RECENT DEVELOPMENTS IN WASINGTON CASE LAW: GUARANTOR LIABILITY FOLLOWING NON-JUDICIAL FORECLSOURE

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One by-product of the decline of real estate values and mortgage defaults arising from the Great Recession and the resulting struggle between creditors and debtors has been a steady stream of litigation involving issues under the Washington Deed of Trust Act that previously attracted little judicial attention. In all probability, the litigants would have preferred that this contribution to Washington case law had been achieved without their active involvement. Courtesy of now-defunct Venture Bank, Division II of the Court of Appeals recently considered two cases in a rarely litigated area (in fact, prior reported decisions are virtually non-existent) – post-foreclosure liability of a guarantor under RCW 61.24.100.

In *First-Citizens Bank & Trust v. Reikow*, No. 43181-5-II, decided November 13, 2013, the court considered the effect of the "fair value" provision of RCW 61.24.100(5) as a limitation on the guarantor's liability. NBP LLC borrowed $6.7 million from Venture Bank for the development of a business part. Reikow, who was also an owner of NBP, guaranteed the loan. The project failed, the lender (now First-Citizens having acquired the assets of Venture Bank after it was liquidated) foreclosed and purchased the property at a non-judicial sale for $5,215,000. At the time of foreclosure, the note balance was $7,168,710.74. First-Citizens then sued Reikow to collect a deficiency as allowed under RCW 61.24.100(5)

> in an amount to be proven at trial, representing the outstanding balance of the Note . . . less the fair value of the Property sold at the trustee's sale or the price paid at the trustee's sale . . . plus [costs and attorney fees].

Reikow denied any liability, and, in response to the bank's motion for summary judgment provided the trial court with a copy of an IRS form prepared by First-Citizens showing the fair market value of the property at the time of sale was $7,820,000. In response, First-Citizens claimed that the form was erroneously completed with the "stabilized" value of the property (i.e. a value that assumed the project was completed and fully leased) and that the "as-is" value of the property was $6,630,000 as of the date of foreclosure. The trial court then held a hearing to determine the fair value of the property. At the hearing, the bank presented an appraisal performed shortly before the foreclosure sale establishing the value at $6,630,000 and additional testimony that the value should be reduced to $6,370,000. From that amount, the bank deducted past due real estate taxes owed as of the date of foreclosure to arrive at the bank's view of "fair value." Reikow again asserted the value was as reported by the bank to the IRS and that the "as-is" value reflected the negative impact of the inability to obtain tenants during the

foreclosure process. The trial court found that the fair value was $7,820,000, which exceeded the amount due on the note plus the real estate taxes and dismissed the bank's complaint. Reikow was awarded attorney fees under the attorney fee provision in the guaranty.

On appeal, First-Citizens contended that the trial court erred in holding the fair value hearing because Reikow waived any right to a fair value hearing under the terms of the guaranty and the trial court erred in its determination of "fair value." In the guaranty, Reikow waived "any defenses given to guarantors at law or in equity other than actual payment" of the debt and "any and all rights or defenses arising by reason of any 'one action' or 'anti-deficiency' law." The Court noted that RCW 61.24.100(5) specifically defined the deficiency to equal the difference between the note balance and the fair value of the property and rejected the waiver argument:

> Nowhere, however, does First-Citizens explain how this questionable proposition [waiver of statutory rights], were it established, would entitle the bank to a larger deficiency judgment than the statute allows.

The Court also noted that the bank itself called for a fair value hearing in its complaint and the trial court, after denying First-Citizen's motion for summary judgment, set the hearing more or less *sua sponte* after expressing concern that the sale price for the property substantially below the bank's own appraisal and a prior recovery from another guarantor might create a windfall for the lender. The denial of the motion for summary judgment and scheduling of a fair value hearing was a proper exercise of the trial court's discretion.

Relying on *Sec. State Bank v. Burk*, 100 Wn.App. 94 (2000), the Court held that the bank had the burden of proof to establish the deficiency amount. *Sec. State Bank* held that RCW 62A.9-504(3), which requires a secured party to dispose of collateral in a commercially reasonable manner, was available to a guarantor as an affirmative defense in an action to enforce the guaranty, even though the guarantor had waived any defenses arising from claims asserting an unjustified impairment of collateral. In reviewing the criteria set forth in RCW 61.24.100(5), the determination of fair value, a term defined in RCW 61.24.005(6), was within the discretion of the trial court and any review of that determination was limited to an abuse of discretion:

> Thus, the uncontroverted evidence showed that First-Citizens' appraisers based the lower valuation on the then-current reduced tenancy status, which resulted in part from the foreclosure process itself. The trial court could reasonably have concluded that this assumption did not comport with the statutory requirement of "reasonable exposure in the market under conditions requisite to a fair sale," but instead reflected a seller under " duress." RCW 61. 24. 005(6). Further, the resolution of the conflicting testimony concerning First Citizens' apparent admission on the IRS form lies in

> the province of the trial court. We hold that the trial court' s fair value determination was not an abuse of discretion.

The provisions in the DTA allowing post-foreclosure claims against the guarantor in commercial real estate loan transactions were enacted in 1998 (Laws of 1998, ch. 295) and *Reikow* is the first case in 15 years to interpret the statute. However, in the context of judicial foreclosures, there have been similar provisions to establish a minimum value for the foreclosed property to be deducted from the amount due the lender. Pursuant to RCW 61.12.060, the court "may in its discretion, take judicial notice of economic conditions" in fixing an upset price prior to sale and following the sale, if an upset price has not be fixed, "establish the value of the property, and, as a condition of confirmation, require that the fair value of the property be credited upon the foreclosure judgment." Surprisingly, the Court did not refer to any of the prior Washington cases (there are not many, but the Respondent's brief did cite them) that have considered the establishment of fair value under RCW 61.12.060. Those decisions are not necessarily inconsistent with the outcome in *Reikow,* but there are nuances in the holdings.

A discussion of the evolution of the concept of "fair value" in judicial foreclosures appears in *Lee v. Barnes*, 61 Wn.2d 581 (1963) and *National Bank of Washington v. Equity Investors*, 81 Wn.2d 886 (1973):

> Thus, we think that the statute [RCW 61.12.060] is properly invoked in any case where all of the circumstances leading to and surrounding a distress or foreclosure sale warrant the superior court in the exercise of a sound discretion in finding that there will be no true competitive bidding. . . .
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> Accordingly, where, in the court's sound discretion at a foreclosure or other judicially ordered distress sale, an upset price should be fixed, the next step is to fix the amount. The statute calls not for what the court would determine to be the Minimum value, but rather its Fair value. As we said in *Lee v. Barnes, Supra* the court "should assume the position of a competitive bidder determining a fair bid at the time of sale under normal conditions." This means that, in deciding upon fair value at a foreclosure sale, the court may consider *the state of the economy and local economic conditions, the usefulness of the property under normal conditions, its potential or future value, the type of property involved, its unique qualities, if any, and any other characteristics and conditions affecting its marketability along with any other factors which such a bidder might consider in determining a fair bid for the mortgaged property*. The court may properly receive any competent evidence, whether opinion or of direct facts which might affect the amount of such a bid. *National Bank of Washington v. Equity Investors,* 925-926. [Emphasis added]

The *Equity Investors/Barnes* formulation of "fair value" is slightly different from the definition in RCW 61.24.005(6), with the latter leaning toward a date-of-sale fair market value under traditional appraisal guidelines. However, the last portion of the statute requiring the value of the property to be established "under conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under duress" probably includes sufficient definitional latitude to allow courts to harmonize the concepts in both judicial and non-judicial settings.

It is clear from *American Federal Sav. & Loan Ass'n v. McCaffrey*, 107 Wn.2d 181 (1986) that in a judicial foreclosure it is necessary for the debtor to demonstrate some disorder in the market place or limited marketability of the property as a condition for seeking an order to set an upset price:

> It is apparent from the language of RCW 61.12.060 and interpretive case law that the mortgagor is not entitled to an upset price in every foreclosure proceeding. *The court must exercise its discretion in finding that it should fix an upset price based upon economic conditions or peculiarities of the mortgaged property.* Thus, the upset provisions may be invoked in any case where all the circumstances leading to and surrounding a foreclosure sale warrant the exercise of discretion in finding that there will be no true competitive bidding. *McCaffrey*, 187-188. [Emphasis added]

Arguably, it is not necessary to demonstrate market disorder or limited property marketability to justify a "fair value" determination under the DTA. Although the Court did not consider this precise issue and reviewed the propriety of conducting the "fair value" hearing as a matter within the discretion of the trial court, it is hard to envision when a "fair value" determination would be refused because, as the Court of Appeals noted, RCW 61.24.100(6) defines the deficiency judgment in a formula that requires a monetary sum for "fair value" that can be compared to the bid price at the non-judicial foreclosure sale.

The reliance in *Reikow* on *Sec. State Bank v. Burk, supra*, on the issue of burden of proof and the lack of any requirement that the guarantor demonstrate that current market conditions adversely affect value (in fact, the guarantor may argue that the mere existence of the foreclosure may create a condition of duress affecting "fair value") means that if the guarantor can present any evidence that the "fair value" of the property is more than the foreclosure bid, the creditor has the burden of proof on establishing "fair value." For lenders that must comply with federal and state regulations concerning property appraisals, it will be a rare loan that does not have at least one appraisal in the lender's file showing the original loan amount to be less than the "stabilized" value of the project. In *Reikow*, by the time the trial court rendered its decision, the bank had (i) bid $5,215,000 for the property at the foreclosure sale; (ii) presented an appraisal that valued the property at $6,630,000 7 months prior to the foreclosure sale; (iii) presented other testimony at the hearing

reducing the value based on "adjustments" to $6,370,000; (iv) filed a form with the IRS that stated the fair market value of the property was $7,820,000 and (iv) acknowledged that the "stabilized" value of the property was $7,820,000. While consistency may be the hobgoblin of narrow minds (a slight modification of Ralph Waldo Emerson's formulation), inconsistency is the antithesis of "more probable than not." Given these shifting values, it is easy to discern why the trial court and Court of Appeals found that the bank had not carried its burden on the issue of "fair value."

In the never-ending war between creditors and debtors, the holdings in *Reikow* may provide a slight battlefield advantage to debtors. In a historical context, however, the result is very much a kindred spirit to *Suring State Bank v. Giese*, 210 Wis. 489, 246 N.W. 556 (1933), the Great Depression opinion that served as the basis for the Washington amendment of RCW 61.12.060 to take into account current economic conditions in establishing an upset price:

> In theory, a thing that cannot be sold has no value, and so with a parcel of real estate that is offered for sale at foreclosure. It may be argued that it is worth what purchasers will pay for it, and no more, and that if the only price offered constitutes but a negligible part of its theretofore assumed value, it nevertheless represents the value of the real estate at that time. Such a conclusion is shocking to the conscience of the court, or, as the old equity courts said, to the conscience of the chancellor, and to all notions of justice as applied to this situation. Certainly the land has value so long as it or the buildings upon it may be used, and certainly in the case of farm lands, which constitute the homes of farmers, the premises have value in the sense of usefulness, however difficult it may be to translate this value into terms of dollars. Furthermore, this real estate, which is suffering from the consequences of a period of readjustment through which we are passing, has potential or future value which may legitimately be taken into account.

As one final note, the definition of "fair value" embodied in RCW 61.24.005(6) drew heavily on a similar measure enacted in 1990 in Arizona, A.R.S. §33-814, which provides in part:

> A. . . . In any such action against such a person [guarantor], the deficiency judgment shall be for an amount equal to the sum of the total amount owed the beneficiary as of the date of the sale, as determined by the court less the fair market value of the trust property on the date of the sale as determined by the court or the sale price at the trustee's sale, whichever is higher. . . . For the purposes of this subsection, "fair market value" means the most probable price, as of the date of the execution sale, in cash, or in terms equivalent to cash, or in other precisely revealed terms, after deduction of prior

> liens and encumbrances with interest to the date of sale, for which the real property or interest therein would sell after reasonable exposure in the market under conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably and for self-interest, and assuming that neither is under duress. . . .

On September 13, 2013, the First Division of the Arizona Court of Appeals, in *CSA 13-101 Loop, LLC v. Loop 101, LLC*, # 1 CA-CV 12-0167, in a case of first impression and with facts similar to *Reikow*, held that the fair value provisions were not waived by the guarantor, even though the note, guaranty and deed of trust contained waiver provisions much more specific than the general waivers in *Reikow.* The guarantor in *Loop 101, LLC* purportedly waived:

> . . . the benefits of any statutory provision limiting the right of [Holder\Lender] to recover a deficiency judgment . . . after any foreclosure or trustee's sale of any security . . . including without limitation the benefits, if any, . . . of A.R.S. Section 33-814 [(West 2013)]. . . "
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> . . . and relinquishe[d] any right to have the fair market value of the [property] determined by a judge . . . in any action seeking a deficiency judgment including, without limitation, a hearing to determine fair market value" under A.R.S. § 33-814.

Although the statute did not prohibit a waiver, the Arizona court found that waivers were inconsistent with the general statutory scheme that balanced the lender's quick access to an extra-judicial remedy against protections required for the debtor and guarantor because they are "stripped of many protections in a non-judicial foreclosure." This opinion should be a cautionary note to lenders that believe the outcome in *Reikow* could be avoided by more drafting.

The second case, *First-Citizens Bank & Trust Company v. Cornerstone Homes & Development, LLC,* No. 43619-1-II, decided December 3, 2013, was another attempt to recover a deficiency judgment following a non-judicial foreclosure. Allison, the owner of Cornerstone Homes & Development, LLC, had an on-going banking relationship with Venture Bank. In 2003, Allison signed a guaranty on the form provided by the bank that included all future loans by Venture to Cornerstone. In 2006 and 2007, Cornerstone borrowed from Venture for three developments and signed three separate notes, each secured by a deed of trust. Cornerstone defaulted in 2009 and in November, First-Citizens, as the successor to Venture Bank, non-judicially foreclosed on all of the properties. After crediting the sale proceeds (all were credit bids), a deficiency of $4.2 million remained. First-Citizens sued Allison under the 2003 guaranty. The trial court entered a summary judgment in favor of the bank in the amount of the deficiency plus attorney fees.

On appeal, Allison asserted that the trial court erred because Allison's guarantee was secured by the deeds of trust that had been foreclosed and RCW 61.24.100 barred any action to enforce the guarantee after the non-judicial foreclosure. The Court of Appeals agreed and reversed the trial court.

The each deed of trust granted by Cornerstone provided that sums owed under the applicable note and all obligations under any "Related Documents," which was a defined term in the deed of trust. "Related Documents" included any "guaranties . . . whether now or hereafter existing executed in connection with the indebtedness." The Court concluded the guarantee signed by Allison was a Related Document and was therefor secured by the deed of trust.

The Court held that RCW 61.24.100 categorically barred any action to enforce obligations secured by a deed of trust following non-judicial foreclosure:

> (1) Except to the extent permitted in this section for deeds of trust securing commercial loans, a deficiency judgment shall not be obtained on the obligations secured by a deed of trust against any borrower, grantor, or guarantor after a trustee' s sale under that deed of trust.
> . . .
> (10) A trustee' s sale under a deed of trust securing a commercial loan does not preclude an action to . . . enforce any obligation of a . . . guarantor if that obligation ... was not secured by the deed of trust.

The lender asserted that the guaranty was not secured by the deed of trust because there was no language to that effect in the guaranty. The Court rejected that argument. The Court also noted that the deed of trust provided that the environmental indemnity executed as part of the loan documentation was specifically not secured by the deed of trust, and a similar provision could have been included to exclude the guarantee. In rejecting various other arguments advanced by the lender, the Court agreed with the Allison that the bank had a variety of remedies available to it – judicial foreclosure, a suit on the note and guaranty, non-judicial foreclosure, etc. The Court concluded that the lender chose to proceed with a non-judicial foreclosure to obtain the benefits of a speedy foreclosure with no court supervision and the corollary result was a bar in seeking any deficiency against the guarantor whose obligations were secured by the foreclosed deed of trust.