been appealed to the United States District Court for the District of New Jersey. In light of the significant ramifications of the Princeton Office Park decision, investors in New Jersey tax sales certificates and counsel for distressed real estate investors look forward to the District Court's decision and, perhaps, a subsequent decision from the United States Court of Appeals for the Third Circuit. We will continue to monitor this case as it proceeds through the Courts.

### **New Jersey Highlands' Transferable Development Rights Expanded**

On May 5, 2010, Governor Chris Christie signed into law new legislation expanding the receiving zones under the Highlands Transfer of Development Rights program. The Highlands Transferable Development Rights program is a tool provided by the Highlands Water Protection and Planning Act P.L. 2004, c.120 (N.J.S.A. 13:20-1 et seq.) ("Highlands Act") that awards Highlands credits to land owners who lost pre-Highlands Act development opportunities as a result of the Highlands Act. Under the

original legislation, only the municipalities in the seven Highlands Region counties were eligible to serve as voluntary receiving zones for Highlands Credits. Under the new law, any municipality in the state can create a voluntary receiving zone and receive Highlands Credits. A receiving zone is a municipality that has agreed to accept increases in density for residential projects or intensity in commercial or industrial projects than are currently permitted by local zoning ordinances. In those zones, a developer can use transferable development rights purchased from landowners in Highlands restricted zones and would be permitted to build more units than the land is currently zoned for and therefore, make a greater profit than the developer would have received if the municipality was not a receiving zone. Assembly Bill No. 602 can be viewed here:

[http://www.njleg.state.nj.us/2010/Bills/A1000/602\\_R1.pdf](http://www.njleg.state.nj.us/2010/Bills/A1000/602_R1.pdf)

An overview of the Highlands Transfer of Development Rights Program can be viewed at:

[http://www.highlands.state.nj.us/njhIGHLANDS/master/tdr/tdr\\_over.pdf](http://www.highlands.state.nj.us/njhIGHLANDS/master/tdr/tdr_over.pdf)

### **Statewide Nonresidential Development Fee Back In Effect. . . For Now**

As most of us were getting ready for the July 4th holiday weekend, the short-lived moratorium barring the imposition of non-residential development fees on projects seeking approval subsequent to July 1, 2010 was permitted to silently expire. This latest news, of course, should come as

no surprise to those in the real estate development community who have essentially been left with no meaningful guidance in terms of complying with affordable housing obligations following the colossal failure of the Council on Affordable Housing's (COAH) "growth share" methodology in 2007. Since that time, COAH has been the subject of increasing scrutiny, which has only intensified under the Christie administration. With COAH's future growing increasingly bleak, this most recent lapse just adds to the uncertainty that has frustrated developers for the past three years.

The on-again/off-again debate concerning the imposition of non-residential development fees has its roots in the Statewide Non-Residential Development Fee Act (N-RDF), which permitted municipalities to impose a 2.5% development fee for most non-residential new construction and additions for which certificates of occupancy were issued on or after July 18, 2008. Nearly a year later, on July 27, 2009, Governor Corzine signed the New Jersey Economic Stimulus Act of 2009 which, in an effort to spur activity in the real estate sector, suspended the ability of municipalities to subject non-residential projects to the 2.5% development fee permitted under the N-RDF. This moratorium was primarily limited to projects for which preliminary or final site plan approval was received prior to July 1, 2010, provided building permits are issued prior to January 1, 2013.

Due to a lack of consensus in the Assembly, however, concerning controversial Senate Bill S-1 (R. Lesniak, C. Bateman and J. Van Drew) – which

is primarily focused on abolishing COAH and otherwise reforming the way the State implements the Fair Housing Act to meet the constitutional mandate of providing low to moderate income housing – the temporary moratorium against non-residential development fees was permitted to expire on June 30th. Although there was a last-minute bill proposed in the Assembly (A-3055) which would have extended the moratorium through October 30, 2010, Governor Christie made it clear that any last-ditch efforts to merely extend the moratorium, without any meaningful progress toward the reformation of the affordable housing system in New Jersey, would be vetoed. As a result, New Jersey municipalities are once again required to impose the 2.5% non-residential development fee

permitted under the N-RDF for projects seeking approvals subsequent to July 1, 2010. The Governor's flat refusal to simply extend the moratorium, a sentiment that was shared by Senate leaders, will place pressure upon the Assembly to find some consensus regarding S-1, and find it soon. In the interim, Senate President Stephen Sweeney has indicated his hope that any development fees collected by municipalities during this "transition" period will be fully refunded once the Legislature reaches a consensus as to the future of affordable housing in New Jersey.

**Please contact any member of Lowenstein Sandler's Real Estate Practice Group with questions regarding the topics discussed in this newsletter.**

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