



Deficiency Judgments in Commercial Real Estate Loans: When Lenders Pursue Them and How They Are Determined

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When a commercial real estate mortgage loan goes into default and the lender enforces its collateral, the value realized from the property or pledged interests may not be sufficient to repay the outstanding indebtedness. The resulting shortfall is commonly referred to as a “deficiency”, and may give rise to a deficiency judgment in a commercial real estate loan depending on the loan structure and applicable law.

Whether a lender will pursue that deficiency (and when and how the amount is determined) depends on several factors, including the recourse structure of the loan, the method of collateral enforcement, applicable state law, and the financial condition of the borrower and guarantor.

For sponsors, borrowers, and guarantors, deficiency liability often represents the most consequential financial risk following a distressed real estate project.

What Is a Deficiency in Commercial Real Estate Loans?

A deficiency arises when the lender’s total claim exceeds the value realized from the collateral after enforcement.

This typically includes:

- unpaid principal balance
- accrued interest
- default interest
- protective advances
- enforcement costs and legal fees

Example:

| Item | Amount |
|---------------------------|---------------|
| Loan balance | \$60M |
| Accrued interest and fees | \$3M |
| Total indebtedness | \$63M |
| Foreclosure sale price | \$50M |
| Potential deficiency | \$13M |

Whether that deficiency may be recovered depends primarily on whether the loan is recourse or non-recourse and whether any recourse carve-outs have been triggered.

Deficiencies Under Recourse Loans

Full Recourse Loans

In a recourse [mortgage loan](#), the borrower is personally liable for repayment of the debt. If the foreclosure proceeds do not fully satisfy the loan balance, the lender may seek a deficiency judgment against the borrower.

Once a deficiency judgment is obtained, the lender may pursue:

- bank accounts
- other real estate assets
- partnership interests
- personal assets of the borrower or guarantor

When Lenders Typically Pursue Deficiencies

In practice, lenders are most likely to pursue deficiencies where:

- the borrower or guarantor has significant recoverable assets
- the deficiency is material relative to litigation costs
- the borrower engaged in bad faith or misconduct
- the lender seeks to enforce discipline within a sponsor relationship

Where borrowers or guarantors appear judgment-proof, lenders often decline to pursue deficiency litigation.

Partial Recourse Loans and “Bad Boy” or “Carve-Out” Guarantees

Most institutional commercial mortgage loans today are structured as non-recourse loans with recourse carve-outs guaranteed by a sponsor principal.

These provisions are commonly known as "bad boy" guarantees or "carve-out" guarantees.

Common Full Recourse Triggers

Typical triggers that convert a non-recourse loan into full recourse include:

- voluntary bankruptcy filings by the borrower
- unauthorized transfers of the property or equity interests
- fraud or material misrepresentation
- misapplication of rents or insurance proceeds
- violations of single-purpose entity covenants

If one of these triggers occurs, the guarantor may become liable for the entire deficiency after foreclosure.

Limited Recourse Carve-Outs

Other carve-outs create liability only for specific losses, including:

- misappropriated rents
- environmental liabilities
- tenant security deposits
- waste or damage to the property

In these circumstances, lenders typically pursue the guarantor only for the amount attributable to the violation.

Deficiencies Under Non-Recourse Loans

Under a true non-recourse mortgage loan, the lender's remedies are limited to the collateral property. If the foreclosure proceeds do not satisfy the debt, the lender generally cannot pursue the borrower for the deficiency.

This structure is typical in:

- CMBS financings
- life company loans
- stabilized institutional assets

However, lenders frequently examine whether borrower conduct triggered recourse carve-outs, which can convert the loan into a recourse obligation.

When and How Is the Deficiency Determined?

The timing and calculation of deficiency judgments are governed largely by state foreclosure statutes. Two primary approaches are common:

1. Foreclosure Sale Price Method

In some jurisdictions the deficiency equals:

- **Loan balance - foreclosure sale price**

This method can produce distorted results where distressed properties sell at artificially low foreclosure prices.

2. Fair Market Value Method

Many states impose fair value limitations designed to protect borrowers.

Under these statutes the deficiency equals:

- **Loan balance - fair market value of the property**

rather than the foreclosure auction price.

Courts often determine fair market value through:

- expert appraisals
- valuation hearings
- evidence of comparable sales

Example

| Item | Amount |
|---------------------------------|--------|
| Loan balance | \$60M |
| Foreclosure sale price | \$40M |
| Court-determined property value | \$52M |

Deficiency would be calculated using the \$52M value, not the foreclosure sale price.

New York Deficiency Judgment Rules

New York provides a frequently cited example of statutory deficiency procedures.

Under [RPAPL §1371](#):

- the lender must move for a deficiency judgment within 90 days after the foreclosure sale
- the court determines the fair market value of the property as of the sale date

The deficiency equals:

Total indebtedness - the greater of:

- **foreclosure sale price**
- **court-determined fair market value**

If the lender fails to seek the deficiency within the statutory period, the foreclosure proceeds are deemed to fully satisfy the debt, eliminating the deficiency claim.

Deficiencies After Mezzanine Loan Foreclosures

Commercial real estate capital stacks often include mezzanine loans secured by equity interests rather than the real estate itself. [Mezzanine lenders](#) typically foreclose through a UCC Article 9 sale of the borrower's equity interests.

The deficiency is calculated as:

- **Loan balance - value realized in the UCC sale**

However, borrowers frequently challenge these claims by arguing that the sale was not "commercially reasonable," as required under the Uniform Commercial Code.

Courts evaluating these disputes examine:

- adequacy of marketing
- fairness of the bidding process
- timing of the sale
- independence of valuation evidence

Deficiencies Following Deeds-in-Lieu of Foreclosure

Borrowers sometimes transfer property to the lender voluntarily through a deed in lieu of foreclosure. Whether a deficiency survives depends entirely on the terms of the deed-in-lieu agreement.

Common structures include:

- **Full Satisfaction of Debt:** The lender accepts the property in full satisfaction of the loan, eliminating the deficiency.
- **Reserved Deficiency Rights:** The lender accepts title but retains the right to pursue the borrower or guarantor for the remaining balance.
- **Negotiated Settlement:** Borrower and lender negotiate a discounted payoff that resolves the loan and eliminates deficiency exposure.

Deeds in lieu are often attractive because they:

- avoid foreclosure litigation
- reduce transaction costs
- preserve property value

Credit Bidding and Deficiency Calculations

At foreclosure sales, lenders often credit bid their debt rather than paying cash.

Example:

| Item | Amount |
|----------------------|--------|
| Loan balance | \$60M |
| Lender credit bid | \$45M |
| Remaining deficiency | \$15M |

Borrowers sometimes challenge deficiencies in these circumstances by arguing that the lender's credit bid undervalued the property relative to fair market value.

Tax Consequences of Deficiency Forgiveness

If a lender forgives a deficiency, the borrower may recognize cancellation of debt (COD) income under federal tax law.

COD income may be taxable unless an exception applies, such as:

- insolvency of the borrower
- bankruptcy proceedings
- certain qualified real estate restructurings

In partnership structures common in real estate funds, COD income may be allocated among partners even where the investment has already lost value.

How Borrowers Challenge Deficiencies

Borrowers and guarantors frequently seek to reduce or eliminate deficiency exposure through litigation.

Common strategies include:

- **Valuation Challenges:** Arguing that the fair market value of the collateral exceeds the foreclosure sale price.
- **Procedural Challenges:** Claiming that the lender failed to comply with:
 - statutory foreclosure procedures
 - required deficiency timelines
 - commercially reasonable sale standards
- **Recourse Disputes:** Borrowers often contest whether alleged recourse carve-out triggers actually occurred, particularly in cases involving bankruptcy filings or alleged transfers.

When Lenders Choose Not to Pursue Deficiencies

Even when deficiency recovery is legally available, lenders often elect not to pursue it.

Common reasons include:

- **Judgment-Proof Borrowers:** If the borrower or guarantor lacks meaningful assets, litigation may not justify the cost.
- **Sponsor Relationships:** Institutional lenders frequently maintain long-term relationships with sponsors and may prefer negotiated resolutions over aggressive litigation.
- **Litigation Cost:** Deficiency litigation often requires:
 - expert appraisal testimony
 - valuation hearings
 - extensive discovery
- **Reputational Considerations:** Certain lenders, particularly life companies and institutional investors, weigh reputational implications when pursuing personal liability claims.

Deficiency Exposure in by Lender Type

The likelihood of deficiency pursuit can also vary depending on the lender type.

CMBS Loans

CMBS structures typically involve:

- strict enforcement of loan documents
- special servicer decision-making
- recourse primarily limited to carve-out guarantees

Deficiency claims against guarantors are often pursued where carve-out triggers occur.

Bank Balance Sheet Loans

Banks often have greater flexibility in workouts and may prefer negotiated restructurings rather than pursuing guarantor liability.

Debt Funds

Private credit funds may be more aggressive in pursuing deficiencies, particularly where guarantors have identifiable assets.

Deficiency Waivers in Loan Workouts

During restructurings or distressed negotiations, borrowers sometimes seek deficiency waivers from lenders.

These waivers may arise in the context of discounted payoff agreements, note sales, deed-in-lieu transactions, or loan modifications involving additional capital contributions.

In these situations, borrowers often offer partial cash paydowns, additional collateral, or equity infusions in exchange for a lender's agreement to release guarantors from deficiency exposure.

Strategic Considerations for Lenders

Before pursuing a deficiency, lenders typically evaluate:

- **Probability of Recovery:** Does the borrower or guarantor have sufficient assets to justify litigation?
- **Cost and Duration of Litigation:** Deficiency actions often involve complex valuation proceedings.
- **Relationship with the Sponsor:** Institutional lenders frequently balance recovery objectives with long-term sponsor relationships.

Regulatory and Accounting Considerations

Banks and other regulated lenders may also factor in regulatory and accounting considerations when evaluating whether to pursue a deficiency.

These can include loan loss recognition, potential regulatory scrutiny, and broader portfolio management objectives, all of which may influence the timing, structure, or desirability of pursuing recovery.

Conclusion

Deficiency liability represents one of the most significant financial consequences following a commercial real estate loan default. While recourse loans permit lenders to pursue borrowers for shortfalls after foreclosure, non-recourse loans typically limit recovery to the collateral unless specific carve-out triggers apply.

Even where deficiencies are available, the amount recoverable often depends on complex valuation proceedings, statutory timing requirements, and the strategic decisions of lenders and borrowers alike.

For sponsors and guarantors, careful attention to recourse provisions, foreclosure procedures, and valuation issues is essential in assessing potential exposure when a real estate investment becomes distressed.

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