

# New Jersey Law Journal

VOL. CLXXXIX—NO.10—INDEX 915

SEPTEMBER 3, 2007

ESTABLISHED 1878

IN PRACTICE

## FORECLOSURE LAW

BY STEPHEN V. FALANGA

### Lender's Election of Remedies Altered

Issue preclusion may limit claims of lenders in commercial foreclosure actions

This spring, the New Jersey Supreme Court decided the case of *First Union National Bank as Indenture Trustee v. Penn Salem Marina, Inc.*, 190 N.J. 342 (2007), which addressed an issue of first impression before the Court, namely whether the amount awarded in a judgment in a foreclosure action is collateral estoppel in a subsequent action on the underlying note secured by the mortgage. After analyzing the legislative history and case law relating to the enforcement of a note (as well as bonds) secured by mortgages against real property, the Supreme Court concluded that collateral estoppel should be applied to the action on the note with certain limited exceptions.

*Penn Salem* involved a commercial loan from First Union National Bank to Penn Salem Marina, Inc. and its principal Marvin Hitchner (collectively Penn Salem) in the amount of \$750,000. The promissory note was partially secured by a mortgage on a commercial marina owned by Hitchner that was located in Pennsville. The note in question required the payment of interest at the rate of 13.5 percent per annum through monthly installments. Significantly, the note permitted First Union to recover judgment on the note either before, during or after any proceedings for the enforcement of the mortgage.

*Falanga is with Connell Foley of Roseland.*

The terms of the note were fully incorporated into the mortgage. The mortgage provided that First Union's rights under the mortgage would "be separate, distinct and cumulative," and none would "be given effect to the exclusion of the others." In the event of the default, both the note and mortgage provided that default interest would accrue and that First Union would be entitled to collect reasonable attorney's fees incurred in enforcing the note and mortgage.

Sometime towards the end of 2002, Penn Salem failed to make its monthly payments and First Union declared a default under the note and mortgage. Thereafter, in January of 2003, First Union filed a complaint on the note in the law division against the Penn Salem. Approximately one month after filing the Law Division action, First Union commenced a separate mortgage foreclosure action on February 4, 2003, in the Chancery Division seeking a sale of the marina to satisfy the debt due under the note.

Penn Salem failed to answer the Law Division action and First Union moved for the entry of default judgment. As part of that application, First Union filed a certification of amount due, certifying that the amount due and owing to First Union was \$833,835.03, which included interest at the rate under the note as of the date of application for final judgment. First Union also sought

attorney's fees and costs which, together with the principal and interest due under the note, resulted in a combined total of \$845,799.72. On Aug. 8, 2003, the Law Division entered final judgment by default against Penn Salem in the amount requested by First Union. Subsequent attempts by the Penn Salem to vacate the judgment were unsuccessful and no appeal was taken.

Thereafter, Penn Salem filed a motion seeking permission in the Chancery Division to file a late contesting answer in the foreclosure action and was permitted to do so. First Union was successful in disposing the Penn Salem's arguments on summary judgment, and the matter was remanded to the foreclosure unit for processing as an uncontested matter. In June of 2004, First Union moved for the entry of final judgment in the foreclosure action and submitted a new certification, certifying additional amounts that were due through Jan. 22, 2004. The differences between the amounts sought in the Law Division action and the amounts sought in the foreclosure action relate to First Union's request for interest at the default rate as provided under the note and mortgage, increased late charges, and escrow advances. All totaled, the additional amount sought exceeded \$150,000.

In response, Penn Salem filed objections to First Union's application for the entry of final judgment, asserting

that any final foreclosure judgment should be consistent with judgment in the Law Division on the underlying debt. Penn Salem sought to have the additional amounts sought denied. On Jan. 18, 2005, final judgment in foreclosure was entered in favor of First Union in the amount of \$1,042,111.46, with the Chancery Division overruling Penn Salem's objection.

On appeal, the Appellate Division affirmed concluding that *res judicata* and collateral estoppel did not limit the amount of the foreclosure judgment to the amount of the judgment on the note. The Appellate Division's decision was based in part on the rationale that the New Jersey Legislature treats a "lawsuit to enforce the terms of a note as distinct from a mortgage foreclosure action" because there are different remedies for each action.

In analyzing the issue, the Supreme Court agreed that there are important differences "between a foreclosure action and an action on a note" which made application of *res judicata* inapplicable. However, the Supreme Court found that the principals behind collateral estoppel or issue preclusion could have application. As the Court explained, "[i]ssue preclusion requires a similar, yet less demanding, analysis than *res judicata* or claim preclusion" and "[i]f an issue between the parties was fairly litigated and determined, it should not be relitigated."

The Court identified five factors that are required to apply the doctrine of collateral estoppel. First, the issue to be precluded must be identical to the issue decided in the prior case. Second, the issue must actually have been litigated in the prior proceeding. Third, the court in the prior proceeding must have issued a final judgment on the merits. Fourth, the

determination of the issue must be essential to the prior judgment. Finally, the party against whom the doctrine is asserted must be a party to or in privity with the party to the earlier proceeding.

Applying these factors, the Supreme Court concluded that, with certain exceptions, collateral estoppel should be applied to the action on the note to ensure consistency between the judgments in both actions. The Court noted that "there is a high degree of similarity between the two actions" while recognizing that the relief sought in the foreclosure action was different in nature from that sought in the Law Division because it included the broader right of the bank to foreclose on the property securing the underlying debt. However, the Court recognized that in both proceedings the bank demanded similar relief in terms of money damages in connection with its final judgment applications. The only difference in this regard was that First Union sought additional items of damages that it did not seek in the Law Division action, specifically default interest and pre-payment penalties.

Although the Supreme Court agreed that the plaintiff was authorized to seek these additional remedies pursuant to the terms of the loan documents and further recognized that the loan documents did not require all damages to be claimed at the same time, the Court nevertheless concluded that the damages were sufficiently similar to satisfy the first factor of collateral estoppel. The Court disposed of the remaining factors relatively quickly to conclude that the requirements for the application of collateral estoppel were satisfied. In short, the Court concluded that for "identical time periods, issue preclusion would require that the amount claimed in each category

of damages in the Law Division Action must be the same as the amount claimed in the same category of damages in the Foreclosure Action."

The Court was careful to note that its holding was not intended to pertain to any damages that accrued after the date of the first judgment, explaining that application of collateral estoppel would not prohibit a lender from recovering advances, interest, costs, and additional attorney's fees that accrue after the date of the first judgment. Similarly, the Court held that "because the note and the mortgage permitted the lender to claim different categories of damages," collateral estoppel would not bar the lender's claim for a category of damages that was not sought in the Law Division Action.

In considering the issue, the Supreme Court recognized that N.J.S.A. 2A: 50-2.3, which generally requires that a foreclosure action be instituted first *before* any action for a deficiency on the note, does not apply in the case of a bank that grants mortgage loans to businesses involving the financing of commercial properties. Accordingly, the Court's holding does alter a lender's election of remedies in commercial mortgage situations.

The Supreme Court's decision in *Penn Salem* should be considered by lenders in commercial foreclosure situations as they decide which remedy to pursue. Although the lender may still pursue an action on the note and mortgage in either order it wishes, a lender should ensure before seeking final judgment in the first action that it has correctly sought all relevant amounts to avoid the possibility of claims preclusion being applied in the subsequent action to bar further damages. ■