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## The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan

Gregory M. Stein

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# The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan

Gregory M. Stein\*

## *Abstract*

*The nonrecourse real estate lender agrees to seek satisfaction solely from the mortgaged property and not from the borrower or any of its equity holders personally. The lender presumably receives consideration for its relinquishment of this important remedy, and it would be unfair for a court later to award the lender a personal judgment against the borrower solely because the foreclosure sale proceeds were insufficient to satisfy the debt.*

*Because the nonrecourse lender cannot reach the borrower's personal assets, the location of the dividing line between the mortgaged property and the borrower's personal assets turns out to be far more significant in the nonrecourse loan than in the full recourse loan. Unfortunately, the legal definition of the mortgaged property may be unsettled at its edges, and borrowers possess the ability to shield assets from nonrecourse lenders by transforming real estate into personal property.*

*Borrowers and lenders that believe nonrecourse loans are just like other loans except for the waiver of a significant remedy soon may discover that nonrecourse borrowers have a greater tendency to allow or cause the condition and value of the property to deteriorate once foreclosure appears inevitable. This Article proposes a standard that will encourage nonrecourse borrowers in distress to act as they would if they were personally liable while also preventing lenders from enjoying the benefits of a remedy they agreed to forego.*

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\* Associate Professor of Law, University of Tennessee (gstein@utk.edu); B.A. Harvard, 1983; J.D. Columbia, 1986. I would like to thank Peter Engel, Jeanette Kelleher, Don Leatherman, Bob Lloyd, Joshua Stein, and participants in the University of Tennessee Faculty Forum for offering numerous helpful comments and suggestions as I was developing my analysis, and Stacy Ellison and Palmer Pillans for their research assistance in the early stages of this project. My work was generously supported by a University of Tennessee College of Law Summer Research Award, a University of Tennessee-Knoxville Professional Development Award, and a Lewis, King, Krieg, Waldrop & Catron, P.C., Faculty Research Grant.

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*I. Introduction*

People participate in the commercial real estate market for a wide variety of reasons. Some investors plan to construct buildings or renovate existing structures, while others intend to operate and manage commercial property as

an ongoing business. Whatever their goals, real estate professionals typically form business entities to hold investment property rather than holding that property personally. Investors in the position of selecting an ownership structure usually seek to minimize their taxes and to shield themselves from personal liability on contract and tort claims.

In the past, real estate investors most often chose to hold property in limited partnerships, although limited liability companies have surged in importance during the past several years.<sup>1</sup> Partners historically have faced a substantially lower effective federal tax rate than corporate shareholders have. Nonetheless, real estate business persons sometimes form corporations and forego the enormous tax advantages of the partnership. This acquiescence to the tax collector arises primarily out of concerns about personal liability: Shareholders of corporations ordinarily cannot be sued personally by creditors of the business, but general partners of partnerships can. Thus, if someone is injured on the property or if the real estate entity does not pay its debts, general partners may encounter unlimited liability in tort or contract that corporate shareholders escape.

Real estate professionals often attempt to finesse this decision by forming limited partnerships and then trying to avoid the unlimited liability that this ownership form creates. In some cases, partnerships can minimize these risks easily. A partnership that secures adequate amounts of workers' compensation, property, and liability insurance, for example, virtually eliminates any chance that its general partners will have to pay for the costs of accidents. The partners enjoy the tax benefits of partnership status while avoiding most of the tort risks of that form of ownership.

Real estate owners also face potential contract liabilities. The largest obligation that most real estate partnerships confront is their mortgage loan. If the property owner fails to pay its lender and the property sells at foreclosure for less than the outstanding amount of the debt, then the partnership and its general partners are personally liable for the deficiency. Thus, one bad investment can poison an otherwise successful real estate portfolio, and the unpaid lender on this bad investment can eventually have its debt repaid from the partnership's more successful projects or from the general partners' personal assets.

For this reason,<sup>2</sup> real estate partnerships often seek nonrecourse loans, in which the lender agrees that the mortgaged real estate is the only asset of the partnership and its partners that the lender will pursue if the debt is not repaid. The other assets of the partnership and its partners are shielded, and each

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1. See *infra* notes 13-14 and accompanying text.

2. This is not the only reason partnerships seek to borrow on a nonrecourse basis, but it is an important one. See *infra* Part II.A.2.

partner can lose no more than he or she agreed to invest. This nonrecourse status is accomplished by including exculpatory language in the documents, by which the lender agrees to look solely to the property for satisfaction of the secured debt.

Real estate lenders readily agree to nonrecourse loans in spite of their greater risk. Lenders are aware of the liability and other concerns facing partners in real estate ventures and may be willing to accommodate their partnership clients rather than risk losing business to competing lenders. If these lenders furnish an amount that does not exceed seventy to eighty percent of the value of the property, they generally are comfortable that the property can be sold at foreclosure for an amount sufficient to repay the debt. The slightly greater risk may translate into a modest increase in the interest rate. Lenders also may seek other forms of assurance that the debt will be repaid, such as limited personal guaranties or letters of credit.<sup>3</sup> Nonrecourse loans have become a staple of the commercial real estate lending industry, with their prevalence and scope fluctuating with business conditions in much the same way that interest rates and other business terms do.

Lenders are considerably less accommodating after the loan becomes delinquent. Once a borrower defaults, its lender is likely to look for gaps in the nonrecourse provisions so that it can reach the other assets of the partnership and the personal assets of the general partners if the foreclosure sale should fail to generate sufficient funds to satisfy the entire debt. If the borrower committed fraud in obtaining the loan, for example, courts ordinarily will disregard the exculpatory language and allow the lender to recover from the partnership and perhaps from its partners.<sup>4</sup> In the typical case, however, a lender that agreed to a nonrecourse loan will find itself with few attractive options if the loan turns out to be a poor one and the value of the property has dropped below the outstanding amount of the debt.

Several recent cases from different parts of the country reveal that courts are becoming more willing to circumvent nonrecourse provisions in loan documents.<sup>5</sup> In particular, courts have begun to find that owners that fail to maintain the mortgaged property or to pay real estate taxes commit the tort of waste. The borrower that fails to repay principal and interest is protected from the lender by the remedial provisions of the nonrecourse note, but a court may be less willing to apply these same provisions to absolve the borrower for the consequences of its tortious acts. The result of these recent cases is that

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3. See *infra* notes 22-24 and accompanying text.

4. See, e.g., *Manson v. Reed*, 231 Cal. Rptr. 446, 451 (Ct. App. 1986) (observing that "[a] recognized exception to [California's] anti-deficiency statute is a suit for fraud"). Anti-deficiency statutes and nonrecourse loans operate in much the same way. See *infra* note 31.

5. See *infra* Part II.B.

partnerships and their individual partners that believe themselves immune from personal liability may be in for a surprise when the project fails, while lenders that agreed in advance not to pursue their borrowers' personal assets sometimes recover nonetheless.

In some cases, this result seems proper—imagine the property owner who sees financial disaster looming and starts tearing out appliances, fixtures, and building components to raise cash, to the ultimate detriment of the foreclosing mortgage lender. This example illustrates the more straightforward case of active waste, in which the owner intentionally damages the lender's security for the owner's own benefit. No court should shield a partnership that behaves in this fashion or any of its general partners. In contrast, the failure to maintain the property or to pay real estate taxes constitutes, at most, passive waste, and a court may be more inclined to treat these omissions by the borrower as falling within the protection of the nonrecourse note.<sup>6</sup>

This Article examines the question of how to treat the common actions and inactions of the distressed borrower that may or may not fall within the scope of the nonrecourse note. These borrower missteps will not always constitute the active destruction of the property, for which the lender should receive tort damages, nor will they always constitute the simple failure to repay the debt, for which the nonrecourse lender already has waived its right to recover. Rather, these breaches fall somewhere between these easier extremes and may or may not lead to personal liability.

Part II describes the problem in some detail, focusing on the important pre-foreclosure events that will contribute to the outcome. Specifically, this Part examines the selection of a business entity to own the real estate, the nature of the nonrecourse loan, and the options facing a nonrecourse lender when its borrower defaults. This Part closes with a brief analysis of several recent cases addressing this issue.

Part III proposes a test to determine when the nonrecourse lender should be permitted to look beyond the mortgaged property. This Part begins by demonstrating that a so-called nonrecourse loan actually provides the lender with access to the borrower's personal assets in some limited circumstances. Next, this Part initiates the challenging task of defining the mortgaged property with some precision so that a court can begin to distinguish between the property that the borrower has pledged to the lender and the other assets that the lender has agreed not to pursue. This Part then demonstrates that the chief problem with nonrecourse loans is a psychological one rather than a financial one: Borrowers who believe that their personal liability is limited do not treat the mortgaged property with the same degree of care as borrowers who

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6. See *infra* Part IV.A.

believe that their personal liability is unlimited. Part III closes by proposing a test that can help a court decide whether a nonrecourse lender should be allowed to reach assets beyond the mortgaged property and then discussing this test in detail. The proposed standard should persuade the nonrecourse borrower to act with greater concern for the interests of its lender, without overlooking the fact that the lender has voluntarily agreed to forego the use of a powerful remedy.

Finally, Part IV demonstrates the effectiveness of this standard by applying it to two of the more common sets of facts that may arise. This Part examines the personal liability of the nonrecourse borrower in cases in which the borrower fails to maintain the mortgaged property or fails to pay real estate taxes. These two demonstrations exemplify the types of intermediate breaches the proposed test is designed to address: cases in which the borrower does not flagrantly damage the property but does allow physical damage or financial devaluation to occur.

## *II. The Current Analysis of Nonrecourse Lending*

Part II examines the use of nonrecourse loans in real estate transactions and the subsequent treatment of those loans by the courts. Subpart A focuses on how nonrecourse loans are employed by those who plan real estate transactions. This subpart discusses the factors that real estate professionals must weigh when choosing the type of entity that will own the real estate and then looks at the use of nonrecourse financing by these owner entities. Subpart B examines three leading cases in which lenders attempted to recover personally from property owners in spite of legal arrangements that appeared to insulate those owners.

### *A. Nonrecourse Lending in the Planning of Real Estate Transactions*

#### *1. Selecting an Entity to Own the Real Estate*

Real estate professionals, like other business people, generally aim to maximize their profit and to minimize their risk. To attain this end, they must minimize their federal tax obligations while exposing themselves to the least possible tort and contract liability, two goals that in some ways demand contradictory actions. The first and perhaps the most important decision that any real estate professional must make is the selection of the entity that will hold title to the real estate.

At its simplest, this decision traditionally has boiled down to a choice between forming a corporation and forming a partnership.<sup>7</sup> The corporation

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7. Most other types of ownership will prove to be impractical. Individual ownership is feasible only for the experienced and wealthy investor who has no need to rely on others for

offers the greatest protection available against personal liability. The corporate property owner, a separate legal entity under state law, is fully liable for all contracts into which it enters and for all torts for which the law imposes liability on an owner, but the individual shareholders of the corporation are not.<sup>8</sup> Investors who hold shares of corporations that own real estate can cap their losses at the amount they agree in advance to invest and need not worry that they will be called upon to make unanticipated contributions in the future. No other form of ownership better limits its investors' personal liability, a privilege that corporate owners pay for when they calculate their taxes. As a separate entity, the corporation must file its own tax return and pay taxes on any income at the corporate level. Distributions to individual shareholders then are taxable to those shareholders, with the result that each shareholder effectively pays a double tax.<sup>9</sup>

The general partnership lies at the other extreme, offering significant tax advantages to its partners but exposing them to greater liability. The general partnership is not taxed separately at the partnership level, and the double tax

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either their expertise or their equity. But these types of wealthy and knowledgeable owners are precisely the people who will most wish to avoid the unlimited personal liability that an individual owner faces, although insurance and nonrecourse financing can aid sole proprietors in the same ways that they help partnerships and their general partners. See *infra* notes 16-18 and accompanying text. Wealthy investors are unlikely to opt for the sole proprietorship, and most investors will not be in a position even to consider this option.

The tenancy in common might be a feasible alternative for a sufficiently small group of investors, but still provides no insulation from individual liability while creating practical management problems. Major decisions by owners who are tenants in common require the consent of all co-tenants, and disagreements or the death of a principal can lead to management gridlock. The use of agreements analogous to corporate shareholder agreements may sidestep some of these problems, but the tenancy in common still offers many of the drawbacks of the partnership with far fewer of the advantages.

See *infra* notes 13-15 and accompanying text for a discussion of limited liability companies.

8. There are some exceptions to this general rule, and these vary from state to state. For example, courts sometimes will pierce the corporate veil in cases in which it would be unjust to do otherwise. See HARRY G. HENN & JOHN R. ALEXANDER, *LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* 344-52 (1983) (discussing when corporateness should be disregarded). Tennessee imposes liability on corporate officers and employees for taxes that the corporation should have collected from its customers. See TENN. CODE ANN. § 67-1-1443 (1994 & Supp. 1997). New York allows employees of closely-held corporations to recover unpaid wages from the ten largest shareholders of the corporation. See N.Y. BUS. CORP. LAW § 630 (McKinney 1986 & Supp. 1998). In addition, any shareholder that willingly assumes personal liability, such as in the form of a guaranty, may be held liable for those voluntary assumptions in spite of the fact that the corporate form insulates the shareholder from liability for general corporate obligations.

9. For a good discussion of the double taxation problem, along with a numerical illustration, see GEORGE LEFCOE, *REAL ESTATE TRANSACTIONS* 909-11 (2d ed. 1997).



problem vanishes. Each partner, however, is personally liable in full for all partnership liabilities, including those incurred on behalf of the partnership by the other partners. Taxes are kept to a minimum, but liability is unpredictable and potentially limitless.

At their simplest, the general partnership option and the corporate option each offer investors a major advantage paired with a major flaw, which is to say that the entrepreneur confronted with only these two options would need to make an important initial choice. This harsh choice has been softened, however, by statutory relaxation of these two forms, with S corporations, limited partnerships, and, most recently, limited liability entities offering investors greater flexibility.

The major drawback to the business corporation from the perspective of the real estate investor lies in its heavier tax burden. These extra costs can be eliminated if the corporation qualifies as an S corporation.<sup>10</sup> If the corporation so qualifies, it is taxed like a partnership but provides its investors with the limited liability of a corporation. The S corporation has never become as popular as these dual advantages might suggest, however, because of the numerous restrictions Congress placed on S corporations and the burdensome record keeping involved.<sup>11</sup>

Just as S corporation status softens the tax blow for certain corporate shareholders, the use of the limited partnership form softens the liability exposure of some partners in partnerships. Limited partnerships possess two classes of partners, limited and general.<sup>12</sup> General partners of limited partnerships, like general partners of general partnerships, still face unlimited liability. Limited partners, in contrast, are treated much like corporate shareholders and may lose only those amounts that they invest initially or commit to contribute in the future.

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10. See I.R.C. §§ 1361-1379 (1994 & Supp. II 1996).

11. S corporations may not have more than 75 shareholders, and all shareholders must be individuals who are not nonresident aliens. See *id.* § 1361(b)(1). Rules regarding election, revocation, and termination are detailed and complex. See *id.* § 1362. Because of the strict limitations on S corporations and the ease with which these entities can lose their desirable tax status, S corporations have served as only a modestly useful solution to the problem facing the investor hoping to balance liability and tax concerns. See generally Comment, *Recent Legislation—Taxation—Small Businesses—Congress Reforms Rules for S Corporations*, 110 HARV. L. REV. 553 (1996) (criticizing 1996 amendments to subchapter S). Nonetheless, entities that plan to acquire real estate may not find it particularly troublesome to comply with these rules.

12. Limited partnerships are created in accordance with state laws, such as those adopting the *Revised Uniform Limited Partnership Act* (RULPA). See, e.g., DEL. CODE ANN. tit. 6, §§ 17-101 to -1111 (1993 & Supp. 1996) (establishing RULPA in Delaware). The *Uniform Limited Partnership Act* was promulgated in 1916, and RULPA was adopted in 1976 and revised in 1985. The full text of both acts and the revision appears in 7 STATE LIMITED PARTNERSHIP LAWS Acts-1 to -118 (Michael A. Bamberger & Joseph J. Basile, Jr. eds., 1987 & Supp. 1998).

Unlike the S corporation, the limited partnership form has been enormously popular within the real estate industry. It is an excellent choice for the partnership that has at least one general partner willing to live with the risk of unlimited personal liability but that also has other investors that insist on both limited liability and the tax advantages of a partnership. This form of ownership is not without its own drawbacks, however. The general partners of a limited partnership retain unlimited liability in contract and tort, and those limited partners that participate in the management and control of a limited partnership risk being treated as general partners for tort and contract liability purposes.

The limited liability company has become an important option for real estate investors during the last several years.<sup>13</sup> While the contours of this entity are less consistent from state to state than are those of the other available entities, limited liability companies are designed to allow their investors both limited liability and partnership tax treatment. In addition, recent regulatory changes have simplified the process by which the Internal Revenue Service will classify business entities for tax purposes. Under the new "check-the-box" regulations, many noncorporate entities such as limited liability companies and limited partnerships will more easily qualify for partnership tax treatment.<sup>14</sup> Real estate investors have been quick to recognize that limited liability companies can offer the combination of favorable tax treatment and limited liability that they previously had to struggle to attain. If the limited liability company has not already surpassed the limited partnership as the entity of choice for real estate investors, it is likely to do so soon. Nonetheless, limited partnerships, including the large number of limited

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13. Many states allow for the creation of both limited liability companies and limited liability partnerships. See, e.g., DEL. CODE ANN. tit. 6, §§ 18-101 to -1109 (governing limited liability companies); *id.* §§ 1515, 1544-1553 (governing limited liability partnerships). The attributes of these two types of business entity vary from jurisdiction to jurisdiction, but each entity offers its owners both limited liability and favorable tax treatment. See generally Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393 (1996) (discussing tax and liability issues that factor into entity selection decision and examining enormous growth in popularity of limited liability entities in last decade). For discussions of the origins of the limited liability company, see William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 857-59 (1995); Debra Cohen-Whelan, *Individual Responsibility in the Wake of Limited Liability*, 32 U.S.F. L. REV. 335, 338-40 (1998).

14. See Treas. Reg. §§ 301.7701-2(b)(1)-(8) (1997). These regulations became effective on January 1, 1997. See generally Jerold A. Friedland, *Tax Considerations in Selecting a Business Entity: The New Entity Classification Rules*, 9 DEPAUL BUS. L.J. 109 (1996) (describing new "check-the-box" rules); George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125 (1997) (discussing several issues left unresolved by new regulations).

partnerships established prior to the growth in popularity of the limited liability company, will remain important for many years to come.<sup>15</sup>

## 2. *The Nonrecourse Loan*

The business corporation and the general partnership each possess one major advantage accompanied by one major drawback. Statutorily created variants of these two entities – the S corporation and the limited partnership – are hybrids, each offering the major advantage along with a less undesirable drawback. Investors seek to improve on these two variants by maximizing the advantages of each of these forms while paring back still further on the disadvantages of each. The disadvantages to the S corporation are created by the Internal Revenue Code and cannot be modified in the corporate charter or in the corporation's contractual arrangements, although careful planning and oversight will reduce some of these negative effects. Investors who plan ahead carefully, however, are more likely either to turn to the limited partnership and then look for ways to eliminate or minimize the liability risks that characterize this type of entity or, more recently, to choose the limited liability company.<sup>16</sup>

Most of the liability risks that general partners in limited partnerships encounter fall into the two broad categories of torts and contracts. Tort risks cannot be eliminated, of course. Accidents and disasters happen, and the

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15. Lenders that lend to thinly capitalized limited liability entities will have the same concerns as lenders that lend to partnerships on a nonrecourse basis, and lenders in either group may insist on personal guaranties or other forms of credit enhancement. Thus, the explosive growth in limited liability companies is not likely to eliminate the problem this Article addresses. Rather, it will move the problem from the mortgage to another document, such as a guaranty. The parties still will need to agree on the scope of the liability of any parties who may personally bear financial responsibility. *See infra* note 16.

16. As noted earlier, the use of a limited liability company or S corporation will not necessarily solve the liability problem for investors wishing to avoid unlimited risk. Lenders and other large creditors recognize that these limited liability entities impair their ability to recover and may insist upon the same additional assurances or credit enhancement devices that nonrecourse lenders to limited partnerships require. *See supra* note 15; *infra* notes 22-24 and accompanying text.

Investors recognize that they cannot fool lenders into lending to thinly capitalized limited liability entities. If these investors prefer the limited partnership form for other reasons and are concerned only about the unlimited liability that its general partners face, they may conclude that, practically speaking, they will be no more exposed to liability as general partners in partnerships than as interest holders in S corporations or limited liability companies. Once the lender starts to diminish the liability advantages of the S corporation or the limited liability company, the investors may decide that the limited partnership with nonrecourse or limited recourse debt offers a better combination of benefits and drawbacks than do these alternative business forms.

universe of potential plaintiffs is limitless. But the magnitude of these risks can be minimized through the use of insurance. Prudent purchases of sufficient liability, property, and workers' compensation insurance convert small risks of devastating liability into modest and easily quantified periodic premium payments. Well-run partnerships will obtain adequate amounts of each type of insurance, particularly if state or local law, or their lender, so requires.

Avoiding contractual liability is more problematic. The only way to reduce the risk of contract liability is for the limited partnership to ask each party with which it contracts to agree in advance not to look to the personal assets of the partnership or its partners if the partnership should breach the contract. Most parties with which a partnership contracts would not seriously entertain such a request. But for the largest liability the typical commercial real estate limited partnership faces, this problem has an amazing tendency to vanish. For, much to the surprise of anyone unfamiliar with the real estate market, lenders routinely agree to precisely such provisions, when they lend on a nonrecourse basis.<sup>17</sup> In short, if a real estate limited partnership asks its largest creditor for a promise not to sue the partnership or its partners personally, the creditor often will agree without much argument.<sup>18</sup>

Why would a lender agree to give up its right to sue a borrower partnership and its general partners?<sup>19</sup> There are several reasons. To begin with, lenders understand exactly why general partners of limited partnerships are so concerned with obtaining nonrecourse financing and are willing to provide nonrecourse loans as a business enticement, particularly if competing lenders are doing so. In addition, in a real estate mortgage loan, the primary security is the real estate itself. Most lenders recognize that their borrowers may be

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17. See Joshua Stein, *Nonrecourse Carveouts: How Far is Far Enough?*, REAL EST. REV., Summer 1997, at 3, 3 (stating that "[n]onrecourse is . . . the marketplace standard for long-term financing of income-producing commercial real estate").

18. A nonrecourse agreement affects the enforceability of the note but not of the mortgage. "A mortgage is enforceable whether or not any person is personally liable for . . . performance." RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 1.1 (1997). "Such a restriction or exclusion of personal liability does not impair the enforceability of the mortgage by means of foreclosure, but it does limit or bar the mortgagee's access to both a personal judgment prior to foreclosure and a deficiency judgment following foreclosure." *Id.* cmt.

19. This Article generally assumes that a nonrecourse loan to a limited partnership is a loan in which the creditor agrees not to seek personal recourse against the partnership borrower or its general partners. Borrowers and lenders sometimes may agree to a more limited type of nonrecourse debt, in which the lender is permitted to pursue other assets of the partnership but not the assets of its partners. The same issues that arise in the broader type of nonrecourse loan also are relevant in this narrower type, and this Article's analysis applies equally well to both types of loans. Note that if the limited partnership owns just one real estate asset, the difference between the two types of nonrecourse debt turns out to be largely insignificant, with protection of the partners being the main goal of the nonrecourse provisions either way.

unable to satisfy a personal judgment by the time of any default on the note and lend under the assumption that they will have nothing else to look to beyond the secured real estate. That, after all, is one of the reasons lenders insist on a mortgage in the first place.

Moreover, in evaluating applications for loans to be secured by commercial real estate, lenders are most concerned with the income stream that tenant leases will generate and with the owner's expertise in managing commercial real estate. This contrasts sharply with the residential real estate loan market, in which the lender is more likely to scrutinize the income and assets of the individual borrower. If the commercial lender is more concerned with the income stream from the property and with the skill of the property manager than with the net worth of the partnership and its partners, then the lender that agrees to a nonrecourse loan is relinquishing a remedy that it sees as relatively unimportant.<sup>20</sup> Lenders also realize that extending a nonrecourse loan to a single-asset real estate partnership places them in a position that is little worse than the one they would be in if they had lent with full recourse to a single-asset corporation.

Lenders that agree to exculpatory language also may insist upon extra comfort in the form of a larger equity contribution or additional consideration in the form of a higher interest rate. The lender's determination of what the loan-to-value ratio should be for any given loan factors in its assessment of the riskiness of that loan. For a nonrecourse loan, which by definition is at least as risky as a loan with recourse, the lender may insist upon a lower loan-to-value ratio, which is to say a higher equity investment by the borrower. Similarly, the lender may charge a slightly higher interest rate to reflect the slightly increased risk that its voluntary waiver of an available remedy creates.<sup>21</sup>

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20. Other forms of security may rise in importance for lenders that undertake an analysis such as this one. These lenders may insist on an assignment of leases and rents, on business interruption insurance, and on life insurance policies covering key personnel. *See, e.g.,* Mid-City Hotel Assocs. v. Prudential Ins. Co. of Am. (*In re* Mid-City Hotel Assocs.), 114 B.R. 634, 642 n.9 (Bankr. D. Minn. 1990) (observing that "[i]t is difficult to imagine that [the nonrecourse lender] would have waived its rights to pursue collateral sources of satisfaction [including recourse against the owner and its general partners], had it not gained an unchallengeable right to the fruits of the use of its tangible security"). *See generally* Tanis Reid & Robert A. Maniscalco, *Nonrecourse Real Estate Loans: Dead or Alive?*, REAL EST. FIN. J., Winter 1993, at 27, 27 (noting that, at the time, nonrecourse debt was "most frequently used in the most conservative deals where the lender's underwriting standards [were] fully met by the appraised value, tenant roster, and rent roll of the real estate itself").

21. After constructing a net present value simulation model and performing a multiple regression analysis, Professor Michael Schill concluded that mortgagor protection laws such as antideficiency legislation and statutory redemption "may lead to higher home loan mortgage rates, but the magnitude of the increase in credit costs is likely to be modest." Michael H.

Lenders also may assent to lending on a nonrecourse basis if their risk is reduced through the use of an external credit enhancement device, such as a standby letter of credit or a personal guaranty. If the lender surrenders the right to seek personal recourse from the partnership and all of its general partners and receives in exchange a letter of credit issued by a bank or a personal guaranty from a specific partner or a creditworthy third party, the lender actually may be in a better position than before, with two or more different remedies now available against two or more different sources of repayment.<sup>22</sup> This may be an imperfect option from the borrower's perspective, because at least some of the partners, or the entity itself, are likely to retain some personal liability under a letter of credit reimbursement agreement or a personal guaranty. However, alternative obligations such as these may be limited as to duration, dollar amount, types of risk covered, and types of assets that can be reached. Most general partners would be extremely pleased if they and their partnership could avoid unlimited liability in exchange for, say, an agreement under which one specific partner is liable for the first two years of the loan, up to a maximum amount of \$500,000, for any liabilities arising under federal and state environmental laws.<sup>23</sup> In addition to limiting

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Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 514 (1991). Similar results might be expected in a study of the effects of nonrecourse lending, which functions in much the same way as antideficiency legislation. There is no guarantee, however, that the commercial market would exhibit the same characteristics as the residential market.

22. The lender may foreclose the mortgage, employ the remedies under the letter of credit or guaranty, or do both. For thorough discussions of letters of credit, see Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47, 102-13 (1999); David M. Van Atta, *Using Letters of Credit as Credit Enhancement for Real Estate Loans*, in COMMERCIAL REAL ESTATE LENDING: INNOVATIVE FINANCING STRATEGIES 109 (5 The ACREL Papers 1992). For a discussion of how letters of credit are interpreted in one state with antideficiency legislation, see *Western Sec. Bank v. Superior Court*, 933 P.2d 507, 518-20 (Cal. 1997). This case was sufficiently challenging to the courts to lead to seven published opinions in less than four years.

For a similarly thoughtful analysis of guaranty agreements, see Philip D. Weller, *Credit Enhancement: Guaranty Agreements*, in COMMERCIAL REAL ESTATE LENDING: INNOVATIVE FINANCING STRATEGIES, *supra*, at 93. The author notes that guaranty agreements can be either complete or limited and that a limited guaranty can be employed to provide additional assurance that the borrower will meet its obligation to pay real property taxes and insurance. *See id.* at 93, 100. *See generally infra* Part IV.B (discussing failure to pay real property taxes and insurance premiums).

23. Some of these methods of softening the blow of the nonrecourse loan to the lender also could be included directly in the note, thereby eliminating the middleman, along with the middleman's fee. For example, the note could limit personal recourse solely to a specific partner, in a stated amount, and for a finite period. Such an approach is perfectly sound and has the effect of creating a partial recourse loan, assuming there are no relevant state law limitations. *See infra* Part III.A. The lender, however, may prefer the interposition of a more creditworthy third party such as a bank.

the liability of the partnership and its general partners, these alternative forms of credit enhancement also may protect those parties' balance sheets, thereby enhancing their access to further credit if they should need it in the future.<sup>24</sup> From the lender's point of view, even the limited use of credit enhancement devices provides partial insurance against the most worrisome hazards during the periods of highest risk, such as construction.

Finally, until 1986, limited partners received significant tax advantages when their partnerships borrowed on a nonrecourse basis rather than on a recourse basis. A partner can deduct allocable partnership losses up to the amount of that partner's basis in the partnership, and a limited partner's basis is increased to account for nonrecourse debt but generally not for recourse debt.<sup>25</sup> This advantage caused passive investors to favor limited partnerships with nonrecourse debt. Partnerships that wished to attract capital almost had to borrow on a nonrecourse basis, a fact which lenders understood fully.<sup>26</sup>

The prevalence of the limited partnership form in the real estate industry, the validity of the many reasons limited partnerships have for insisting upon nonrecourse debt, and the lack of grounds for lenders to object have combined to ensure that much commercial real estate is subject to nonrecourse debt. If a project is successful and the borrower pays that debt, then the nonrecourse provisions turn out to have been immaterial. But that is not always what happens, and a nonrecourse lender holding a loan in default must decide which of its available remedies to pursue. In the short term, the lender may attempt to employ one or more of the pre-foreclosure remedies provided for

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24. See Katz, *supra* note 22, at 88 & n.90 (discussing accounting advantages of using standby letter of credit).

In many cases, nonrecourse debt that is personally guaranteed by a partner will be viewed as recourse debt for tax purposes, thereby increasing the guarantor partner's basis. See I.R.C. § 752(a) (1994 & Supp. II 1996) (treating increase in partner's share of partnership's liabilities as contribution of money); *id.* § 722 (stating that partner's basis in partnership interest is increased by contributions of money); Treas. Reg. § 1.752-2 (1997) (discussing tax treatment of this type of debt).

25. See I.R.C. § 704(d) (1994 & Supp. II 1996) (limiting allowance of partnership losses); *id.* § 752 (addressing treatment of certain partnership liabilities).

26. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 1.1 reporters' note (1997) (discussing tax consequences of nonrecourse loans).

The tax shelter benefits of nonrecourse debt were reduced significantly by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended in scattered sections of 26 U.S.C.). See, e.g., I.R.C. § 469 (1994 & Supp. II 1996) (limiting passive activity losses). See generally Sang I. Ji, *Nonrecourse Financing of Real Property: Depreciation Allocation and Full Recapture to Minimize Deferral and Eliminate Conversion*, 29 COLUM. J.L. & SOC. PROBS. 217 (1996) (concluding that 1986 amendments to Internal Revenue Code did not completely solve problem of tax shelter abuse); Linda Sugin, *Nonrecourse Debt Revisited, Restructured and Redefined*, 51 TAX L. REV. 115 (1995) (criticizing overall tax treatment of nonrecourse debt).

in the mortgage or under state law, such as the appointment of a receiver,<sup>27</sup> the activation of an assignment of leases and rents,<sup>28</sup> or the seeking of possession.<sup>29</sup> The availability of these pre-foreclosure remedies may alert the

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27. See GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 4.33 (3d ed. 1994). "An equitable receivership normally entails the judicial appointment of a third party to take possession of the mortgaged property to repair or preserve the property and to collect rents." *Id.* at 195. Courts ordinarily will not appoint a receiver unless state law allows and the documents so provide, and even then some state courts may be reluctant. See generally *id.* §§ 4.33-4.34.

28. An assignment of leases and rents gives the lender access to tenant rents after the mortgagor defaults and prior to foreclosure. Courts tend to favor assignments of leases and rents and consistently enforce them even when the loan is nonrecourse. See *Fidelity Mut. Life Ins. Co. v. Harris Trust & Sav. Bank*, 71 F.3d 1306, 1310 (7th Cir. 1995) (noting advantages of activating assignment of leases and rents before employing other remedies and emphasizing that "[f]oreclosure and receivership are costly remedies and there is no public interest in encouraging mortgagees to seek them at the first hint of default"); *Credit Lyonnais v. Getty Square Assocs.*, 876 F. Supp. 517, 521-22 (S.D.N.Y. 1995) (holding general partner of nonrecourse borrower personally liable for breach of trust because partnership failed to turn over to lender tenant rents collected after default); *Federal Home Loan Mortgage Corp. v. Dutch Lane Assocs.*, 775 F. Supp. 133, 140 n.4 (S.D.N.Y. 1991) (concluding that nonrecourse language in mortgage does not preclude lender's recovery of rents because assignment of rents is absolute and independent and because nonrecourse protection applies only to obligations contained within mortgage); *HomeCorp v. Secor Bank*, 659 So. 2d 15, 20 (Ala. 1994) (concluding that nonrecourse mortgagee is entitled to recover "all rents collected from tenants after the effective date of the assignment, subject to amounts necessarily paid for the operation, maintenance, and upkeep of the [property] from that date forward"); *Hoelting Enters. v. Nelson*, 929 P.2d 183, 187 (Kan. Ct. App. 1996) (stating that "nonrecourse clause only protected the defendants from any liability beyond the security" and concluding that "Hoelting is seeking to recover the rents and profits that accrued between default and foreclosure, which rents and profits were pledged as security"); *International Bus. Machs. Corp. v. Axinn*, 676 A.2d 552, 555 (N.J. Super. Ct. App. Div. 1996) (concluding that nonrecourse lender is entitled to assume control of rent paid by its borrower's tenants, notwithstanding presence of nonrecourse language in promissory note); *Prudential Ins. Co. of Am. v. Corporate Circle, Ltd.*, 658 N.E.2d 1066, 1069 (Ohio Ct. App. 1995) (rejecting trial court's conclusion that nonrecourse protections in note precluded enforcement of assignment of leases and rents, and noting that under this faulty interpretation, "the assignment of leases and conditional assignments of rentals are rendered meaningless, as if they were never negotiated or signed").

29. The mortgagor may relinquish possession voluntarily, or the mortgagee may seek possession over the mortgagor's objections. See NELSON & WHITMAN, *supra* note 27, § 4.24. Courts in lien theory states are more reluctant to award possession to the mortgagee if the mortgagor objects. See *id.*

Lenders who take possession before foreclosing assume certain responsibilities and may incur liability for failure to meet them. In *Thornhill v. Ronnie's I-45 Truck Stop, Inc.*, 944 S.W.2d 780 (Tex. App. 1997), the court noted that "[t]he fact that [the lender] had not yet foreclosed on the motel at the time of the fire did not preclude its legal status as a possessor. A party may be a possessor without any ownership or possessory interest in the premises." *Id.* at 790. The court concluded that the lender, in its role as possessor, "is liable [for two fire deaths] because of the control it exercised over the motel premises with full knowledge of the multitude of fire code violations that existed at the motel." *Id.* at 791. See generally NELSON & WHITMAN, *supra* note 27, §§ 4.27-4.29 (discussing obligations of mortgagee-in-possession).



borrower to the seriousness of the lender's concerns, may preserve the value of the property, and may reduce the magnitude of the default, thereby lessening the need for the lender to foreclose and reducing the risk that it will come up short if it must.

Even if these pre-foreclosure remedies do not accomplish their goals, the lender still may not need to foreclose if the parties are able to negotiate a workout agreement or if the partnership deeds the property to the lender in lieu of foreclosure. If none of these less extreme alternatives prods the borrower into curing the default or satisfying the lender's concerns in some other way, then the lender ultimately may decide to foreclose the mortgage or deed of trust in accordance with state law.<sup>30</sup> In the worst case for all of the parties, the foreclosure sale will not generate proceeds sufficient to pay off the outstanding debt, which by then will have been augmented by overdue interest, late fees, legal fees, and other related costs, and the lender next must seek a deficiency judgment.<sup>31</sup> It is this last option – pursuit of a deficiency judgment

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30. This Article refers to the operative security document as a mortgage, although many states employ the deed of trust in place of or in addition to the mortgage. The distinction between these two types of security instruments should have no impact upon the nonrecourse discussion that follows, although it might be possible to show that one type of instrument is more likely to lead to a deficiency judgment. Some state legislatures appear to believe that private foreclosure sales, which often involve the foreclosure of a deed of trust rather than a mortgage, encourage underbidding and lead to larger and more frequent deficiency judgments. In California, for example, lenders are permitted to seek deficiency judgments only if they foreclose judicially. See CAL. CIV. PROC. CODE §§ 580(b), (d) (West 1976 & Supp. 1998). See generally *Cornelison v. Kornbluth*, 542 P.2d 981, 991 (Cal. 1975) (en banc) (discussing options available to foreclosing lender in California).

31. See, e.g., *FDIC v. Prince George Corp.*, 58 F.3d 1041, 1046 (4th Cir. 1995) (observing that, under South Carolina law, "[i]f a foreclosure fails to bring enough to pay the debt in full, the lender is entitled to bring an action for a deficiency judgment as a matter of course").

States with so-called "one-action" rules require lenders to pursue the deficiency judgment and the foreclosure action in one proceeding. See NELSON & WHITMAN, *supra* note 27, § 8.2. In addition, states with antideficiency legislation either prohibit deficiency judgments altogether or limit their availability. See *id.* § 8.3. For example, some states limit any deficiency to the excess of the debt over the fair value of the property as determined by the court, a jury, or an appraiser, rather than the excess of the debt over the foreclosure sale price. See *id.*

An antideficiency statute is designed to make all loans to which it applies nonrecourse or partially nonrecourse, although the statute or the courts may allow for some exceptions. See *Westinghouse Credit Corp. v. Barton*, 789 F. Supp. 1043, 1045-46 (C.D. Cal. 1992) (holding that California's antideficiency statute prohibits enforcement, following nonjudicial foreclosure, of guaranty given by general partner of borrower); *Manson v. Reed*, 231 Cal. Rptr. 446, 451 (Ct. App. 1986) (allowing recovery by lender, in face of California's antideficiency statute, after borrower was found to have engaged in fraud). Compare *Osuna v. Albertson*, 184 Cal. Rptr. 338, 340 (Ct. App. 1982) (concluding that while failure to pay real estate taxes may constitute waste under California law, state's antideficiency legislation "may take away the remedy") with *Micuda v. McDonald (In re Evergreen Ventures)*, 147 B.R. 751, 755 (Bankr. D. Ariz. 1992) (stating that deed of trust beneficiary may sue for waste, physical abuse, or destruction of trust

ment—that generally is unavailable to the nonrecourse lender. The lender that accepts a nonrecourse note risks coming up short if the borrower defaults and the proceeds of the ensuing foreclosure sale are less than the outstanding amount of the debt.<sup>32</sup>

By this time, counsel for the lender will have examined the loan documents carefully, searching for legal arguments that might allow the lender to reach other assets beyond the mortgaged real estate. If the lender may make a claim against a guarantor or bonding company or may draw on a letter of credit, it will seek to do so. If the borrower committed some impropriety, such as misrepresenting its financial condition in the documents or the loan application or diverting funds to other projects in violation of the terms of the loan, then the lender may succeed in arguing that the nonrecourse provisions are inapplicable. If the nonrecourse provisions were drafted poorly, then the lender may argue that the loan allows for some recourse against the borrower.

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property, notwithstanding Arizona's antideficiency legislation), *aff'd in part*, 174 B.R. 350 (B.A.P. 9th Cir. 1994).

32. If the property sells at foreclosure for an amount that is no less than the total debt then outstanding, then the mortgagee is deemed fully satisfied, even if the mortgagee is the foreclosure sale purchaser, even if the bid exceeds the actual value of the property, even if the mortgagor engaged in fraud when it induced the lender to lend, and whether or not the loan is nonrecourse. *See, e.g.*, *Chrysler Capital Realty v. Grella*, 942 F.2d 160, 163 (2d Cir. 1991) (concluding, under Michigan law, that applying this rule in case in which borrower may have fraudulently overstated value of property "protects mortgagors from deficiency actions . . . and brings certainty to the foreclosure proceedings. Although a borrower may fraudulently induce a mortgage loan, the mortgagee may always limit his damages . . . by bidding for the security no more than its fair market value at the time of the foreclosure sale"); *Penn Mut. Life Ins. Co. v. Cleveland Mall Assocs.*, 916 F. Supp. 715, 717-18 (E.D. Tenn. 1996) (reaching similar result under Tennessee law and concluding that both contract and tort law demand this outcome even when loan is nonrecourse); *Cornelison*, 542 P.2d at 986-93 (offering detailed discussion of interplay among property value, general economic conditions, state antideficiency legislation, and size of foreclosure bid); *Whitestone Sav. & Loan Ass'n. v. Allstate Ins. Co.*, 270 N.E.2d 694, 697 (N.Y. 1971) (stating that

it is not conceivable that the mortgagee could recover a deficiency judgment against the mortgagor if it had bid in the full amount of the debt at foreclosure sale. To allow the mortgagee, after effectively cutting off or discouraging lower bidders, to take the property—and then establish that it was worth less than the bid—encourages fraud, creates uncertainty as to the mortgagor's rights, and most unfairly deprives the sale of whatever leaven comes from other bidders. Mortgagees have the obvious opportunity to bid only so much of the debt as equals the value of the property, and if someone else wishes to bid the same or more, so much the better for every other party concerned with the property).

*See generally* David A. Leipziger, *The Mortgagee's Remedies for Waste*, 64 CAL. L. REV. 1086, 1135-49 (1976) (discussing *Cornelison* and California statutes relevant to it); Frank A. St. Claire, *Special Problems in Real Property Foreclosures*, in REAL ESTATE FORECLOSURES 73, 103-04 (3 The ACREL Papers 1992) (discussing bidding strategies in foreclosure of nonrecourse mortgages).

But in the ordinary case, the nonrecourse lender that expects the foreclosure sale to generate insufficient funds is in a real quandary by this point: It has knowingly waived a remedy that, as things turned out, it needs to use. Some lenders facing this dilemma have looked to the courts, which occasionally will permit nonrecourse lenders to recover. Judicial treatment of this type raises the question of just how nonrecourse a nonrecourse loan is.

### B. Nonrecourse Lending in the Courts

This Part discusses three of the leading cases to examine the question of what actions constitute waste in the setting of a nonrecourse loan.<sup>33</sup> From the property owner's perspective, *Prudential Insurance Co. of America v. Spencer's Kenosha Bowl Inc.*<sup>34</sup> presented something even better than a nonrecourse loan. The original owner of commercial real estate borrowed funds and granted a mortgage, and subsequently sold the property to the defendant, which did not personally assume the obligation to repay the debt.<sup>35</sup> The lender's only recourse was against the property and the original borrower, and it does not appear that the borrower's grantee had any contractual relationship with the lender at all. At foreclosure, the property sold for \$360,000 less than the debt. The trial court listed nine different forms of waste that it found the grantee to have committed, causing total damage to the property of \$445,000. Eight of the nine listed items were failures to maintain the property physically; the ninth and largest, in the amount of \$199,000, arose from the grantee's failure to pay property taxes.<sup>36</sup> The trial court held the grantee personally

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33. For a detailed discussion of the law of waste in general, see *infra* Part IV.A.

34. 404 N.W.2d 109 (Wis. Ct. App. 1987).

35. See *Prudential Ins. Co. of Am. v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109, 111 (Wis. Ct. App. 1987). If a business entity of any kind purchases property subject to existing debt and then defaults on that debt, the lender will not have personal recourse against the current owner absent an assumption by that owner, and the original obligor may not be worth pursuing. Unless the lender makes the original loan due on sale or requires the buyer to assume the debt, sales of property subject to existing financing can lead to inadvertent nonrecourse financing. These cases raise most of the same issues that this Article examines in the case of intended nonrecourse debt, but in situations in which the loan documents are far less likely to confront the issue ahead of time. See generally *infra* Part IV.C.3.

36. See *Spencer's*, 404 N.W.2d at 113-14. For an even more graphic description, arising in the bankruptcy context, of the types of maintenance lapses that can lead a court to find waste, see *Micuda v. McDonald (In re Evergreen Ventures)*, 147 B.R. 751, 756 (Bankr. D. Ariz. 1992) (noting, before listing specific problems, that "[t]he most conspicuous problems at the project, such as backed-up sewers, leaking roofs, and burned out units, were simply the tip of the iceberg. They were symptomatic of the neglect and deferred maintenance suffered throughout the project . . ."), *aff'd in part*, 174 B.R. 350 (B.A.P. 9th Cir. 1994). See also *id.* at 759 (noting that "rudimentary problems could have been remedied easily with a minimum of cost and effort").

liable for all nine of these items but limited the total award to the amount of the deficiency.<sup>37</sup>

The Wisconsin Court of Appeals affirmed the judgment in full. In reaching this result, the court had to resolve two separate issues, neither of which had been precisely presented before in Wisconsin. First, the court decided that "the waste doctrine permits a mortgagee to maintain an action for waste against a nonassuming grantee of a mortgagor."<sup>38</sup> If the lender was permitted to use a waste argument to recover personally from a property owner such as this one, with which it had no privity of contract,<sup>39</sup> then a court

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37. See *Spencer's*, 404 N.W.2d at 113-14. After foreclosure, the lender's loss can easily be quantified. In no case should this loss exceed the amount of the deficiency, because the lender is entitled to nothing more than repayment of its debt.

In deciding whether to award damages for waste prior to foreclosure, a court may have to determine whether the lender is damaged in cases in which the value of the property is reduced but continues to exceed the outstanding amount of the debt. The lender will argue that it has an interest in the mortgaged property even before foreclosure; that its loss is not just a financial one; and that it ends up holding a riskier loan than it anticipated even if the borrower still has equity in the property, because of the increased loan-to-value ratio. This argument may be more compelling in title and intermediate theory jurisdictions, in which the lender ostensibly has some sort of title in the property and not just a security interest.

In *Jaffe-Spindler Co. v. Genesco, Inc.*, 747 F.2d 253 (4th Cir. 1984), for example, the court observed that a mortgagee in a lien theory state ordinarily may recover for waste before foreclosure only if the value of the collateral drops below the outstanding amount of the indebtedness. See *id.* at 257. In contrast, the rule usually applied in title theory states allows a mortgagee to recover before foreclosure for any diminution in the value of the security. See *id.* The court then proceeded to apply the title theory rule in South Carolina, a lien theory state, because the diminution in value arose from physical deterioration that the borrower had a duty to prevent and not from more general market conditions. See *id.* The court noted that "[b]ecause collateral whose value has been diminished through fault attributable to the mortgagor may still be worth something in excess of the outstanding indebtedness one day does not mean that the collateral will suffice on a later, rainy day. The margin of safety will have been significantly reduced." *Id.* at 258 n.6. See also RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.6, cmt. f & reporters' note f (1997) (citing cases that adopt each approach); NELSON & WHITMAN, *supra* note 27, § 4.4, at 136-40 (discussing variety of ways of defining "impairment of security"); *infra* notes 52, 122, 128, 161.

38. *Spencer's*, 404 N.W.2d at 112. Even the United States Supreme Court, which rarely addresses questions of state mortgage law, has recognized the right of a mortgage lender to bring an action for waste against its borrower. See *Waterman v. Mackenzie*, 138 U.S. 252, 259 (1891):

Even against a mortgagor in possession, the mortgagee may obtain an injunction or damages for such cutting of timber as tends to impair the value of the mortgage security, or as is not allowed by good husbandry or by express or implied license from the mortgagee. . . . A mortgagee of a leasehold or other personal property has the like right to an injunction to stay waste by the mortgagor.

*Id.* Similar reasoning should apply to a nonassuming grantee, but the Court was not called upon to address this issue. See generally 8 RICHARD R. POWELL & PATRICK J. ROHAN, POWELL ON REAL PROPERTY ¶ 644 (1998) (discussing waste in context of mortgages and deeds of trust).

39. See *Spencer's*, 404 N.W.2d at 114 n.4 (stating that "[w]e do not view the lack of

would likely find that a lender also could recover personally from a nonrecourse borrower, with which it would have a detailed, though limited, contractual relationship. Second, the court concluded that the failure to pay real estate taxes constitutes passive waste, which is actionable in just the way that active waste is, because either type of waste impairs the lender's security.<sup>40</sup>

*Travelers Insurance Co. v. 633 Third Associates*<sup>41</sup> raised similar issues, but with more money at stake and a less sympathetic group of investors. The borrower, a limited partnership, distributed \$4 million to its partners in 1990 after it learned that its office building would lose some major tenants and prepared soon afterwards to distribute another \$17 million. The lender that had provided a \$145 million nonrecourse loan sued to set aside the first

privity as a sufficient policy reason for not imposing liability where Spencer's negligence is shown to be a substantial factor in occasioning the harm") (citation omitted).

The same result is appropriate in a suit by a remainder holder against a life tenant who fails to pay property taxes, whether or not there is privity of contract between the two. *See, e.g.,* McIntyre v. Scarborough, 471 S.E.2d 199, 200-01 (Ga. 1996) (extinguishing life estate due to waste after life tenant failed to pay real property taxes); Hausmann v. Hausmann, 596 N.E.2d 216, 219, 220 (Ill. App. Ct. 1992) (noting that "[i]t has long been accepted . . . that a life tenant has a duty to pay real estate taxes assessed against the land during his life tenancy" and concluding that failure to pay these taxes gives remainder holder cause of action for waste); *see also* Weed v. Knox, 27 So. 2d 419, 420 (Fla. 1946) (stating that remainder holder may protect against injury to its inheritance); Chapman v. Chapman, 526 So. 2d 131, 135 (Fla. Dist. Ct. App. 1988) (remanding for determination of whether receiver should be appointed); Thayer v. Shorey, 191 N.E. 435, 437 (Mass. 1934) (stating that waste action will lie against life tenant who fails to pay taxes); First Nat'l Bank v. Clark & Lund Boat Co., 229 N.W.2d 221, 222, 224 (Wis. 1975) (providing for appointment of receiver); *see generally* Pike v. Wassell, 94 U.S. 711, 715 (1876) (deciding that holders of remainder may "do whatever is necessary to protect [their future interest] from forfeiture or incumbrance").

40. *See Spencer's*, 404 N.W.2d at 113. Other courts have reached the same conclusion with respect to financial omissions such as the failure to pay property taxes. For example, the Illinois Appellate Court has held that someone lawfully in possession of property commits waste by neglecting the property or diminishing its value if a future holder is prejudiced. *See Pasulka v. Koob*, 524 N.E.2d 1227, 1239 (Ill. App. Ct. 1988). The same court expressly stated four years later that waste is not limited to physical damage. *See Hausmann v. Hausmann*, 596 N.E.2d 216, 220 (Ill. App. Ct. 1992); *see also* North Am. Sec. Life Ins. Co. v. Harris Trust & Sav. Bank, 859 F. Supp. 1163, 1165 (N.D. Ill. 1994) (noting that "[t]his broad conception of waste appears to be part of an emerging legal trend with roots dating to the 19th Century"); Capitol Bankers Life Ins. Co. v. Amalgamated Trust & Sav. Bank, No. 92 C 4480, 1993 WL 594103, at \*5 (N.D. Ill. May 6, 1993) (holding that "the Partnership's failure to pay taxes constitutes waste as that term has been defined by the Illinois courts"), *aff'd sub nom.* Capitol Bankers Life Ins. Co. v. Gross, 16 F.3d 1225 (7th Cir. 1994).

The states are not unanimous on this point. *See, e.g.,* Krone v. Goff, 127 Cal. Rptr. 390, 393 (Ct. App. 1976) (concluding that "[n]one of the [California] cases even suggest that the traditional and legal meaning of waste, as that word is used in a mortgage or trust deed, embrace the failure to pay taxes").

41. 14 F.3d 114 (2d Cir. 1994).

distribution and to enjoin the second as fraudulent conveyances. The federal district court, applying New York law, denied a temporary restraining order and dismissed the claims because the loan was nonrecourse and the lender had no claim to the partnership's cash assets,<sup>42</sup> but the United States Court of Appeals for the Second Circuit vacated the district court's dismissal and remanded the case.<sup>43</sup>

The landowner's troubles continued, and on January 1, 1992, it failed to remit its semiannual installment of real estate taxes in the amount of \$3.8 million, as well as its monthly loan payment. Twelve days later, the partnership distributed the \$17 million to its partners. The lender filed for foreclosure the next day and then amended its complaint to allege that the borrower's distribution to its partners rendered it incapable of performing its obligations under the loan, including its obligation to pay property taxes. The amended complaint added claims for equitable relief from waste and for specific performance of the borrower's obligations. The district court dismissed the complaint once again,<sup>44</sup> but the Second Circuit reversed.<sup>45</sup>

The Second Circuit reached two related conclusions: The failure to pay real estate taxes constitutes waste under New York law; and the lender could bring claims for waste, for specific performance, and for setting aside the distributions, notwithstanding the nonrecourse provisions in the loan documents. The court focused its attention on the first issue. After reviewing the largely inapposite precedent<sup>46</sup> and several cases from other jurisdictions, the Second Circuit determined that "the intentional failure to pay property taxes

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42. See *Travelers Ins. Co. v. 633 Third Assocs.*, No. 91 Civ. 5735 (CSH), 1991 WL 236842, at \*1 (S.D.N.Y. Oct. 31, 1991) (declining to enter temporary restraining order). The district court dismissed the complaint in an unpublished order the next day. See *Travelers Ins. Co. v. 633 Third Assocs.*, 973 F.2d 82, 83 (2d Cir. 1992) (noting prior disposition of case).

43. See *Travelers*, 973 F.2d at 86 (noting that, while plaintiff may not have direct access to funds already distributed by defendant, "plaintiff nonetheless may have standing under New York's Fraudulent Conveyance Act to set aside the conveyance if the conveyance caused a diminution in the value of the real property, to which plaintiff is entitled to look in the event of default").

44. See *Travelers Ins. Co. v. 633 Third Assocs.*, 816 F. Supp. 197, 206 (S.D.N.Y. 1993) (referring to funds previously distributed by borrower to its partners as "monies which are placed beyond Travelers' reach by the non-recourse provisions of the mortgage"), *aff'd in part and rev'd in part*, 14 F.3d 114 (2d Cir. 1994).

45. See *Travelers*, 14 F.3d at 126. The Second Circuit affirmed portions of the district court's opinion that are not relevant here, reversed the rest of the lower court's opinion, and remanded once again. See *id.*

46. See *id.* at 120-23. The one state statute on point speaks only to waste by tenants and does not define the term "waste" at all, and the New York cases – none of which was decided by the state's highest court – focus largely on borrowers who physically damage the real property security. See *id.*

where there is an obligation to do so or where the failure is fraudulent constitutes waste under the law of New York."<sup>47</sup> The court did not discuss the second issue and appears to have assumed that the actions could be maintained in spite of the nonrecourse language in the mortgage.<sup>48</sup>

Conversely, in *Chetek State Bank v. Barberg*,<sup>49</sup> the Wisconsin Court of Appeals concluded that the failure to pay real estate taxes and mortgage interest does not constitute waste. *Chetek* cited *Spencer's* in passing but failed to give any explanation for its contrary result. *Chetek* involved the foreclosure of a nonrecourse mortgage that led to a deficiency of \$1.4 million. Conceding the validity of the nonrecourse provisions, the lenders nonetheless sought \$192,000 in unpaid real estate taxes and \$151,000 in unpaid mortgage interest from two of the general partners of the partnership that had owned the property. The appellate court held in favor of the two general partners,<sup>50</sup> concluding that the lender had not proven that the borrower had committed all of the elements of the tort of waste.<sup>51</sup>

47. *Id.* at 123. The court did not explain how one's failure to pay real property taxes when required can ever be unintentional. *See id.* at 126 n.1 (Mishler, J., dissenting) (noting that "[t]he mere failure by a mortgagor in possession to pay property taxes is willful since the mortgagor is chargeable with knowledge that taxes are due and constitute a prior lien").

48. For further discussion of this issue, see *infra* Parts IV.B, IV.C.1. Other courts have mustered stronger support in reaching a similar conclusion. *See, e.g.,* Genesco Inc. v. Monumental Life Ins. Co., 577 F. Supp. 72, 85 (D.S.C. 1983) (finding it "particularly equitable" that nonrecourse borrower should be held liable after it allowed shopping center to deteriorate physically to point where leading tenant was deemed constructively evicted), *aff'd sub nom. Jaffe-Spindler Co. v. Genesco, Inc.*, 747 F.2d 253 (4th Cir. 1984); *Micuda v. McDonald (In re Evergreen Ventures)*, 147 B.R. 751, 755 (Bankr. D. Ariz. 1992) (tracing seven centuries of waste litigation and concluding that, "under Arizona law, a trust deed beneficiary, like a mortgagee, has an unequivocal statutory right to maintain an action for waste, physical abuse to or destruction of the trust property, or impairment of the security [despite the borrower's statutory nonrecourse protection]"), *aff'd in part*, 174 B.R. 350 (B.A.P. 9th Cir. 1994).

49. 489 N.W.2d 385 (Wis. Ct. App. 1992).

50. *Chetek State Bank v. Barberg*, 489 N.W.2d 385, 387 (Wis. Ct. App. 1992). The court noted that the degree of waste sufficient to support the appointment of a receiver is lower than the degree of waste that results in tort liability. *See id.* On this basis, the court concluded that the precedent was inapplicable. *See id.* The court failed to point out that *Spencer's* was a tort action and not an action for the appointment of a receiver.

51. *See id.* (citing *Prudential Ins. Co. of Am. v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109, 111 (Wis. Ct. App. 1987)). It is not clear whether the court believed that *Chetek* and *Spencer's* were factually distinguishable, either because of the differing nature of the two property owners' defaults or the fact that one case involved a nonrecourse loan while the other involved a nonassuming grantee (a distinction which might lead one to conclude that the court was wrong in both cases). The lender in *Chetek* sought to recover mortgage interest, which plainly was not available to it, in addition to taxes; perhaps the court was confused or irritated by this request and awarded nothing as a result. *See id.* at 386.

In reaching a similar result and denying the lender's claim for taxes and other overdue amounts, a Florida appeals court determined that, "because of the no recourse provisions of the

### *III. Improving the Analysis of Nonrecourse Lending*

Part III offers a test that is designed to help courts decide exactly when a lender should be allowed to recover personally from its nonrecourse borrower. Subpart A demonstrates that few loans truly are nonrecourse loans and shows that most so-called nonrecourse loans actually leave the borrower with some level of liability. Subpart B begins to define the mortgaged property, which is the one asset that unquestionably is available to the nonrecourse lender. This subpart describes the incentives that nonrecourse borrowers have to transform mortgaged property, which is pledged to the lender, into personal property, which the lender may be unable to reach. Subpart C discusses this moral hazard problem in greater detail, observing how the absence of personal liability may cause the borrower to become disinterested in or hostile toward the mortgaged property after troubles with the loan develop. Subpart D ties the three prior sections together by proposing and describing in detail a legal standard that should help to restore the lost motivation of the distressed nonrecourse borrower.

#### *A. Recognizing that the "Nonrecourse" Loan Is a Loan Allowing Partial Recourse*

The use of the adjective "nonrecourse" suggests that a real estate lender agreeing to this type of loan waives all of its rights to seek satisfaction from the personal assets of its borrower. This suggestion is misleading. One of the sources of this confusion that borrowers, lenders, and courts may face is a linguistic one, with the use of the word "nonrecourse" causing the parties to overlook the fact that these loans do not fully insulate borrowers. This subpart demonstrates that the so-called nonrecourse loan actually provides the lender with partial or limited recourse to the borrower's personal assets.

In a typical real estate loan with full recourse, the documents will not expressly state the parties' intentions as to the personal liability of the borrower. By not departing from settled law in the loan documents, the borrower and the lender implicitly agree to abide by the state's default rules, which usually are clear. The borrower effectively guarantees to the lender that the net foreclosure sale price will be no lower than the total obligation of the

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[note,] the mortgagee was not entitled to a deficiency judgment against the mortgagor-maker for any sums over and above the amount which a sale of the property might bring." *Heim v. Kirkland*, 356 So. 2d 850, 851 (Fla. Dist. Ct. App. 1978). The text of this brief opinion suggests that the lender did not make a waste argument and relied entirely on the language of the note.

The courts have not reached any consensus as to whether the failure to pay real property taxes constitutes waste. See generally *Osuna v. Albertson*, 184 Cal. Rptr. 338, 342 & nn.3-4 (Ct. App. 1982) (citing cases reaching differing results); *infra* Part IV.B.



borrower at the time of the sale.<sup>52</sup> If the foreclosure sale proceeds turn out to be insufficient to pay the outstanding debt, the lender next may obtain a deficiency judgment and seek satisfaction from the borrower's other assets. If the borrower happens to be a partnership, each of its general partners will be personally liable for payment of this partnership obligation.<sup>53</sup>

The borrower's liability may be limited by substantive laws such as anti-deficiency legislation<sup>54</sup> and by procedural foreclosure restrictions such as one-action rules,<sup>55</sup> limitations that vary depending on the state and on the type of property involved.<sup>56</sup> The scope of the borrower's liability also may be somewhat fuzzy at its edges, with the body of state law on which the parties rely certain to contain some ambiguities and open questions not yet addressed by the legislature or by the courts. But while the parties to a full recourse loan may not know precisely what they have agreed to, they will have acceded to a fairly predictable body of doctrine, however ill-defined at its borders and however changeable as new issues arise.

Imagine now a mortgage loan with the strongest possible nonrecourse language. To what extent do the parties to this nonrecourse loan plan to deviate from the traditional full recourse model? A court might presume from this forceful language that the parties intended to reverse the standard full recourse rules completely. By shifting from a full recourse loan to a loan with no recourse, the parties must have intended to benefit the borrower in all of those circumstances in which the lender otherwise would have been protected. As a result, the lender's only option is to pursue the secured property, and the borrower and its partners are completely absolved of all personal liability in all instances. This Article will refer to loans such as these as "zero recourse" loans, to distinguish them from the partial or limited recourse loans discussed below.<sup>57</sup>

Even if a zero recourse provision accurately reflects the parties' mutual intent, a court may have valid reasons for refusing to enforce it. An obvious

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52. If the lender acts prior to foreclosure, the borrower may be liable for damages or may become subject to an injunction that will require it to spend its own funds. *See supra* note 37; *infra* notes 122, 128, 161. *See generally* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.6 (1997) (discussing remedies available for waste by mortgagor, both before and after mortgage relationship ends).

53. *See, e.g.*, WIS. STAT. § 178.12 (1997) (stating that individual partners are jointly liable in some cases and jointly and severally liable in others).

54. *See supra* note 31.

55. *See supra* note 31.

56. Owners of residential property often are treated more gently than are owners of commercial property. *See, e.g.*, ARIZ. REV. STAT. § 33-814(G) (1990 & Supp. 1997) (prohibiting deficiency judgment if property subject to deed of trust encompasses two and one-half acres or less and is occupied by single one-family or two-family dwelling).

57. *See infra* notes 62-65 and accompanying text.

illustration of a case in which enforcement would be inappropriate is one in which the borrower proves to have engaged in fraud.<sup>58</sup> If a nonrecourse borrower were to lie when applying for credit and then bribe an appraiser to overstate the value of the property, a court would allow the lender to recover any resulting damages.<sup>59</sup> The court would be correct in assuming that neither these parties nor any hypothetical reasonable parties could have intended, or should be allowed to agree to, an arrangement shielding the borrower from the consequences of its own criminal and intentionally tortious actions.<sup>60</sup> The parties, or at least one of them, probably did not intend to depart from the traditional recourse rules to this degree, and even if they did, a court should not implement that agreement indiscriminately.<sup>61</sup>

A document that contains nonrecourse language manifestly intends to deviate from the usual full recourse model to some extent, and a court ought not allow the lender full recourse in a case in which the parties plainly agreed to something else. At the same time, most borrowers and lenders probably do not intend a complete reversal of the full recourse rules in all circumstances, and even if they do, courts properly are reluctant to enforce a provision that invariably absolves the borrower. The term "nonrecourse," as commonly used, often proves to be misleading. Parties that diverge from the standard full recourse model usually recognize that the lender will remain personally liable in some more narrowly defined set of circumstances.<sup>62</sup> This Article

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58. See, e.g., Portia Owen Morrison & Mark A. Senn, *Carving Up the "Carve-Outs" in Nonrecourse Loans*, 9 PROB. & PROP., May-June 1995, at 8, 10 (observing that nonrecourse lenders often will carve out an exception for borrower fraud and noting that this exception "is probably no more than a restatement of the right of rescission for fraud in the inducement, which could well override a full exculpation in the loan"). See generally NELSON & WHITMAN, *supra* note 27, § 8.3, at 607-09 (offering similar example in context of analysis of California's antideficiency legislation).

59. See *FDIC v. W.R. Grace & Co.*, 877 F.2d 614, 622-24 (7th Cir. 1989) (holding nonrecourse borrower that committed fraud personally liable for compensatory and punitive damages); *Manson v. Reed*, 231 Cal. Rptr. 446, 451-53 (Ct. App. 1986) (allowing lender to recover in spite of California's antideficiency statute because borrower engaged in fraud).

60. Cf. GRANT GILMORE, *THE DEATH OF CONTRACT* 95, 96 (2d ed. 1995) (describing how law of "'contract' is being reabsorbed into mainstream of 'tort'" and concluding that soon there may "no longer [be] any viable distinction between liability in contract and liability in tort").

61. If the nonrecourse provision is negotiated at all, one of the first carveouts that the lender is likely to demand is a fraud exception. See, e.g., Reid & Maniscalco, *supra* note 20, at 28 (observing that "[f]raud, deceit, dishonesty, chicanery, deception; whatever it is called, there is no argument that the borrower cannot expect to be excused from this type of conduct"). Any borrower that can concoct a reason to object to the presence of a fraud exception is likely to raise serious concerns with the lender that has the forethought to demand this exception. The content of this fraud exception may be heavily negotiated, however, with the borrower worrying that the lender will have an expansive view of precisely what constitutes fraud.

62. Cf. John E. Barnes, *Don't Sound the Death Knell for Nonrecourse Lending Yet: A*

sometimes will refer to these more realistic types of loans as "partial recourse" or "limited recourse" loans, although it should be evident that they are nothing more than standard, if inaccurately named, nonrecourse loans. Once it becomes apparent that a nominal nonrecourse loan usually is a loan with some limited recourse, the obvious next problem is the determination of how limited that recourse is.

In a realistic nonrecourse loan, which actually is a limited recourse loan, the parties jettison the default package of state liability rules and supersede it with doctrine they create themselves. The lender agrees to waive a powerful remedy in some circumstances. In exchange, the borrower presumably offers the lender some consideration such as a higher interest rate, a larger equity contribution, or, perhaps, nothing more than its resolution to borrow from this lender rather than from a competitor.<sup>63</sup> If the parties refine this new set of rules carefully and reasonably in their documents and limit the lender's remedies with some precision, then the court ordinarily will enforce their agreement as written.<sup>64</sup>

Problems arise, however, when the parties fail to specify all of the details of their limited recourse relationship. The borrower and the lender may inadvertently fail to clarify the meaning of their agreement due to haste, sloppiness, or a lack of legal sophistication. Alternatively, the parties may deliberately decline to address all of these complexities for a variety of reasons. They may fear delaying the transaction and losing a short-lived business opportunity over an issue that they optimistically view as unlikely to arise. They may wish to keep their legal fees as low as possible. One party may prefer not to draw attention to some subtle ambiguity in what the other believes they have agreed to, thereby accepting an uncertain "maybe" rather than risking a certain "no." Whatever the reason, the parties may have agreed upon an incomplete legal relationship by employing a legally significant term without concurring as to its definition. Any document can contain such a

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*Proposal for Determining a Nonrecourse Lender's Standing Under the Uniform Fraudulent Conveyance Act*, 49 BUS. LAW. 669, 677-78 (1994) (noting that term "nonrecourse" does not typically mean "no recourse" but rather a limitation of recourse to enumerated assets").

63. See *supra* notes 19-26 and accompanying text.

64. See Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 89 (1996) [hereinafter LoPucki, *The Death of Liability*] (observing, in context of tort liability to involuntary creditors, that "[t]he liability system, as currently conceived, is a system for determining 'what wealth particular judgment creditors should be able to reach'" while also noting that "the system's schemes for making that determination have consistently been defeated by strategy [on the part of potentially liable parties]") (citation omitted); *infra* notes 93, 98.

For an opposing view, see James J. White, *Corporate Judgment Proofing: A Response to Lynn LoPucki's "The Death of Liability"*, 107 YALE L.J. 1363 (1998) (disagreeing with principal article and offering empirical evidence in response to it). For responses to these criticisms, see Lynn M. LoPucki, *Virtual Judgment Proofing: A Rejoinder*, 107 YALE L.J. 1413 (1998).

failing, of course, but by opting out of well-defined state recourse rules and choosing instead to create their own, the parties increase their chances of reaching an agreement that is incomplete.

A court called upon to resolve a dispute that results from this type of omission must place this set of loan documents at an appropriate point on the spectrum between full recourse and zero recourse, recognizing all the while that the parties meant to depart from the standard full recourse rules to some extent. In order to infer the level of personal liability that the parties intended, the court will need to contemplate more carefully the nature of nonrecourse loans. A nonrecourse loan proves to be a loan in which the lender agrees to look solely to the mortgaged property in far more instances than otherwise would be the case.<sup>65</sup> In many, but not all, of the factual situations that might arise, the lender has agreed prospectively to relinquish its access to the borrower's other resources, with the inevitable result that the mortgaged property takes on additional importance. The court cannot estimate accurately how much personal recourse the parties might have intended for the lender to retain until it considers more closely the nature of the mortgaged property, which is the only security that unquestionably is available to the lender in all cases. Once it understands just what the mortgaged property is, the court is in a better position to decide when the lender may look beyond the mortgaged property and how far.

### *B. Beginning to Define the Mortgaged Property with Care*

The property that a borrower mortgages to its lender is a collection of physical and financial attributes. The physical traits of the mortgaged property generally are well understood and agreed upon by both parties, consisting of corporeal, property-like features such as the land itself.<sup>66</sup> Other tangible property attributes frequently included within the scope of a mortgage are the improvements that are on the land or that will be constructed on the land, timber, and crops, even though these may not yet exist at the time of the grant

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65. A simpler definition of a nonrecourse loan would be one in which the lender agrees to look solely to the mortgaged property in all instances. This subpart has just shown that this definition is too simple. The more precise definition offered here emphasizes that the nonrecourse lender agrees to waive its access to other assets of the partnership and its partners in many more cases than it would in a full recourse loan. The remainder of this Article addresses the question of just how many more cases.

66. Even something as seemingly easy to define as the land may be more confusing than first appears. The property covered by the mortgage may include a leasehold, a unit in a high-rise condominium, air rights, transferable development rights, an easement, rights to the flow of water, rights of lateral support, or mineral rights. The mortgagee of any of these types of property may technically hold state law rights in land, but not necessarily rights in anything resembling the surface of the earth.

of the mortgage.<sup>67</sup> While not every borrower intends to grant its lender rights in all of these physical aspects of the property, the parties to any particular mortgage are likely to agree which physical property rights the borrower is mortgaging to its lender and will draft the granting clause of their mortgage accordingly.<sup>68</sup>

The mortgaged property is more than just a collection of physical traits, however, and also includes financial attributes that are less tangible than bricks, mortar, coal, or timber. In a commercial real estate loan, one of the most important characteristics of the real property security is its capacity to produce rental income.<sup>69</sup> A lender is likely to base its decision as to whether and how much it will lend on the overall value of the property, and this value will largely be a function of the property's ability to generate rents. The commercial lender is sure to inspect the land and to estimate the replacement cost of the buildings on it, but likely will be at least as concerned with the identities of the tenants, the amount of rent that each of these tenants is paying, and the number of years remaining in each lease term.<sup>70</sup> Both parties will understand from the outset that the lender is concerned with these components of the property's value, and the borrower typically will provide all relevant documents to the lender at the time it requests the loan so that the lender may undertake a due diligence review. In addition, the loan may be conditioned upon the lender's receipt of tenant estoppel letters, which authenticate and verify the major provisions of the leases;<sup>71</sup> an assignment of leases and rents from the borrower, which provides the lender with a security interest in this important income stream;<sup>72</sup> and subordination, nondisturbance, and

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67. Construction loans, for example, ordinarily are secured by a mortgage on the property on which the improvements will be constructed. As the loan is disbursed, the security increases in value correspondingly, at least in theory.

68. This is not to suggest that the definition of "property" is an easy one, as any first-year law student quickly learns. However, in most real estate loans the parties generally agree which sticks in the property bundle the borrower is hypothecating to the lender. Once they reach this agreement informally, they then can draft documents that describe those attributes of the land and the things permanently attached to it which the lender may pursue.

69. See *supra* note 20 and accompanying text.

70. See, e.g., *East N.Y. Sav. Bank v. 520 W. 50th St., Inc.*, 611 N.Y.S.2d 459, 462 (Sup. Ct. 1994) (recognizing importance of rent roll to nonrecourse lender).

71. See, e.g., *Prudential Ins. Co. of Am. v. Allied Tower, Ltd.*, 874 P.2d 36, 37-39 (Okla. 1993) (illustrating use of tenant estoppel letters in mortgage loan transaction); *First Union Mortgage Corp. v. Thomas*, 451 S.E.2d 907, 910 (S.C. Ct. App. 1994) (same).

72. See *supra* note 28. Many lenders insist upon an assignment of leases and rents so that they can gain access to the rents after default and before foreclosure. These lenders worry that the defaulting borrower will squander the property's income stream rather than using it to pay interest and principal or to maintain the property physically and financially. Whether the loan provides for full recourse or no recourse, the lender that activates an assignment of leases and

attornment agreements from the major tenants, which assure the lender that these tenants will remain after a foreclosure.<sup>73</sup>

While the parties sometimes may find it a challenge to describe the collection of physical and financial property rights to be mortgaged, the significant volatility typical of the real estate market makes it far tougher to place a value on this collection of rights. Some of this volatility arises from general business or regulatory conditions, such as the cost of building materials, variations in interest rates, or changes in tax laws.<sup>74</sup> Some of this unpredictability mirrors more localized economic circumstances, including business conditions in the relevant market and the financial well-being of major tenants of the property.<sup>75</sup> Another portion of this instability may reflect the skills of

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rents in the manner required by state law and that notifies the tenants properly is entitled to receive the income stream from that point until foreclosure.

Even the lender that does not insist upon an assignment of leases and rents will care greatly about the status of the property's tenants, because the value of commercial property is a function of its income stream. Such a lender may not have direct access to the rents before foreclosure — particularly in a lien theory state — but a reduction in or loss of those rents will lead to a lower foreclosure price and a greater risk that the lender will suffer financial injury.

73. For a good discussion of subordination, nondisturbance, and attornment agreements, see generally Arnold B. West & Sidney A. Keyles, *Does the A in Your SNDA Work?*, 7 PROB. & PROP., Sept.-Oct. 1993, at 54.

74. If the price of reinforced steel were to double overnight, the value of existing steel structures would be likely to rise, reflecting the fact that they suddenly are a rarer, more valuable, and more difficult to replace asset. See, e.g., Chris Fiscus, *Ripple Effect: Hurricanes Andrew, Iniki Make Waves on Local Lumber Prices*, PHOENIX GAZETTE, Sept. 19, 1992, at E1 (discussing enormous increase in plywood prices after Hurricane Andrew destroyed or damaged 85,000 homes in Florida and Louisiana). If interest rates go up, thereby causing the universe of potential buyers to shrink, property values drop accordingly. If Congress reduces the tax shelter benefits of investing in real estate, as it did in 1986, see *supra* notes 25-26 and accompanying text, then the price of real estate assets should drop. Most commercial property owners have little direct control over these physical and financial ingredients of value and recognize these risks as a regular part of their business.

75. During local labor shortages, wages rise, the number of tradespeople available to construct new buildings is small, and the number of people looking to rent or purchase existing structures is large. As a result, property values can be expected to increase. See, e.g., Nicole Runday, *Finding Laborers Is Hard Work*, TAMPA TRIBUNE, Apr. 30, 1998, at 1 (noting how local labor shortage has led to higher wages and higher home prices). Conversely, if the largest employer in town lays off half its work force, those former employees are likely to spend less. Commercial tenants in a mortgaged property whose rents are calculated as a percentage of store volume will pay less rent, thereby devaluing the property. See *supra* note 20 and accompanying text. If a significant portion of the property is occupied by tenants that are experiencing financial difficulty, the landlord will anticipate that some portion of their rents will never be paid and that vacancies may result, outcomes that lower the overall value of the property. See, e.g., *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 117 (2d Cir. 1994) (noting impact of vacancies on overall value of office building). An individual property owner may have somewhat more influence over local matters such as these, but still is unlikely to be able to control these types of risks in any significant way.

the person managing the property.<sup>76</sup>

A lender considering extending a loan will instruct its appraiser to scrutinize the entire collection of physical and financial property rights that the borrower has offered to mortgage and then to place a value on that set of rights. The lender well knows that subsequent buyers such as foreclosure sale purchasers are likely to calculate value in much the same manner. Particularly in a nonrecourse loan, in which the proceeds of a future foreclosure sale may be the sole source of repayment to the lender, the lender will want to guess at how potential future bidders will value the property and then will decide how much it is willing to lend on the basis of that calculation. The lender will determine how much it can lend against the mortgaged property only after its appraiser has examined the entire web of physical and financial features that together constitute the property and then placed a value on this tangled collection of attributes.

More worrisome to the lender is the fact that the borrower possesses the power to transform elements of the mortgaged property into personalty. Owners easily can convert physical components of the mortgaged property into personal assets of the borrower partnership. A shopping center owner might remove physical components of the structure and sell them for scrap, or a developer could purchase building materials with the proceeds of a construction loan and then sell them for cash before they are incorporated into the building. In each case, items that were a part of the mortgaged property or that were intended to become a part of the mortgaged property are transformed into or left as personal property. These personal assets, and the cash they later are exchanged for, might appear to be beyond the nonrecourse lender's reach.

Property owners also can transform financial components of the mortgaged property into personalty. The owner of a distressed shopping center might offer its anchor tenant a substantial rent discount in exchange for a prepayment of two years of that reduced rent. The owner thereby transforms a stream of twenty-four future monthly payments, to be enjoyed by the owner or owners of the center over that extended time period, into a discounted prepayment, to be fully enjoyed now by itself or by its partners. Any entity considering bidding on the property at a foreclosure sale during the next two years should discover that the anchor tenant will not be paying any rent for the duration of that period and should factor that foregone portion of the income stream into its calculation of the property's value, downgrading its bid accord-

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76. These skills include the ability to locate suitable tenants and negotiate desirable arrangements with them, the capacity to control and plan for business expenses, and the general expertise needed to manage and operate the property successfully as a going concern over a period of time. A capable manager with a good track record can significantly enhance the worth of the mortgaged property.

ingly.<sup>77</sup> The nonrecourse borrower transforms the rent that a particular tenant would pay over a protracted future period, which was a financial component of the security, into a lump sum cash prepayment to the borrower, which the lender or a subsequent owner of the property may be unable to recover.<sup>78</sup>

The mortgaged property turns out to be a form of security that is both blurry and permeable. It is legally blurry in that the parties operate against a

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77. This is not to say that a court will always enforce such agreements. See 11 U.S.C. § 548 (1994) (allowing bankruptcy trustee to set aside certain constructively fraudulent transfers); *Prudential Ins. Co. of Am. v. Allied Tower, Ltd.*, 874 P.2d 36, 40-41 (Okla. 1993) (rejecting improper lease amendment between distressed borrower and its tenant); RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.4 (1997) (allowing receiver to disaffirm this type of "sweetheart" agreement if it contravenes provisions of senior mortgage or if mortgage was in default when agreement was made and agreement is not commercially reasonable).

78. Actions of this type appear to meet the definition of waste. If so, a court may enjoin the borrower from acting in a way that will harm the property or may allow the lender to recover personally from the borrower after the borrower acts in a way that has harmed the property. See, e.g., *East N.Y. Sav. Bank v. 520 W. 50th St., Inc.*, 611 N.Y.S.2d 459, 462 (Sup. Ct. 1994) (granting nonrecourse lender's motion to enjoin cooperative corporation from reducing maintenance or rent paid by owners of cooperative units in building). Such a remedy may be granted even if the documents do not specifically authorize it.

Borrower actions such as these often are prohibited in the loan documents. It is common for the borrower to grant an assignment of leases and rents, which ordinarily will prohibit the borrower from accepting more than one month of rental prepayments from its tenants. Subordination, nondisturbance, and attornment agreements typically include similar prohibitions and thus would discourage some tenants from agreeing to large rental prepayments. See *Morrison & Senn*, *supra* note 58, at 10-11 (observing that legal treatment of prepaid rent is unclear and noting that these issues might be clarified in a subordination, nondisturbance, and attornment agreement).

The loan documents also may require the borrower to maintain a reserve fund of a certain size. A nonrecourse borrower that breaches this obligation by failing to establish the reserve fund or by distributing some or all of the fund to its partners could be seen as attempting to transform property that the lender may reach into property that is beyond the lender's grasp. See *id.* at 11 (suggesting that "funding and application of those reserves [might] constitute proof of the borrower's compliance with its maintenance obligations"); *infra* notes 119, 156. The fact that a reserve fund is required does not automatically imply that the lender may reach it personally, or may reach personally the borrower that fails to maintain or restore that fund. See, e.g., *United States v. Thompson*, 272 F. Supp. 774, 778 (E.D. Ark. 1967) (describing note with partial recourse under which assuming grantees would not be liable for failure to make payments into reserve fund for replacements), *aff'd*, 408 F.2d 1075 (8th Cir. 1969). If the borrower has breached this obligation, however, a court should be more inclined to find that the borrower has committed waste.

Borrowers sometimes decide on their own to maintain a reserve fund. Tenant rent represents the proceeds of the property accruing during the current month while the reserve fund is a step further removed, consisting of proceeds that accrued over a longer period. The lender probably has a stronger claim to the current month's rent, which arguably should be applied to the current month's expenses, than it has to the balance of a voluntary reserve fund, which the borrower could have distributed earlier rather than retaining. *But see infra* note 115.



background of uncertainty to the extent that there are any pertinent unsettled questions of state law: The edges of the legal definition of this asset may not be sharp. It is financially blurry in the sense that its value can fluctuate dramatically from time to time. The mortgaged property is permeable in that the borrower easily may transform elements of this property, which appear to be part of the lender's security, into personal property, which may seem to be beyond the lender's grasp.<sup>79</sup>

Even scrupulously honest and fair parties may disagree as to whether seemingly well-meaning borrower actions transform vulnerable property into shielded property, given how porous the membrane between them is and given the compelling incentives for the borrower to traverse it. The nonrecourse lender will be more concerned than the full recourse lender about these legal and financial uncertainties because the nonrecourse lender has a great deal more to lose.<sup>80</sup> The blurriness and permeability of the mortgaged property translate into higher risk for the nonrecourse lender.

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79. Courts sometimes recognize that nonrecourse borrowers may intentionally act in a way that devalues the lender's security for their own benefit. *See, e.g., East N.Y. Sav. Bank v. 520 W. 50th St., Inc.*, 611 N.Y.S.2d 459, 462 (Sup. Ct. 1994):

This mortgage is a non-recourse mortgage and plaintiff's only security is the property. The Cooperative Corporation contends that plaintiff in this case is not entitled to a money judgment at all. But the "property" which secures the mortgage includes the rent roll. If the receiver's account is artificially reduced because the cooperative tenants seek to enrich themselves at the mortgagee's expense, the mortgagee will not receive the full value of its security and will not be able to recover the shortfall from anyone).

*Id.*

For a discussion of another aspect of the interconvertibility of different types of property, see *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186, 1200-01 (7th Cir. 1989) (holding that "the preference-recovery period for outside creditors is one year [rather than the usual 90 days] when the payment produces a benefit for an inside creditor, including a guarantor"). This case, commonly known as *Deprizio*, appears to have been overruled by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994) (codified in scattered sections of 11 U.S.C.). *See, e.g., Pereira v. Lehigh Sav. Bank (In re Artha Mgmt., Inc.)*, 174 B.R. 671, 677 (Bankr. S.D.N.Y. 1994) (discussing effect of this legislation on holding in *Deprizio*). Nonetheless, the portion of the *Deprizio* discussion cited above illustrates the interconvertibility point nicely.

80. Generally speaking, neither the borrower nor the lender can lose any more than they have invested or committed to invest in the property. In a nonrecourse loan, the borrower typically has not committed to invest any more than its original equity contribution. Once that equity is gone, all further risk rests with the lender, which has waived its right to recover personally from the nonrecourse borrower. Given the high leverage typically found in commercial real estate projects, moreover, the lender is likely to have made a much larger financial commitment than the borrower has. The lender's loss is secondary to the borrower's, but it has the potential to be much greater. *See Barnes, supra* note 62, at 687-88 (observing that, while borrowers should remain liable for their torts "[u]nder nonrecourse loan provisions, lenders must bear the risk of their collateral losing value due to forces beyond the parties' control, such as the

### C. Moral Hazard and the Indispensability of Some Borrower Liability

Many lenders are willing to tolerate the financial risks of nonrecourse loans, granting their borrowers the financial security and tax advantages that those borrowers demand by agreeing not to seek personal recourse.<sup>81</sup> These same lenders, however, probably wish to preserve the psychological characteristics of full recourse loans, particularly the strong motivation that the fear of personal liability produces in most borrowers. Stated bluntly, even those lenders willing to forego personal claims against their borrowers want those borrowers to behave as though they believe and fear that their loans provide for full personal recourse. The two previous subparts began to illuminate the inherent inconsistencies between the financial and psychological aspects of nonrecourse loans. This subpart examines this moral hazard problem in greater detail.

If a borrower defaults, its lender forecloses, and the debt exceeds the net foreclosure sale proceeds plus the value of any backup security, then the nonrecourse lender may suffer a loss that a full recourse lender might have avoided.<sup>82</sup> The reason why the property sells for less than the debt may be important, however. At one extreme, the nonrecourse lender bears the risk that external market conditions will degenerate to the point at which it suffers a loss that it would not have suffered had the loan provided for full recourse.<sup>83</sup> Both parties recognize from the beginning that good planning, careful negotiation, and skilled professional management might be wholly undercut by rising interest rates, mounting local unemployment, and the insolvency of an anchor tenant. The nonrecourse lender gives up its personal claims against the bor-

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collapse of real estate markets. It is inappropriate for lenders to shift this risk with 20/20 hindsight.").

81. See *supra* Part II.A.2.

82. See *supra* note 32 and accompanying text. The lender that retains full recourse may not be significantly better off, because recourse to the borrower is only as valuable as the borrower itself. If the borrower is a partnership, however, the lender also has recourse to the personal assets of each of its general partners.

83. In *Eldridge v. Burns*, 142 Cal. Rptr. 845 (Ct. App. 1978), the court interpreted purchase money loan documents under California's antideficiency statute, which has the same effect as a nonrecourse provision, observing:

[I]t is clear that when the depreciation of the value of the security is occasioned, not by waste committed by the buyer-debtor, but by a general or local depression of property values, the buyer-debtor is to be protected. . . . There is no warrant for arbitrarily shifting all of the depreciation in the market value of the property from seller to buyer by enhancing the former's security.

*Id.* at 869. See generally *Cornelison v. Kornbluth*, 542 P.2d 981, 990-91 (Cal. 1975) (en banc) (making similar point, and also discussing ways in which waste and antideficiency legislation should be analyzed under different types of market conditions).

rower arising from these market conditions, with the result that a large portion of the lending risk that ordinarily resides with the borrower migrates to the lender.<sup>84</sup>

Conversely, the nonrecourse lender never should bear financial responsibility for intentional bad acts or gross negligence on the part of the borrower.<sup>85</sup> These types of actions often will run afoul of criminal, tort, or bankruptcy laws. Whether or not they do, the lender should be permitted to recover the damages that it suffers as a result of such misfeasance when a foreclosure sale fails to make it whole, even if the parties previously agreed that the loan would be nonrecourse.

Most cases fall between these two extremes, and a nonrecourse borrower that sees problems looming might begin to respond to these troubles in a variety of ways. First, the borrower might act responsibly, or even altruistically, exerting tremendous effort and perhaps spending additional funds in an all-out attempt to save the property. The altruistic borrower might act in this way even though it knows that the loan is nonrecourse and that it might be better off financially if it simply gives up. Second, the borrower might react more pragmatically, by allowing certain features of the property to deteriorate while still maintaining the property at a reduced level. This more pragmatic

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84. Lenders may resist accepting this risk at the outset or may attempt to lessen its effects by raising the borrower's required equity contribution, insisting on personal guarantees or other types of alternative security, or increasing pre-leasing requirements. *See* *Fidelity Mut. Life Ins. Co. v. Harris Trust & Sav. Bank*, 71 F.3d 1306, 1308-10 (7th Cir. 1995) (Posner, J.) (enforcing, under Illinois law, indemnity agreement that required borrower to remit tenant rents to its lender, in spite of fact that underlying note was nonrecourse); *see generally supra* Part II.A.2. But while a risk such as this can be resisted, minimized, or shifted to others in part, uncontrollable risks, by definition, can never be eliminated. If the borrower defaults, the lender forecloses, and external factors have caused the mortgaged property to depreciate to a level at which it sells for an amount less than the outstanding debt, then the nonrecourse lender suffers a loss that a full recourse lender might have avoided.

85. *See supra* notes 57-61 and accompanying text. The borrower that removes lighting fixtures and copper pipes from the building and attempts to sell them for their salvage value hardly can complain when the court refuses to afford it nonrecourse protection for the damages that these extractions caused. *See supra* notes 74-80 and accompanying text. The borrower that solicits a steeply discounted prepayment of the next year's rent from a major tenant, distributes these rent proceeds to its partners, and then abandons to the lender an asset that will produce a greatly reduced cash flow should not be insulated from personal liability to the lender. *See supra* notes 77-78; *see also* *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 117 (2d Cir. 1994) (describing negative effects on lender of large distribution by borrower). The developer that diverts monthly construction draws to another project not encumbered by the lender's mortgage and then surrenders to the lender a building worth less than the outstanding debt should be forced to reimburse the lender even if the lender agreed to a nonrecourse loan. *See supra* notes 30-32 and accompanying text. Similarly, the borrower that procures a loan through fraud hardly can complain when a court pierces the nonrecourse language contained in the documents. *See supra* notes 57-61 and accompanying text.

borrower recognizes that the finite funds available are insufficient to meet all of the property's needs and that these limited funds must be budgeted to address only the most serious problems. Third, the borrower might react more selfishly, by beginning to transform realty into personalty or simply by failing to transform personalty into realty in situations in which it otherwise would have.<sup>86</sup> This more self-centered borrower acts out of its belief that business failure is nearly inevitable, and sees no reason to expend effort or funds to maintain the value of property it soon will lose.<sup>87</sup>

The boundaries between these different types of behavior are indistinct, of course, and many borrowers will act inconsistently. A borrower might choose two or more of these approaches concurrently or change its approach over time. This is not to suggest that borrowers are irrational or foolish, although some of them certainly are. Borrowers may adjust their responses over time as conditions change, and they sometimes will have to act before

86. See *supra* notes 77-80 and accompanying text.

87. The fear of this last sort of behavior is one of the rationales frequently given for having a law of waste. As Judge Posner notes in the context of the life tenancy:

[T]he common law doctrine of waste . . . mediates between the competing interests of life tenants and remaindermen. A life tenant will have an incentive to maximize not the value of the property, that is, the present value of the entire stream of future earnings obtainable from it, but only the present value of the earnings stream obtainable during his expected lifetime. He will therefore want to cut timber before it has attained its mature growth—even though the present value of the timber would be greater if the cutting of some or all of it were postponed—if the added value from waiting would enure to the remainderman. The law of waste forbade this.

RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 83 (5th ed. 1998). Because of these same concerns, the analysis of waste in the context of the nonrecourse loan that is offered in the next subpart parallels the traditional law of waste. Compare *infra* notes 96-98 and accompanying text (proposing test to determine when nonrecourse borrowers should be found personally liable for waste) with *infra* notes 143-50 and accompanying text (discussing traditional law of waste).

These concerns are even more relevant in the case of a mortgage that is nearing default. If the borrower has resigned itself to a very short remaining tenure, it has strong incentives to cut timber quickly or, in the case of commercial real estate, to act in other similar ways. This borrower, in effect, acts like a life tenant with very little time left to live. See *Travelers*, 14 F.3d at 120 n.7 (noting how use of waste doctrine may correct improper incentives facing mortgagors); see also *Williams v. Kimes*, 949 S.W.2d 899, 900-01 (Mo. 1997) (en banc) (recognizing right of holder of recorded contingent remainder to receive notice of private foreclosure from lender); POSNER, *supra*, at 82-84 (discussing incentives facing tenants that wish to improve property that they lease); *infra* notes 96-98 and accompanying text.

This problem does not end when the mortgagor defaults; in fact, there is the potential for it to get worse. See J. Philip Rosen et al., "*Travelers*" *Redux*: 2d Circuit Rules on Waste and Non-Recourse Liability in N.Y., N.Y. L.J., June 29, 1994, at 5, 6 (observing how "it often seemed that any [post-default] effort [by the borrower] to avoid or delay foreclosure was justified, on the grounds that, in the interim, the borrower or its affiliates might obtain benefits from continued operation and a turnaround was a possibility even if not expected," and concluding that after default, nonrecourse borrowers face "an 'all upside, no downside' situation").

they have access to all of the facts, or time for all of the forethought, they might desire.<sup>88</sup>

Any lender will care about how its borrower responds to adverse conditions, but the nonrecourse lender has more at stake than does the full recourse lender. In a full recourse loan, the lender wields an immense psychological stick, stating, in effect, "You may manage the property as you wish, but if I suffer a loss, you will pay." The threat of unlimited personal liability is sure to inspire a significant amount of fear in a borrower partnership and its partners. That fear, in turn, will motivate the borrower to act prudently and with respect for the lender's interests, even if the borrower's assets could not come close to making the borrower whole. The personally liable borrower may see little reason to conserve its funds if it believes that the funds it spends now may save the property while any funds it conserves will end up satisfying the lender's inevitable personal judgment anyway.

The zero recourse loan turns the full recourse loan on its head, with the lender effectively stating, "You may manage the property as you wish, period." The borrower may lose its equity in the property, but nothing more.<sup>89</sup> At one level, the lender is hardly in a position to complain about the unavailability of a remedy that it agreed in advance to waive.<sup>90</sup> But this problem extends beyond the loss of a financial remedy, for once the nonrecourse borrower believes that the property's value has dropped permanently below the outstanding amount of the debt, the borrower simply may resign itself to losing its investment in the property. This problem, a variation of the moral hazard problem described by scholars of law and economics, can be devastating to the lender.

"The tendency of an insured to relax his efforts to prevent the occurrence of [a] risk that he has insured against because he has shifted the risk to an insurance company is known as 'moral hazard.'<sup>91</sup> In a nonrecourse loan, the

88. See generally *Cornelison*, 542 P.2d at 990-91 (observing, in context of California's antideficiency statute, that "not all owners of real property subject to a purchase money mortgage commit waste solely or primarily as a result of the economic pressures of a market depression; indeed many are reckless, intentional, and at times even malicious despoilers of property," and concluding that "[i]n these latter circumstances . . . the purchase money lender should not go remediless").

89. The lender that agrees to a more detailed limited recourse loan modifies this statement somewhat, stating, "You may manage the property as you wish, but if I suffer a loss in any of the following enumerated ways, you will pay." This modified type of nonrecourse loan falls between the two extremes discussed in the text and eliminates some of the uncertainty that is this Article's concern. See *supra* Part III.A.

90. The lender also may have received some consideration in exchange for accepting this risk, in the form of a higher interest rate or an alternative credit enhancement device. See *supra* notes 19-23 and accompanying text.

91. POSNER, *supra* note 87, at 121.

lender acts as the insurer by promising the borrower that its potential losses are capped. The borrower's equity contribution serves much the same purpose as a deductible and offers the lender some assurance that the borrower will be attentive to the property's needs. If the borrower loses all its equity and is not required to contribute any further copayments, the lender has great cause for worry. The "insured" borrower will have little incentive to preserve the property any further if the entire remaining value of that property is pledged to another.<sup>92</sup>

The borrower may minimize its efforts to care for the property if foreclosure seems inevitable and its own personal losses are limited.<sup>93</sup> It will see little potential for gain from hard work and resourcefulness if any additional investment of time or money will do nothing more than raise the value of the property closer to the amount of the debt, thereby reducing the lender's loss without improving the borrower's position. Moreover, borrower inattention in the future will lead to no further borrower loss because the loan eliminates any risk beyond the amount already committed and lost. Therefore, the nonrecourse borrower is likely to view attempts to salvage troubled property as effort that might help the lender but not itself, and may simply resign itself to losing its previous investment or, worse, may scavenge whatever it can for its own benefit.<sup>94</sup> The absence of any remaining motivation to save the prop-

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92. See *Fidelity Mut. Life Ins. Co. v. Harris Trust & Sav. Bank*, 71 F.3d 1306, 1310 (7th Cir. 1995) (Posner, J.) (describing variation of problem discussed in text and noting that, on those facts, borrower "would be better off abandoning the property," "would gain nothing by collecting . . . rents," and "would be worse off" if it incurred expenses in collecting those rents); *Genesco Inc. v. Monumental Life Ins. Co.*, 577 F. Supp. 72, 85 (D.S.C. 1983) (finding nonrecourse borrower liable for waste and noting that, "[w]here the mortgagee may look only to the security for repayment, it is particularly equitable to allow an action for waste to be maintained"), *aff'd sub nom. Jaffe-Spindler Co. v. Genesco, Inc.*, 747 F.2d 253 (4th Cir. 1984).

Just as automobile renters are less likely than car owners to take care of their vehicles, nonrecourse borrowers are less likely than full recourse borrowers to spend their time and money trying to salvage a troubled property. See POSNER, *supra* note 87, at 85-86 (discussing short-term automobile rentals). Nonrecourse borrowers are more likely to view their interest in the property as temporary and to treat the property accordingly. Once their equity contribution is lost, they may take advantage of the "clean getaway" that is available. Even worse for lenders, nonrecourse borrowers may deplete the property for their own benefit — in effect, returning the rental car with a nearly empty gas tank.

93. See LoPucki, *The Death of Liability*, *supra* note 64, at 4 (observing, in another context, that "[t]he system by which money judgments are enforced is beginning to fail. The immediate cause is the deployment of legal structures that render potential defendants judgment proof" (footnote omitted)); *supra* note 64; *infra* note 98; see also GILMORE, *supra* note 60, at 15 (observing that Holmes-Williston general theory of contract law "seems to have been dedicated to the proposition that, ideally, no one should be liable to anyone for anything" (footnote omitted)).

94. Lenders have just the opposite incentives. See, e.g., *Shelden v. United States*, 34 Fed. Cl. 355, 368-69 (1995) (observing, in another context, that lenders have incentive to see that money is spent to maximize rents).

erty from foreclosure, such as fear of further losses, may transform the borrower's attitude from one of nervous creative energy to one of disinterest, apathy, or selfishness.<sup>95</sup>

Thus, there actually are two aspects to recourse, one of them financial and the other one psychological, and the typical nonrecourse lender probably wishes to relinquish only the first of these. This lender is willing, for consideration, to give up its right to a deficiency judgment from the borrower. But this same lender probably is not willing to accept the possibility that its now-shielded borrower will lose interest in the property and will let it deteriorate, or will rescue whatever it can for itself, once the borrower concludes that its equity contribution is lost. What the nonrecourse lender would like to do, if it can think of a way to do so, is to fashion a nonrecourse loan that the borrower does not learn is nonrecourse until after the gavel comes down at the foreclosure sale. It is the lost motivation of the nonrecourse borrower that the test proposed in the next subpart attempts to recreate.

*D. A Test to Determine When the Lender May Look Beyond the Mortgaged Property*

The test can be stated in its simplest form as follows:

*The lender may recover from the borrower to the extent that the lender shows it suffered losses caused by actions the borrower would not have taken had it been fully liable.*

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95. In discussing the history of waste law, the *Travelers* court observed that [a]n action for waste gave the owner a remedy against a tenant who undermined the long-term profit maximizing potential of the property in order to realize short-term gains. . . . In this way, it has been suggested by one commentator, the doctrine of waste developed to force tenants to manage the property as if they were the owner of the property.

*Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 120 (2d Cir. 1994) (citing RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 64-65 (3d ed. 1986)). The court further noted that the gradual evolution of the use of the waste doctrine to permit actions by lenders against borrowers is supported by the same rationale that originally supported the doctrine: it corrects incentives on the part of a mortgagor who anticipates default to deplete the collateral as much as possible before defaulting. Such an incentive leads to the inefficient use of property. Expansion of the doctrine of waste to mortgagor/mortgagee relationships removes this incentive.

*Id.* at 120 n.7; see also 8 POWELL & ROHAN, *supra* note 38, ¶ 638 (observing that waste law permits courts "to intervene to determine whether the current possessing party has overstepped the reasonable uses allowed under all the facts of the case").

These statements alone do not resolve the question of how to treat the nonrecourse borrower, for in the nonrecourse loan the court confronts the additional fact that the lender has voluntarily relinquished one of its most important remedies.

This statement does not mean that the lender always may recover – if it meant that, then the test would convert every nonrecourse loan back into a full recourse loan. Rather, the test means that the lender may recover only to the extent that it can prove that this borrower, shielded behind the nonrecourse provisions, acted in a way that differs from the way that it would have acted had it been fully exposed to liability, and thereby caused loss to the lender. If the nonrecourse lender cannot show that the borrower would have behaved any differently had it feared personal loss, then the borrower should not be held financially accountable.

This test attempts to create a reasonable default position for limited recourse loans that lack a specific statement as to the scope of the borrower's liability. Nonrecourse borrowers will not routinely be held liable, as that would undercut the financial expectations of many nonrecourse borrowers and would give a financial windfall to lenders who already have been compensated once for their relinquishment of a specific financial remedy.<sup>96</sup> At the same time, nonrecourse borrowers have a special responsibility to protect an asset of theirs that they have pledged to another as the sole security for repayment of a debt. A borrower that wishes to receive the numerous benefits of a nonrecourse loan has the concomitant obligation to treat its lender's concerns with the same degree of seriousness with which it would treat its own.<sup>97</sup> Any nonrecourse borrower that acts just as it would have acted had it

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96. A court that wished to find borrowers liable habitually would, in effect, be adopting a definition of waste that is broad enough to negate the nonrecourse provisions of the loan documents. This Article argues for a more balanced approach, on the assumption that the parties intended for this language to have some meaning, however poorly they drafted it. The fact that a nonrecourse loan is riskier to the lender should not, by itself, make the court any more inclined to rule in the lender's favor.

97. The test established here differs from the prudent person standard familiar to trust lawyers. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 11-2.3(b) (McKinney Supp. 1998) (describing elements of prudent investor standard under Uniform Prudent Investor Act). A commercial borrower is not a fiduciary for its lender and, like other business persons, is free to act in ways that a fiduciary never could. See, e.g., *infra* Parts III.D.1-3. Prudent trustees shy away from speculative real estate investments due both to personal prudence and fear of liability. Commercial borrowers, in contrast, are entrepreneurs, and often are imprudent even with their own money. The test proposed here requires only that the borrower treat the lender's interest as it would treat its own. It does not, however, demand that the borrower treat its own interest with any particular degree of prudence.

Some borrowers may be particularly rash even when their own money is at risk. The lender that extends credit to these borrowers on a nonrecourse basis should constrain their actions in the loan documents. See *infra* notes 105-08 and accompanying text. The test proposed here does limit the behavior of these borrowers to some extent by demanding that they adhere to a weak version of the reasonable person test, but the most reckless borrowers are the ones that will be the least constrained by this limitation. See *infra* Part III.D.3.

A more significant check on the behavior of these borrowers arises from the fact that lenders that commence waste actions are bringing tort claims and not contract claims. This



been fully liable should not be held responsible for its lender's losses.<sup>98</sup>

Three corollaries follow from this bare statement of the test. First, the nonrecourse lender implicitly agrees to defer to the borrower's professional judgment and generally bears the risk of poor business decisions by the borrower. Second, because nonrecourse loans are loans in which the borrower's losses are capped, the nonrecourse lender suffers those losses that were inevitable no matter how the borrower acted. Third, the lender carries the burden of proof. Each of these corollaries is explored below.

*1. The Lender Implicitly Agrees to Defer to the Business Decisions of the Borrower, Absent Express Agreement to the Contrary*

Every lender, whether or not it retains personal recourse against its borrower, knows that it places a large part of its economic fate in the hands of a borrower entity that will have to make numerous business decisions every day. Lenders defer to their real estate borrowers in matters of real property management, because lenders are primarily in the business of evaluating requests for credit and monitoring the loans that result while borrowers possess expertise in operating real estate.<sup>99</sup> The lender that agrees to a loan not only has agreed that the mortgaged property constitutes acceptable collateral but also has decided that the borrower's property management skills are satisfactory.<sup>100</sup> In return for receiving funds, the borrower pledges to the

means that the court can award punitive damages to the lender in extreme cases. *See, e.g.,* *Manson v. Reed*, 231 Cal. Rptr. 446, 453 (Ct. App. 1986) (awarding punitive damages in case in which borrower committed fraud). The threat of punitive damages, if they are likely enough and sizable enough, should deter borrowers from engaging in reckless or intentionally malicious behavior. *See generally* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869 (1998) (examining deterrent effect of punitive damages).

98. In comparing the nonrecourse borrower to a fully liable borrower, this analysis assumes that the fully liable borrower has something of value to lose, or has general partners with something of value to lose. The fully-liable-but-judgment-proof borrower would not be a fair foil for the nonrecourse borrower and would, in fact, be subject to the same temptations as the nonrecourse borrower. *See supra* Part III.C; *see also* LoPucki, *The Death of Liability*, *supra* note 64, at 89 (stating that "Americans do not want judgment-proof businesses to be able to operate, but neither do they want to exclude persons of moderate means from participation in the economy," and observing that this tension has led to system in which persons of limited financial responsibility have been allowed to participate in most aspects of economy and to have their debts excused when they cannot pay them); *supra* notes 64, 93.

99. Lenders also may fear adverse consequences under tort and environmental laws if they assume too great a role in day-to-day management. *See, e.g.,* 42 U.S.C. § 9607(a)(1) (Supp. II 1996) (imposing liability for certain environmental cleanup costs on "owner[s] and operator[s] of a . . . facility"); 42 U.S.C. § 9601(20)(E)-(F) (Supp. II 1996) (defining "owner or operator").

100. *See* Leipziger, *supra* note 32, at 1111:

lender a significant asset over which the borrower ordinarily retains nearly complete management control.<sup>101</sup>

This issue of control is unusually important in nonrecourse loans, in which the property is the sole source of repayment of the debt. The lender that has agreed not to look to the borrower will care far more about the fate of the property than it otherwise would. Once the nonrecourse borrower begins to believe that it is likely to lose the property, however, its time horizon becomes shorter than that of the lender, and it may react to a critical financial emergency by simply reconciling itself to losing its prior financial investment.<sup>102</sup> If the borrower perceives that there is no opportunity to gain and nothing further to be lost, it may take advantage of this absence of any further financial stake by neglecting or even milking the property.<sup>103</sup> In short, management control over this important asset rests with a borrower that may become disinterested in or hostile toward the property just as the property's importance to the lender peaks.<sup>104</sup>

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It has long been recognized that the mortgagor has dominion over the mortgaged property and may deal with it as if he were the owner. . . . Thus the mortgagor has considerable discretion in deciding how to manage the property, including the right to decide, within reasonable limits, whether it is economically sound to incur the cost of repairs.

*Id.*

101. Even in title theory states, in which the documents ostensibly convey the mortgaged property to the lender, the borrower retains actual control over the property at least until default, either by law or by language routinely included in the documents. *See generally* NELSON & WHITMAN, *supra* note 27, § 4.1, at 128-29 (discussing operation of mortgages in title theory states today).

102. The owner also may manage the property inadequately. *See* *Micuda v. McDonald (In re Evergreen Ventures)*, 147 B.R. 751, 753-54 (Bankr. D. Ariz. 1992) (finding that, in accordance with distressed owner's request, "roofing repairs were improperly made . . . producing unstable roofs and short-lived repairs. These repairs were performed in anticipation of a workout with the [lender], but the parties never completed an agreement. Despite the limited repairs, general maintenance of the facilities declined markedly."), *aff'd in part*, 174 B.R. 350 (B.A.P. 9th Cir. 1994).

103. *See* NELSON & WHITMAN, *supra* note 27, § 4.42, at 218. "When a mortgagor becomes resigned to the eventual loss of the mortgaged real estate, he or she frequently attempts to squeeze as much money out as possible before surrendering it. This process is often referred to as 'milking.'" *Id.*; *see* *People v. Bell*, 53 Cal. Rptr. 2d 156, 161-70 (Ct. App. 1996) (upholding California statute that criminalizes rent skimming); *Prudential Ins. Co. of Am. v. Allied Tower, Ltd.*, 874 P.2d 36, 40-41 (Okla. 1993) (rejecting improper lease amendment between distressed borrower and its tenant); *cf.* *Mills v. Sdrawde Titleholders, Inc. (In re Mills)*, 841 F.2d 902, 905 (9th Cir. 1988) (finding that borrower who suffered substantial losses had not engaged in milking).

104. From a purely financial standpoint, the severely distressed nonrecourse borrower will be sorely tempted to maintain or enhance the value of its personal assets at the expense of the real estate. If the loan has become seriously troubled, then the value of the real estate to the

The nonrecourse lender should anticipate that the borrower's interests could diverge from its own and should demand loan covenants that constrain the borrower's management discretion.<sup>105</sup> Lenders that wish to include detailed standards of operation in the documents are as capable of doing so as are sophisticated commercial tenants.<sup>106</sup> Failure by the borrower to meet these detailed standards would trigger an early default that will notify the attentive lender of problems while the borrower still has some equity in the property and will afford the lender the timely opportunity to take advantage of a wide array of pre-foreclosure remedies.<sup>107</sup> The lender also must remember to insist on partial recourse or some other type of financial assurance that these loan covenants will not be breached.<sup>108</sup>

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nonrecourse borrower is beginning to approach zero, and the borrower probably perceives no risk of further personal loss.

The borrower who is personally liable and possesses assets of value will see things differently, because a decrease in the value of the real estate will lead to a dollar-for-dollar increase in any potential deficiency judgment. *See* FDIC v. Prince George Corp., 58 F.3d 1041, 1046 (4th Cir. 1995) (recognizing that full recourse lender is entitled to deficiency judgment).

105. *See, e.g.,* Rosen et al., *supra* note 87, at 6 (offering illustrations of items that might be specifically excepted from blanket nonrecourse language); Joshua Stein, *Lender's Model State-of-the-Art Nonrecourse Clause (with Carveouts)*, PRAC. LAW., Oct. 1997, at 31, 40-54 (offering detailed form nonrecourse clause, along with shorter alternative form); J. Stein, *supra* note 17, at 6-9 (listing items for which lenders might demand carveouts from nonrecourse treatment and other items for which lenders ordinarily would not demand carveouts); John G. Wharton, *Negotiating Carveouts to Non-Recourse Loan Documents*, PRAC. REAL EST. LAW., Nov. 1997, at 47 (discussing this issue and offering form language).

106. The long term commercial tenant may find itself in a position similar to that of the nonrecourse lender. Both the tenant and the lender hold significant interests in real estate that is owned by another. The tenant pays rent in exchange for the use of the property during the lease term. The lender advances the principal to the borrower in exchange for the right to foreclose on the property if the borrower does not repay the debt.

Both the tenant and the lender, then, need to ensure that their respective counterparts maintain the property up to a certain standard for the duration of their relationship. In contrast, both the commercial landlord and the borrower may be motivated to spend the lowest amounts allowable under their respective documents, particularly if they are experiencing financial difficulties. The distressed landlord has little incentive to provide any more heat or air conditioning than the lease requires it to, which means that the tenant had better state its requirements in the lease. The distressed nonrecourse borrower has little incentive to maintain property that it believes it soon may lose, which means that the lender had better include management standards in the loan documents, with recourse. Note also that a single entity often will be both a borrower and a landlord at the same time. *See generally supra* notes 87, 91-95 and accompanying text; *infra* notes 143-50 and accompanying text.

107. *See supra* notes 27-29 and accompanying text. Even after default, the lender may be reluctant to act, out of a fear of incurring environmental or tort liability. In addition, meaningful action may take time, with the lender impatiently waiting for a grace period to expire or for a court to appoint a receiver.

108. The nonrecourse lender that remembers to include a covenant requiring the borrower to perform a given obligation but forgets to provide for personal liability for failure to meet that

The nonrecourse borrower pressed to make these management concessions may respond that if restraints on its flexibility force it to spend more of its own money or time on the property after trouble strikes than it otherwise would have, then the lender is importing a type of indirect, limited recourse.<sup>109</sup> In fact, that is precisely what the lender is trying to do. For if real world nonrecourse loans truly are limited recourse loans, then the parties need to establish at the outset just how limited that recourse is or else risk suffering the consequences of this ambiguity later on.<sup>110</sup> By specifying exactly what obligations the borrower has toward the property, with effective remedies available for breach of these obligations, the documents are constraining the borrower's discretion and shifting some management control back to the lender.<sup>111</sup> The parties are agreeing on exactly how limited the borrower's recourse is and, in effect, are defining the mortgaged property with precision.<sup>112</sup>

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obligation may find itself unable to recover personally for the borrower's failure to perform. Mortgages generally contain language requiring that the borrower maintain the property and pay real estate taxes, but these provisions alone are unlikely to lead to borrower liability in a nonrecourse loan. The borrower is sure to point out that the mortgage contains similar standard language requiring it to pay principal and interest, an obligation that obviously will not be enforced personally in a nonrecourse loan. A court is likely to find that nonrecourse terms specific to this particular transaction override the more standard covenants, so the lender needs to make sure that the documents not only require the borrower to meet these maintenance and tax obligations, but also provide for personal recourse in the event of a breach. *See, e.g., Smart v. Tower Land & Inv. Co.*, 597 S.W.2d 333, 336-37 (Tex. 1980) (finding that lender may pay real property taxes on behalf of borrower that fails to do so and may add amount of those taxes to mortgage debt, but may not recover personally from its nonrecourse borrower).

109. The assets that a nonrecourse borrower may wish to protect from the lender are not limited just to funds. Those assets also include the borrower's time and attention. If the borrower is subject to personal liability, it may spend more of its own time on the project, thereby transforming an otherwise unreachable personal asset — its labor — into a reachable real asset — the increase in the value of the property that is attributable to that labor. To the extent that a mortgage loan possesses some of the attributes of a personal services contract by the borrower, it would not be unreasonable for the nonrecourse lender to demand performance standards for those services, with some recourse available for failure to meet those standards. *See supra* Part III.B; *infra* note 112.

110. *See supra* Part III.A.

111. It also is possible for the borrower to agree in advance how it will respond after default. For example, the parties might determine that the loan will become nonrecourse if the borrower cooperates during the foreclosure process. *See, e.g., Morrison & Senn, supra* note 58, at 9 (observing that "[t]o discourage use of frivolous defenses as a delaying tactic, some lenders provide that their loans become fully recourse if the borrower resists foreclosure or other enforcement proceedings," and questioning whether courts will enforce such provisions if borrower files for bankruptcy or raises usury defense); *Rosen et al., supra* note 87, at 6 (describing use of such "vanishing recourse" loans).

112. *See supra* Part III.B. It may sound odd to suggest that the parties can define the mortgaged property more precisely by detailing exactly when the borrower must spend its time and money on the real estate, but it is not. A portion of the problem that this Article addresses arises

The borrower may decide to take a much different approach, arguing that the lender's relinquishment of a powerful remedy constitutes tacit permission for the borrower to act more aggressively than it otherwise would. If this is what the parties intended, as it might be in some cases, then they should clarify the point in their documents. The nonrecourse borrower that desires more operational freedom than it usually has, like the nonrecourse lender that wants stricter constraints than it ordinarily demands, must raise the issue during the negotiations. The bare presence of the term "nonrecourse," with nothing more, should not be interpreted as sanctioning rash behavior. The default rule proposed here represents an intermediate and balanced starting point, one that reminds both parties that they must insist on any departures from it before the documents are signed.

The parties to nonrecourse loans should take great care to describe the borrower's obligations with precision. If they fail to do so, then courts should be wary of holding the borrower liable in cases in which the borrower's unfortunate but nonmalevolent actions devalue the real estate. There is little justification for further penalizing the borrower who proves to be nothing worse than foolhardy, incompetent, or unlucky, particularly when that borrower possessed the initial foresight to insist upon a nonrecourse loan and its lender failed to take the precaution of limiting the borrower's flexibility. The nonrecourse lender should suffer the consequences of its original poor decision to place its financial fate so extensively in the hands of a borrower for which things went badly. This is not the type of borrower that treats a nonrecourse loan as a license to act differently than it otherwise would have and is not the type of borrower that this Article's proposals are designed to constrain. If the court second-guesses every business decision that the borrower makes and holds the borrower personally liable for every ill-considered or unfortunate choice that turns out to have devalued the property, then the court inappropriately begins to convert the loan back into a full recourse loan.<sup>113</sup>

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because the parties do not adequately define the mortgaged property, which is the only asset to which the nonrecourse lender has access. Given the distressed nonrecourse borrower's natural inclination to let a doomed asset deteriorate, *see supra* Part III.C, the lender will worry that the real estate will be an inadequate resource by the time the lender can derive some benefit from it.

This problem can be reduced by specifying exactly what obligations to maintain this secured asset the otherwise nonrecourse borrower has, with recourse, thereby offsetting the borrower's tendency to preserve or enhance its personal wealth at the expense of the real estate. If the nonrecourse lender believes that its security includes a certain amount of the borrower's time, attention, effort, and money, then it should be particularly careful to define these components of the mortgaged property in the documents. The mortgaged property, then, turns out to be the real estate, augmented by all of these additional, personal elements. *See supra* note 109. The existence of these other components of the mortgaged property provides another reason why the definition of the mortgaged property may seem so blurry. *See supra* Part III.B.

113. If the borrower's breach "is due to the property's inability to generate sufficient

## 2. Some Lender Losses May Be Inevitable

Every decision not to spend money to replace a cracked window promptly is, in some sense, a decision that hastens the conversion of realty into personalty. The nonrecourse borrower opts to preserve its personal assets, which the lender cannot reach, rather than restoring the value of the real property, which might ultimately inure to the benefit of the foreclosing lender. This inaction, devalues the property physically, in the sense that a slightly damaged building is worth less than an unblemished one, and it devalues the property financially, as business invitees become less willing to patronize establishments at the property and tenants become less willing to pay their rent or renew their leases. Such a decision may be seen as one in which the borrower commits passive waste by failing to transform personalty into realty in a setting in which such a transformation ordinarily would be expected.<sup>114</sup>

The fact that the loan is nonrecourse, however, means that the parties have expressly or implicitly agreed that the borrower's obligation to spend money is capped at some finite amount – perhaps the amount of cash originally contributed by the partners plus all income generated by the building.<sup>115</sup>

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income amid a decline in the real estate market, then it is a reflection of the same market risks that the lender assumes in a non-recourse mortgage." Walter F. Leinhardt & Mitchell L. Berg, *Real Estate*, NAT'L L.J., Dec. 25, 1995-Jan. 1, 1996, at B4.

114. The failure to maintain the property physically or financially may constitute passive waste. See *infra* Parts IV.A-B. To avoid this type of waste, the owner may have to invest its funds and effort to preserve or restore the value of the realty. See *infra* Parts IV.A-B.

115. This "lockbox" approach seems to offer a reasonable estimate of the maximum financial obligation of the typical nonrecourse borrower, although this estimate raises ambiguities of its own. Compare *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 123 n.9 (2d Cir. 1994) (observing that "the fact that the taxes had to be paid from [subsequent] rental income suggests that the distribution of the Partnership's accumulated cash assets and the Partnership's subsequent failure to pay taxes decreased the value of the Property") with *id.* at 128 (Mishler, J., dissenting) (arguing that damages for waste should be reduced "to the extent that rental income for the [subsequent] period is available for payment of taxes"). Even if a project has not been self-sustaining so far, it might become so in the future, and the judges in *Travelers* seem to disagree as to how far into the future the court ought to look to balance the books.

See generally *HomeCorp v. Secur Bank*, 659 So. 2d 15, 20-21 (Ala. 1994) (concluding that assignment of leases and rents gives nonrecourse lender access to all rents collected from tenants, reduced by amount needed to operate and maintain property, and access to all tenant security deposits held by borrower); *Ezriel Equities Assocs. v. 157 E. 72nd St. Assocs.*, 638 N.Y.S.2d 470, 471 (App. Div. 1996) (holding that receiver's decision to use tenant rents to pay condominium common charges takes priority over lender's right to retain those rents); J. Philip Rosen & Stephen B. Kaplitt, "*Travelers*": *Confusion in Non-Recourse Arena?*, N.Y. L.J., Feb. 11, 1993, at 1, 36 n.44 (expressing concern that *Travelers* court's approach "may require the debtor to hold all revenues in trust to cover 'future' operating expenses, an anomaly in light of current non-recourse law").

This uncertainty highlights once again the importance of detailing in the documents just what the borrower's obligations are and how much money and time it is agreeing in advance

This liability ceiling is a chief reason why borrowers request nonrecourse loans. If the amount that the nonrecourse borrower committed to spend is insufficient to meet all of the needs of the property, then the borrower need not commit additional funds and some obligations will not be met.<sup>116</sup> Thus, the description of the cracked window disregards the fact that the borrower may have been performing triage in a situation in which some lender loss was inevitable.<sup>117</sup>

If the borrower, in spending all of the funds it was required to spend, opted for an electrician rather than a glazier, the court must begin with the assumption that the borrower believed the funds spent on the electrician would benefit the property at least as much as the funds spent on the window repair would have. The borrower faced an unenviable decision as to which of two different types of deterioration to suffer, and the court should not penalize it for choosing the one it thought would cause the lesser harm to the property.<sup>118</sup> Both parties benefit if the party charged with maintaining the

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that it must spend. The loan documents, and perhaps the borrower's governing documents, should address such questions as whether and when the partners of the borrower are entitled to receive distributions, whether they ever are obligated to contribute additional funds, which capital improvements the borrower must undertake and when, and whether the borrower must maintain a reserve fund. *See, e.g.,* *Thompson v. United States*, 408 F.2d 1075, 1080-81 (8th Cir. 1969) (finding general partners of nonrecourse borrower personally liable after partnership withdrew funds earmarked for reasonable operating expenses and necessary repairs and used them to pay legal fees, to equip part of premises as private club, and to reimburse partners for prior advances). The assignment of leases and rents should specify exactly what rights the lender has in the cash flow generated by the building and when those rights accrue. *Cf. Vector Realty Group, Inc. v. 711 Fourteenth St., Inc.*, 711 A.2d 1265, 1267-69 (D.C. 1998) (holding that mortgagee's claim to tenant rent and to reserve fund took priority over claim of judgment lien holder and allowing mortgagee to apply these sums to reduce debt). All of these decisions must be made with appropriate consideration for the effect of federal and state fraudulent conveyance laws. *See infra* Part IV.C.1.

116. The court in *Spencer's* seems to have overlooked this point, *see infra* notes 174-91 and accompanying text, while the court and the dissenter in *Travelers* did not, *see supra* note 115. *See also* *Lexington 360 Assocs. v. First Union Nat'l Bank*, 651 N.Y.S.2d 490, 493 (App. Div. 1996) (observing that "the property's net operating income was inadequate to service the \$42,000,000 debt at the time of the alleged misapplication and that foreclosure was inevitable, if not on the basis of the arrears documented in the record, then certainly on the basis of the principal remaining unpaid after maturity").

117. *See infra* note 188 and accompanying text.

118. The point discussed in this section dovetails with the point discussed in the previous section. *See supra* Part III.D.1. The previous section addressed cases in which the lender loses because the borrower, acting within the scope of its permitted discretion, was unlucky or made a decision that turned out badly. This section addresses cases in which loss was inevitable no matter how the borrower acted. It may be difficult to determine, after the fact, into which of these categories a given decision falls. Under the test proposed here, such a determination becomes unnecessary.

property, and most familiar with it, uses all of its available but limited funds in the way it believes most beneficial to the property.<sup>119</sup> If the borrower is held liable for a negative result that it attempted to minimize and that may have been inevitable no matter which repair it elected to make, then the borrower is paying for the fact that the property cannot support itself.<sup>120</sup>

119. Some expenditures, such as distributions to the partners, *see supra* note 115, *infra* Part IV.C.1, or even payment of principal and interest, *see infra* notes 123-26 and accompanying text, raise additional questions. On the other hand, the borrower need not always spend all available funds. For example, maintaining a reserve fund may represent good business practice, particularly if current demands, while significant, are not emergencies.

For a good analysis of the types of expenses that a nonrecourse lender to a single-asset real estate borrower is deemed to have approved in advance, in the context of a Chapter 11 bankruptcy proceeding, see *In re Willowood E. Apartments of Indianapolis II, Ltd.*, 114 B.R. 138, 143-44 (Bankr. S.D. Ohio 1990). The court stated:

Lincoln must have known that some portion of the gross rents would be required to keep the Property operating. . . .

Thus, the Court finds that Lincoln's interest in assigned rents effectively extends only to net Rents after payment of ordinary, necessary expenses required to maintain and operate the Property to preserve its value. . . . Effectively, Lincoln's security interest in the Rents is limited to those Rents remaining after the payment of reasonable expenses attributable to the Property.

*Id.* The court then proceeded to list acceptable expenses, including payroll; utilities; insurance; marketing, advertising, and management fees; ordinary and necessary repairs and maintenance (but not capital expenditures); taxes; bookkeeping and accounting fees; and other reasonable business expenses. *Id.* at 144.

120. The borrower also may question the extent to which it should be expected to make capital improvements, as opposed to undertaking ordinary maintenance. The Supreme Court of North Dakota recognized this point in the context of a breached contract for deed, after the seller took the property back and then brought an action against the buyer for the cost of replacing the roof. The court stated:

If recovery of the replacement cost of the roof were allowed in this case, the Vogels would be unjustly enriched. The Vogels sold the Partners an eighteen-year-old building with an eighteen-year-old roof. There was testimony that the normal useful life of a roof of this type was approximately twenty years. During the period that the Partners were in possession, the roof reached the end of its useful life through ordinary depreciation, wear, and age. If the Vogels were allowed to now recover the replacement cost, they would enjoy the benefit of a brand new roof with another twenty year life expectancy. Conversely, the Partners, through the happenstance of possessing a building with a roof nearing the end of its useful life, would be forced to bear the cost of its replacement, even though the roof required replacement through no fault of their own. Clearly, such a result would unjustly benefit the Vogels. We conclude that the trial court did not err in refusing to award damages for the replacement of the roof.

*Vogel v. Pardon*, 444 N.W.2d 348, 350 (N.D. 1989).

If this defense were to fail, the borrower or contract vendee still could argue that it is responsible only for that portion of the capital cost that is attributable to its period of possession. *See, e.g., id.* at 350-51 (awarding actual value, rather than replacement cost, for furniture that contract vendee discarded or sold).



Nonrecourse provisions are supposed to shield borrowers from these kinds of losses.<sup>121</sup> Even if the failure to repair the window is seen as passive waste, the borrower that already has spent all it is required to spend will have committed a tort without damages.<sup>122</sup>

The distressed borrower's decision whether to pay principal and interest can be a tricky one.<sup>123</sup> The borrower may reason that if its resources are inadequate, it ought to meet all its other commitments first, as its principal and interest burden is the one obligation for which it is not personally liable.<sup>124</sup> However, nonpayment of principal and interest telegraphs the borrower's

121. See *Mills v. Sdrawde Titleholders, Inc. (In re Mills)*, 841 F.2d 902, 904-05 (9th Cir. 1988) (rejecting claim of waste under California law in case in which borrower's failure to maintain might have resulted from bad faith but also might have been normal response to economic difficulties); *supra* note 116.

122. In addition, if the borrower commits waste but the value of the property remains greater than the amount of the debt, then the lender arguably has not suffered any loss. See, e.g., *Ginsberg v. Lennar Fla. Holdings, Inc.*, 645 So. 2d 490, 500 (Fla. Dist. Ct. App. 1994) (observing that, under Florida law, "in order for a mortgagee to allege waste against a third party the mortgagee must demonstrate that the mortgage security has been injured and is now worth less than the amount of the outstanding debt"); *Stevensen v. Goodson*, 924 P.2d 339, 349 (Utah 1996) (noting that, particularly in lien theory states, "[s]ince a mortgagee has neither possession of nor title to the mortgaged property, it may not maintain an action to recover for damage to the premises. The mortgagee's recovery is limited to the extent of the impairment of its security interest"). But see *supra* note 37 (noting that lender is damaged when loan-to-value ratio increases, even if ratio remains below one hundred percent); *supra* note 52 (addressing remedies available both before and after foreclosure); *infra* note 128 (discussing calculation of damages); *infra* note 161 (discussing relationship between loan-to-value ratio and lender's risk).

123. The California Supreme Court addressed this question in some detail, in the context of that state's antideficiency legislation. See *Cornelison v. Kornbluth*, 542 P.2d 981, 990 (Cal. 1975) (en banc). In discussing the impact on a borrower of a generalized economic downturn, the court observed that

[d]amages for waste would burden the defaulting purchaser with both loss of land and personal liability and the acts giving rise to that liability would have been caused in many cases by the economic downturn itself. For example, a purchaser caught in such circumstances may be compelled in the normal course of events to forego the general maintenance and repair of the property in order to keep up his payments on the mortgage debt. If he eventually defaults and loses the property, to hold him subject to additional liability for waste would seem to run counter to the purpose of [the antideficiency legislation] and to permit the purchase money lender to obtain what is in effect a deficiency judgment.

*Id.*

124. Cf. *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186, 1195 (7th Cir. 1989) (observing, in context of bankruptcy proceeding, that "insiders [who guaranteed loans from outsiders and are] bent on serving their own interests . . . could do so by inducing the [distressed] firm to pay the guaranteed loans preferentially"). Portions of this case were overruled by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (codified as amended in scattered sections of 11 U.S.C.).

distress to the lender, and the borrower might choose instead to mask its predicament by meeting its principal and interest obligation and deferring other commitments, the breach of which may be less obvious. The lender that later discovers such behavior might argue that, by neglecting its obligations in this less transparent way, the borrower has been passively liquidating the security and using the proceeds to meet monthly loan obligations. If the cash available to the nonrecourse borrower was insufficient, then the overall monthly shortfall will be the same size as it otherwise would have been,<sup>125</sup> but more months will have passed before the lender was alerted to the problem. This stalling mechanism, the lender will argue, constitutes waste, with the lender suffering damages equal to the amount by which its total losses increased after it otherwise would have learned of the problem and could have taken remedial action. If the lender can prove that its nonrecourse borrower acted in this way because of its insulation from liability, then the test this Article proposes would allow the lender to recover.<sup>126</sup>

### 3. *The Lender Carries the Burden of Proof*

The lender always has the burden of proof in an action for a deficiency judgment.<sup>127</sup> This burden is fairly light for the typical full recourse mortgagee, and the lender ordinarily can prove what it needs to by introducing easily obtained documents such as the note, canceled checks, and receipts.<sup>128</sup> The burden is far heavier when a nonrecourse mortgage is in dispute, with the

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125. See *supra* notes 117-22 and accompanying text; *infra* text accompanying note 189.

126. This point is particularly obvious, and the calculation of damages unusually easy, when the deterioration consists of a financial loss, such as a failure to pay real estate taxes, rather than a physical loss. See *infra* Part IV.B.

For an examination of a related problem in the context of the National Housing Act, see *United States v. Haddon Haciendas Co.*, 541 F.2d 777, 785 (9th Cir. 1976), in which the court concluded that:

[P]ermitting post-foreclosure damage actions should not discourage sound investors from participating in [federal housing] projects. It should only discourage them from hanging onto projects after losing the ability to maintain them. . . . To hold otherwise would serve only to encourage short-swing profiteering at the expense of the public investment by owners failing to deduct sums appropriate for capital improvement from rents.

*Id.*

127. See, e.g., *Eichman v. J & J Bldg. Co.*, 582 A.2d 182, 185-86 (Conn. 1990) (discussing claimant's burden of proof). This section focuses on post-foreclosure actions in which the lender pursues a deficiency judgment, but the analysis offered here should apply equally well to pre-foreclosure actions in which the lender seeks an injunction or damages.

128. Demonstrating the amount of damages may be extremely difficult prior to foreclosure. Cf. *Leipziger*, *supra* note 32, at 1118-29 (discussing when court should require lender to foreclose before it can recover damages); *supra* notes 37, 52, 122; *infra* note 161.

lender also having to demonstrate to the court why it should hold the borrower liable in spite of the presence of exculpatory language in the loan documents. Under the test this Article proposes, if the nonrecourse provisions are ambiguous, then the nonrecourse lender must show that the borrower acted in a way that it would not have had it been personally liable,<sup>129</sup> that the borrower's actions were more than just the ordinary discretionary activities of a property owner to which the lender is deemed to have consented,<sup>130</sup> and that the lender would have lost less had the borrower acted in some other way.<sup>131</sup> The nonrecourse lender that cannot make all portions of this difficult showing must lose.

In asking whether the nonrecourse borrower acted differently than it otherwise would have and whether those differences fall within the borrower's permitted discretion, a court will need to confront the question of whether the nonrecourse borrower is under any obligation to act reasonably. The borrower-lender relationship is unique in every commercial loan, involving documents that are tailored to a specific transaction and personal relationships between pairs of parties that sometimes act atypically. Given the extent to which the provisions of commercial loans are negotiated, particularly the nonrecourse provisions of loans in which the borrower had the forethought to seek exculpation, it would be improper for a court to intervene and to assume that a particular borrower involved in a distinct transaction should be held to some generic standard. No borrower in such a sophisticated transaction should be presumed to be a "reasonable" borrower, and the nonrecourse lender should be required to prove that this borrower acted differently than *it*, and not some hypothetical median borrower, would have acted had it been personally liable.

At the same time, no borrower should be given license to act in any way it chooses, shielded from liability by its knowledge of how difficult it will be for its lender to prove that it acted differently than it, rather than the typical borrower, would have acted had the loan allowed for full recourse. Instead of rejecting the reasonable borrower standard completely, then, courts should recognize that a wide spectrum of behavior is acceptable within these individualized relationships, while also acknowledging that behavior demonstrably outside of the range that the lender ought to have anticipated should lead to liability.<sup>132</sup> A prudent lender will undertake a high level of due diligence

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129. See *supra* notes 96-98 and accompanying text.

130. See *supra* Part III.D.1.

131. See *supra* Part III.D.2.

132. Nonrecourse lenders presumably have a high degree of confidence in the skills of their borrowers. See *supra* text accompanying note 20 (emphasizing heightened degree of confidence that nonrecourse lender must have in its borrower's expertise); *infra* note 182 and accompanying text (same); *infra* note 212 (same). This might imply that nonrecourse borrowers should be

review and will investigate its borrower's past transactions carefully. A borrower's performance in prior transactions should be highly probative of the type of behavior the parties are agreeing to accept as permissible in the current one. If the lender wants to constrain the borrower's actions any further, it must include these additional constraints in the documents.<sup>133</sup>

Unless the borrower acts in a manner well beyond the range of expected behavior, the lender that attempts to construct a case is likely to have to rely on prior real estate activities by this borrower or by its principals.<sup>134</sup> It may have to show the court how the managing partners of the borrower reacted to financial difficulties in earlier projects for which they were personally liable and how they succeeded in overcoming similar problems in the past. These will be difficult showings and may require the lender to undertake a detailed and complex examination of the borrower's books,<sup>135</sup> as well as the books of

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permitted more flexibility in their operations. If the lender has recognized a borrower as unusually skilled, then the lender should not interfere with this borrower and should trust it to act properly.

The lender is likely to respond that when it agrees to waive an important remedy, it expects its borrower to behave more prudently than it otherwise would. If nonrecourse borrowers face a reduced risk of personal loss, they will have a greater tendency to commit passive waste, *see supra* Part III.C, suggesting, perhaps, that they should be required to operate within a narrower range of discretion. Once again, thoughtful drafting can prevent any ambiguity.

133. This difficulty in inferring performance standards demonstrates again why it is so important for the lender to include detailed guidelines in the loan documents, with personal recourse available after a breach. If the lender fails to insist on management and operation standards beforehand, the court should be reluctant to import them later.

134. In attributing motives to an entity, especially a single-asset entity, the court actually is examining how the persons with management control of the entity act. The court should explore how these principals have acted in past real estate projects even if the owners of those projects were entities different from the borrower in the present case.

This examination is appropriate because it is so similar to the analysis most lenders undertake in evaluating any loan application. A lender often will be more concerned with the past performance of the borrower's principals than with the past performance of a particular borrower entity itself. It is particularly fitting for a court to take this approach when the loan is nonrecourse because nonrecourse lenders rely so heavily on the expertise of these principals.

135. Lenders always are well advised to monitor their loans carefully and expeditiously. A lender that sees trouble developing will have the opportunity to react quickly, perhaps by seeking the appointment of a receiver. This type of oversight will help to prevent the lender from later having to reconstruct where every dollar went. Any lender that waits until its borrower defaults before taking these precautions may find that assessing what went wrong and responding effectively are impossible or prohibitively expensive.

These options must be selected and employed with care. For example, the presence of a receiver does not ensure that the lender will jump to the head of the debt collection line. *See, e.g., Ezriel Equities Assocs. v. 157 E. 72nd St. Assocs.*, 638 N.Y.S.2d 470, 471 (App. Div. 1996) (recognizing right of receiver to require mortgagee to return tenant rentals so that they may be used to pay condominium common charges).

other entities in which the borrower's key management personnel have been involved. The lender also may attempt to make the necessary showing by contrasting how the borrower acted early in the disputed loan, when things were going well and the borrower still had equity to lose, with how the borrower acted later on, after it became clear that the borrower would lose its entire investment.<sup>136</sup>

The general partner of the borrower, for example, may have earned a reputation for making large cash distributions to its partners at every opportunity and then operating the business with the thinnest of cash cushions. This manager may be willing to take the risk of a cash shortage that leads to default, foreclosure, a deficiency, and personal liability, even in a full recourse loan. The partner might act in this risk-preferring way because of its experience of usually coming out ahead, with frequent successes outweighing occasional failures. If a lender, after conducting its due diligence review, lends to this borrower on a nonrecourse basis and without constraining the borrower's discretion over distributions, it does so with full awareness of the risks that this particular borrower presents. Even if most borrowers might act more conservatively, this specific borrower should not be treated as operating beyond the range of its permitted discretion if it behaves this time just as the lender knew it had behaved in the past. Only conduct that is egregious under the standard appropriate for this unusually aggressive borrower should lead to borrower liability.

When the borrower's past behavior does not so plainly reveal how the lender might have expected the borrower to act in the future, the court's only option may be to extrapolate based on the borrower's more generalized past activities. This option is unlikely to prove fruitful for most nonrecourse lenders. In the typical case, a court is likely to recognize a wide range of borrower behavior as acceptable under the circumstances, as it should.

The lender's burden does not end when it convinces the court that the borrower acted differently than it would have if it had been personally liable and that these differences went beyond the owner's authorized level of discretion. The lender also must prove that this behavior caused actual loss. The previous section offered a simple example in which the distressed borrower was forced to choose between repairing a broken window and fixing faulty wiring,<sup>137</sup> but

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136. The test proposed in this Article asks the court to estimate how a nonrecourse borrower would act if it were fully liable. If the borrower's project was initially successful, however, the court will not have to guess at this behavior and needs only to observe how the borrower acted in the early days of the loan, when the project was thriving. At that point, the nonrecourse borrower had something of significant value to lose and probably performed much like a full recourse borrower would have performed.

137. See *supra* Part III.D.2.

the facts facing actual owners will be more jumbled, the losses more gradual, and the challenge of proving those losses more difficult to overcome. The distressed property owner is unlikely to respond outrageously at the first whiff of trouble or to abdicate and allow the property to collapse overnight; more likely, it will be forced to relax standards gradually. As money becomes more scarce, the borrower likely will defer discretionary maintenance and cut back on building services little by little and will allow its reserve fund to stop growing and then begin to shrink.<sup>138</sup>

This management strategy may be designed selfishly to begin the borrower-protective processes of transforming realty into personalty and avoiding any unnecessary transformation of personalty into realty.<sup>139</sup> More likely, it will not be a strategy at all, but a series of context-sensitive, pragmatic decisions made over a protracted period of time. Each of these choices will have been formulated to conserve a slowly evaporating bank account so that funds are available for the inevitable expensive emergencies on which money may need to be spent quickly.<sup>140</sup>

More than at any prior time, the competent manager of distressed property needs to make difficult decisions and to conserve declining resources. Every such action by the distressed borrower likely is motivated by a combination of factors. These factors probably will change in relative significance from month to month, and only one of them will be the borrower's desire to preserve or augment its personal assets. Moreover, the self-defense component of the borrower's motivation typically will be a fairly minor consideration as the problems begin, when the owner still has significant equity in the property and probably believes that the misfortunes will not persist. It will be difficult for a lender to show that a managing partner's decision to conserve funds has ceased to be primarily a wise business choice under tough conditions and has become primarily an inappropriate personal enrichment measure. It will be just as difficult to prove the resulting damages.

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138. Cf. *Micuda v. McDonald (In re Evergreen Ventures)*, 147 B.R. 751, 760-61 (Bankr. D. Ariz. 1992) (discussing and rejecting mortgagor's "depreciation" defense, under which mortgagor argued that repairs that mortgagee later had to make were caused by ordinary wear and tear rather than by mortgagor neglect), *aff'd in part*, 174 B.R. 350 (B.A.P. 9th Cir. 1994).

139. See *supra* notes 86-87 and accompanying text.

140. Note how the discussion in this section ties in with those in the previous two sections. See *supra* Parts III.D.1-2; *supra* note 118. Part III.D.1 emphasized that the parties agree, explicitly or implicitly, that the lender will defer to the borrower's discretion to a great extent, and Part III.D.2 noted that some losses may be unavoidable. This Part III.D.3 has discussed the degree to which the borrower should be held to a reasonableness standard in exercising its discretion and has argued that the burden of proof belongs on the lender, a burden that may require the lender to scrutinize the borrower's finances in great detail.

#### 4. *Summary of the Proposed Test*

Wise nonrecourse lenders always will include provisions in their documents that specify management standards that their borrowers must meet and future financial obligations that they must undertake. These precautions help to define the mortgaged property and to avoid any uncertainties about the borrower's expected performance. Lenders are not always this prescient, however. This subpart has proposed a test that will help courts determine when to allow a nonrecourse lender access to the personal assets of its borrower and the partners of its borrower, a test that will permit some lenders to recover in spite of their failure to include or clarify critical language in the documents. The proposed test attempts to recreate the motivation to preserve the mortgaged property that full recourse borrowers always retain. Those lenders that can make the necessary showing will benefit from a test that recognizes that nonrecourse borrowers may become complacent or aggressively selfish once the loan becomes distressed.

A lender that hopes to recover under this test faces an uphill battle. It will have to carry the very heavy burden of showing that its borrower acted in a way that differs from the way it would have acted had it been personally liable, that the borrower exceeded its significant business discretion, and that the lender suffered actual loss as a result of these improper borrower actions. The next Part will illustrate the operation of this test by applying it to two types of borrower conduct: the failure to maintain the property physically and the failure to pay real property taxes.

Part III.B attempted to define the mortgaged property, concluding that the definition is a blurry one and that the borrower has the power to cloud this definition still more by converting realty into personalty.<sup>141</sup> This fact cannot be overlooked by a court called upon to answer the questions of when the lender may look beyond the mortgaged property and how far, questions this Part III.D has just examined. The more egregious a borrower's actions in converting realty into personalty, the more likely its lender will be able to meet the difficult burden of proof and convince a court that a personal judgment is appropriate, and the further into the borrower's pocketbook the court is likely to reach. If a borrower removed building materials and sold them for scrap, for example, its lender should have little difficulty meeting the elements of the proposed test, and a court should have no reservations about looking beyond the mortgaged property to make this lender whole. The fact that the definition of the mortgaged property is so blurry and so permeable, the question of when the nonrecourse provisions should be set aside, and the extent to which they should be set aside all are interrelated.

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141. See *supra* Part III.B.

#### IV. Demonstrations of the Proposed Test

Part III proposed a test to determine when borrowers should be held personally liable in spite of nonrecourse provisions in their loan documents. Part IV will illustrate how this test works by applying it to borrowers that fail to maintain the mortgaged property or that fail to pay their real estate taxes. These illustrations will demonstrate that active waste, passive waste, and the failure to pay property taxes are not separate cases, but rather are different points along a continuum. The more an action looks like active waste, the easier it will be for a lender to meet the requirements of the proposed test and to recover from its seemingly insulated borrower. Passive waste and the failure to pay real estate taxes differ from active waste in degree only, but that difference sometimes will be sufficient to protect the borrower against a personal judgment.<sup>142</sup>

##### A. Passive Waste

Waste is defined as "the destruction, alteration, misuse, or neglect of property by one in rightful possession to the detriment of another's interest in the same property."<sup>143</sup> Waste can be either affirmative or passive.<sup>144</sup> Affirmative waste, also known as voluntary or active waste, includes deliberate destructive acts by the possessor, such as unreasonable removal of timber, noncustomary extraction of minerals, or physical damaging of improvements.<sup>145</sup> Passive, or permissive, waste is more subtle, and "results generally from the failure of the possessor to exercise the care of a reasonable person to preserve and protect the estate for future interests."<sup>146</sup> Passive waste is a tort of omission rather than one of commission.<sup>147</sup>

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142. As in the previous Part, the discussion here will focus on post-foreclosure proceedings in which the lender seeks a deficiency judgment. Recall, however, that lenders also may pursue a financial remedy before foreclosure, either by seeking damages directly or by requesting an injunction that will require the borrower to spend money. See generally *supra* notes 52, 127; *infra* note 150.

143. 8 POWELL & ROHAN, *supra* note 38, ¶ 636 (footnote omitted). Disputes commonly arise between present interest holders and future interest holders. See *id.* The law of waste "keeps in balance the conflicting desires of persons having interests in the same land and preserves the land for future possessors." *Id.*

144. See *id.* ¶ 640.

145. See *id.*

146. *Id.* ¶ 640[3]. The concept of waste, including passive waste, is an old one: "[F]or he that suffereth a house to decay, which he ought to repara, doth the waste . . ." EDWARD COKE, THE SECOND PART OF THE INSTITUTES OF THE LAWS OF ENGLAND Chap. 24, 145 (Professional Books Ltd. 1986) (1817). The new *Restatement* abandons the distinction between voluntary and permissive waste. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.6 & cmt. b (1997).

147. See 8 POWELL & ROHAN, *supra* note 38, ¶ 640.



Although tenants and life tenants are the types of possessors most likely to come to mind in waste cases, the universe of potential waste defendants also includes mortgagors.<sup>148</sup> Unlike the more obvious voluntary waste cases, in which the borrower actively harms the property, permissive waste cases present borrowers that allow the property to deteriorate without taking adequate action to mitigate the resulting damage.<sup>149</sup> Rather than removing sinks and copper piping, the borrower might merely fail to repair the inevitable dripping faucets and leaky pipes, shortcomings which seem less blameworthy. A lender that initially agreed not to look to the borrower's personal assets now may argue that the nonrecourse borrower's lapse in maintaining the security that serves as the sole fund for repayment of the debt undermines and invalidates that agreement.<sup>150</sup> This subpart examines whether nonrecourse protections should shield borrowers who commit passive waste.

In the case of active waste, such as the physical destruction of a portion of the building, it seems apparent that the nonrecourse lender that suffers an actual loss ought to recover. Under the test that this Article advocates, most such lenders should be able to prevail easily.<sup>151</sup> When the borrower commits intentional bad acts, its lender should have little difficulty in proving that this borrower would not have harmed the property had it been personally liable on the loan, that these actions exceed the discretion that the parties agreed should remain with the borrower, and that the lender suffered actual injury. But what about the closer case of passive waste, in which the borrower does not actively harm the property but simply fails to make needed repairs?<sup>152</sup> The lender that

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148. Powell and Rohan note that courts in states that follow the lien theory or intermediate theory of mortgages are somewhat more reluctant to find mortgagors liable for waste. *See id.* ¶ 644[1].

149. *See id.* ¶ 640[3].

150. *See generally supra* notes 86-95 and accompanying text (discussing incentives facing distressed lenders). The primary focus here is on whether the nonrecourse lender may recover a deficiency judgment from its borrower, although, as previously noted, the issue of damages also may arise prior to foreclosure. *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.6(b) & cmt. e (1997) (examining remedies available for waste, which include enforcement of mortgage, injunction, and recovery of damages); *supra* notes 52, 127, 142.

151. *Cf. Micuda v. McDonald (In re Evergreen Ventures)*, 147 B.R. 751, 755 (Bankr. D. Ariz. 1992) (stating that deed of trust beneficiary may sue for waste, physical abuse, or destruction of trust property, notwithstanding Arizona's antideficiency legislation), *aff'd in part*, 174 B.R. 350 (B.A.P. 9th Cir. 1994).

In some ways, a court that allows a nonrecourse lender to recover from the partners of a partnership that has committed active waste is acting like a court that allows a corporate creditor to recover from corporate shareholders. The court is, in effect, piercing the veil of the nonrecourse loan, much as courts sometimes pierce the corporate veil. *See supra* note 8.

152. *See, e.g., Jaffe-Spindler Co. v. Genesco, Inc.*, 747 F.2d 253, 256 (4th Cir. 1984) (stating, in case in which major tenant vacated shopping center after borrower failed to repair

views passive waste as nothing but a less blatant tort of destruction still must make the same factual showings, and its ability to do so successfully will depend on the borrower's specific actions and on the content of the relevant documents.

It turns out that active waste, the passive failure to perform emergency maintenance, and the passive failure to perform nonemergency maintenance differ from one another in degree only.<sup>153</sup> The lender's ability to make the required showing becomes more and more difficult as the borrower's activity moves further from vandalism and closer to the discretionary operation of the building; the answer never switches from an obvious yes to an obvious no, but slides along a scale.<sup>154</sup> The previous illustration portrayed a case of active waste, but now contrast two examples of passive waste. In the first example, the borrower fails to make an emergency repair, such as patching a large hole in the roof. In the second example, the borrower fails to make a less significant repair, such as patching some frayed carpet in a hallway. Both of these cases may meet the definition of passive waste, but should the nonrecourse borrower be held liable for either of them following a foreclosure sale that does not produce adequate funds to satisfy the debt?

The patching of the roof constitutes necessary maintenance, which is to say that the repair must be performed immediately or nearly so. In some cases, emergencies may make the structure unusable or may even cause local authorities to shut the building down. If the building were to be sold at foreclosure while it still needed an emergency repair, any potential bidder would deduct the entire estimated cost of making this repair from the amount that it otherwise would bid for the property. This deduction reflects the fact that the building in its current state is worth less than the building in usable form. The buyer must undertake the repair promptly and pay its full cost

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large crack in roof, that "[b]ecause waste is a tort, the [nonrecourse] provision in the agreement is inapplicable").

153. See, e.g., *Micuda*, 147 B.R. at 760-61 (observing that "[w]hen an older property is neglected, problems soon escalate out of control" and concluding that "[the general partner's] negligence transformed little problems into big problems. Wear and tear and depreciation, when left unchecked, accelerate and become waste. While natural depreciation is certainly a factor in the damages suffered here, when that depreciation can easily be avoided through proper maintenance, waste occurs."); *Prudential Ins. Co. of Am. v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109, 113 (Wis. Ct. App. 1987) (concluding that "the mortgagee's security may be impaired by either passive or active waste and the policy for allowing the mortgagee recovery is the same regardless of the type of waste involved" (footnote omitted)).

154. One can imagine situations in which even intentional destruction of part of the property might constitute wise management. The borrower that cannibalizes the vacant end of a shopping center to raise cash or provide materials to maintain the occupied end might be acting prudently, and its lender may be unable to prove that these actions should lead to recovery under the test proposed in this Article.

before the building can become economically productive again.

Consider now the case in which the frayed carpet needs to be patched. Once again, the potential foreclosure bidder will reduce the amount that it otherwise would bid for the real estate by an amount equal to the cost of restoring the property. But this time, the bidder will offset against this reduction an amount reflecting the fact that this nonessential maintenance can be deferred for some period of time. This offset should reflect the net investment value, for the period of time until the problem is remedied, of the funds that eventually will have to be spent to correct the problem.<sup>155</sup> The most significant economic difference from the bidder's perspective between a repair that must be made immediately and a repair that can be deferred is the fact that the bidder can postpone the less pressing restoration and invest the funds that it later will have to spend.<sup>156</sup> The roof repair is not a different kind

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155. The bidder also needs to account for the fact that the cost of the repair may increase over time because of either inflation or the fact that the damage will worsen. If the anticipated increase in the cost of the repair exceeds the investment value of the funds, then it is cheaper to make the repair now.

In some cases, it may be possible to avoid the expense altogether, at least in the short run. This is most apparent in cases involving regular maintenance. If the owner decides to reduce expenses by having the carpet vacuumed weekly instead of daily, it can avoid the foregone vacuuming costs completely and not just postpone them. The shabbier appearance of the building will, over time, demoralize tenants and their guests and lead to reduced interest in the structure, lower rents, and lower property value. In the near term, however, these effects may be minimal and easily reversible, and the distressed owner may view this service reduction as a prudent, and nearly free, cost-saving measure. This sort of action probably will have little effect on the amount an outside bidder is willing to bid.

In fact, if the short-term losses that result from this maintenance reduction, such as tenant annoyance, are lower than the short-term gains, such as the ability to use the conserved funds to patch the roof or the carpet, then this is just the sort of corner that the distressed borrower should be cutting, and just the sort of corner that the worried lender will want to see the borrower cutting. The borrower will have correctly chosen the best of the available, bad options. *See supra* Part III.D.2. This may reduce the likelihood of a foreclosure and also may reduce the loss to the lender if there is a foreclosure.

This example demonstrates that the analysis employed here should apply equally well to major capital expenses such as roof repairs, minor maintenance expenses such as carpet patching, and regular upkeep such as vacuuming. Emergency needs must be met quickly while other demands can be postponed. The less necessary an expense is, the longer it can be deferred and the less costly it becomes relative to its current price. If an expense can be avoided completely, it need not be made and should not be made, it becomes effectively costless, and it should be immaterial to the lender's argument.

156. Credit may be available in either case, but interest on borrowed funds will start to accrue earlier in the case of the emergency repair, which must be made sooner.

A wise property manager probably will establish a reserve fund in which it sets aside money for the major repairs that it knows it will have to make from time to time. *See supra* note 78. The presence of a reserve fund does not change the cost analysis significantly, however, as funds in the reserve account will earn interest until spent and funds for emergency repairs will

of repair, and both holes will be patched sooner or later, but the urgency of the roof repair eliminates the borrower's ability to reduce its cost by deferring it.

The nonrecourse lender seeking to apply the proposed test to either of these maintenance lapses must demonstrate that the borrower would not have failed to make these repairs had it been personally liable, that the borrower's failure to make these repairs falls outside of the range of its permitted discretion, and that the lender suffered actual loss as a result of the borrower's failure to act. The greater need for a speedy roof restoration increases the likelihood that the fully liable owner would have patched it swiftly and that any delay will have caused the lender actual loss. As a result, the nonrecourse lender should prevail more easily under the proposed test with respect to the damaged roof. The more urgent the need for the unmade repair, the more the failure to make it resembles an intentional bad act; the more this failure looks like an intentional bad act, the easier it is for the lender to make the showings the proposed test demands.

A more complex collection of facts demonstrates how the proposed test would operate in a different setting. Imagine the nonrecourse borrower that owns a shopping center with total monthly rental income of \$10,000 and total monthly expenses of \$9500. The owner prudently decides to retain the \$500 of net monthly income, with the funds to be used as needed for future maintenance expenses. The owner then learns that a major tenant will relocate when its lease expires in a year; given market conditions, it will be difficult for the owner to re-let the premises. For the remaining year of this tenant's lease, the owner reduces building expenses, allows building standards to slip, and increases the balance of the reserve account more rapidly than it had. Just before the large tenant vacates its space, the owner distributes the entire augmented reserve fund to its partners. From then on, the property operates at a loss, eventually selling at foreclosure for less than the outstanding amount of the debt.

Once again, a court examining the borrower's liability for waste should apply the test this Article proposes. The lender must demonstrate that the borrower would not have decreased building standards and distributed the reserve fund had it been personally liable.<sup>157</sup> To carry this burden, the lender

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be spent sooner. Nonetheless, the wise lender should require the borrower to establish a reserve fund, particularly in the case of a nonrecourse loan, and a court should not penalize a nonrecourse borrower for failing to take a precaution gratuitously that the lender could have demanded but did not.

Reserve funds for maintenance and repairs are analogous to escrow accounts for real property taxes, insurance premiums, and ground lease rental payments, *see infra* notes 191-97 and accompanying text, although the costs and timing of repairs are less predictable than the amounts and timing of these other types of expenses.

157. The district court's analysis of a similar set of facts in *Travelers* is entirely inadequate.

must prove that these actions do not fall within the range of activities that the borrower would have undertaken had it been fully liable. Proving this may require the lender to show that the borrower has not treated other properties it owns, or that its principals own,<sup>158</sup> in this fashion. In fact, the lender may even be able to make the necessary showing by demonstrating that this borrower acted differently earlier in this loan, when it believed that there was little risk of losing the property and that any drop in building standards would only impair its own successful project.<sup>159</sup>

The lender must demonstrate that the borrower overstepped its permitted discretion, a burden that will be much easier for the lender to carry if the loan documents expressly restrict certain borrower actions. If the lender did not constrain the borrower's management discretion in the documents, then the court should be reluctant to infer standards of operation later. If the lender did not demand limits on partnership distributions, then the court should be disinclined to treat past rent collections as a fund that must be retained for the payment of future expenses.<sup>160</sup>

The lender also must demonstrate that the borrower could have reduced or avoided the lender's loss by acting differently, a showing that should be fairly easy to make on these facts. Note, however, that the lender arguably suffers no damages from borrower acts or omissions until the value of the property drops below the value of the debt. Even the borrower that sabotages the building may cause no loss to the lender if the foreclosure sale proceeds still can satisfy the debt — the purchaser at foreclosure will bid less because of this decrease in the value of the property, and the borrower will receive a corresponding reduction in the amount of equity returned to it after the debt is paid.<sup>161</sup> So the borrower's waste may not actually harm the lender until it

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The borrower distributed its available cash to its partners and then failed to pay its real property taxes, and the nonrecourse lender brought an equitable action for waste. *See* Travelers Ins. Co. v. 633 Third Assocs., 816 F. Supp. 197, 202-03 (S.D.N.Y. 1993), *aff'd in part and rev'd in part*, 14 F.3d 114 (2d Cir. 1994). In rejecting this claim, the district court found that the distributed funds were "placed beyond Travelers' reach by the non-recourse provisions of the mortgage." *Id.* at 206. For the same reason, the district court rejected Travelers' fraudulent conveyance claim. *See id.* at 207. Under this rationale, which the Second Circuit rejected, it is difficult to see how any lender could ever successfully bring a waste claim against a nonrecourse borrower. *See supra* notes 41-48 and accompanying text; *infra* notes 201-06 and accompanying text.

158. *See supra* notes 134-35 and accompanying text.

159. *See supra* note 136 and accompanying text.

160. *See supra* note 115 and accompanying text; *cf.* HomeCorp v. Secor Bank, 659 So. 2d 15, 20-21 (Ala. 1994) (finding nonrecourse borrower personally liable to lender for total amount of security deposits paid to borrower by its tenants).

161. The lender may argue that it is damaged any time the loan-to-value ratio increases, because its risk of ultimately suffering financial loss has been elevated. This argument is

causes the value of the property to drop below the amount of the debt, a point that the court acknowledged indirectly in *Spencer's*.<sup>162</sup> The issue, then, is not simply how the borrower treated the property, but whether the borrower's management of the property caused the property's value to dip below, or further below, the amount of the debt.

The intentional damaging of the property, the failure to make emergency repairs, and the failure to make nonemergency repairs all should be seen as different grades of waste. These are not different torts, but are examples of a single tort that can be committed to different degrees, and courts that agonize over the distinction between active and passive waste miss the point that all of these types of waste fall along a continuum. In the context of the test proposed here, these three examples of waste differ from each other primarily in the ease with which a nonrecourse lender will be able to demonstrate its right to recovery.

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particularly compelling for the nonrecourse lender, whose sole recourse is to the property and whose position therefore is more sensitive to increases in the loan-to-value ratio. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.6, cmt. f & reporters' note f (1997) (adopting this approach, and citing cases that support this rule and others that reject it); *supra* notes 37, 52, 122, 128.

This argument is considerably less persuasive when the lender raises it in the context of a post-foreclosure deficiency judgment action. The property has been sold by then, and any earlier increase in the lender's risk either has led to actual loss or has not. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, *supra*, § 4.6 (recognizing that lender is entitled to have its margin of security protected only if it brings its damages action before foreclosure; after foreclosure, there is no further need for margin of security); see also NELSON & WHITMAN, *supra* note 27, § 4.4, at 137-40 (arguing that lender initially sets interest rate based on its assessment of risk and that any unexpected increase in that risk is unfair to lender even when borrower retains some equity in property, while also recognizing that lender's total recovery should never exceed total outstanding debt).

If the borrower's putative waste was one of several causes of actual lender loss, as in the example in the text, then the lender should bear the burden of demonstrating the portion of its loss attributable to this improper behavior by the borrower. See *supra* Part III.D.3.

162. See *Prudential Ins. Co. of Am. v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109, 113-14 (Wis. Ct. App. 1987) (stating that "[w]here, as here, the amount of waste committed on the property is greater than the amount of the debt deficiency, the extent of reduction in the value of the mortgagee's security interest will always be equal to the debt deficiency"). Thus, if there is waste but no deficiency, the lender takes nothing; see also *supra* notes 34-40 and accompanying text; *infra* notes 174-90 and accompanying text. Compare *Cornelison v. Kornbluth*, 542 P.2d 981, 992 (Cal. 1975) (en banc) (concluding that, even if nonassuming grantee committed waste, lender "cannot recover since she purchased the subject property at the trustee's sale by making a full credit bid") with *Alliance Mortgage Co v. Rothwell*, 900 P.2d 601, 613-14 (Cal. 1995) (refusing to apply *Cornelison* rule in case in which borrower fraudulently induced lender to lend).

### B. Failure to Pay Real Estate Taxes

If passive waste results from a failure to protect the rights of future interest holders,<sup>163</sup> then future interest holders, including nonrecourse lenders, can suffer from passive financial waste just as they can suffer from passive physical waste. A property owner's dereliction in paying real property taxes can devalue the mortgaged property every bit as much as its failure to patch a leaking roof can,<sup>164</sup> and potential bidders at foreclosure will take both types of omission into account before deciding how much to bid. Thus, while the states may differ in how they answer this question of law, a court readily could determine that the failure to pay real property taxes constitutes passive waste.<sup>165</sup> A nonrecourse lender that believes it should be allowed to recover

163. See *supra* notes 143-50 and accompanying text.

164. See *Travelers Ins. Co. v. 633 Third Assocs.*, 973 F.2d 82, 86 (2d Cir. 1992) (recognizing this point explicitly); *supra* note 40 and accompanying text.

165. The Restatement definition of waste recognizes that financial omissions can constitute passive waste in the same way that failures to maintain the property can. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.6(a) (1997) (addressing active and passive waste, with passive waste including both physical and financial omissions); see also 8 POWELL & ROHAN, *supra* note 38, ¶ 640[3] (discussing physical and financial passive waste). The *Travelers* court, however, was uncertain enough about this issue that it felt compelled to justify its conclusion that the failure to pay real property taxes constitutes passive waste. See *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 119-24 (2d Cir. 1994) (applying New York law after lengthy discussion of its ambiguities on this point); see also *Spencer's*, 404 N.W.2d at 112-13 (discussing distinction between active and passive waste and concluding that nonassuming grantee may be personally liable for either, in case in which portion of waste arose from grantee's failure to pay real property taxes). The law on this point is likely to differ from state to state, with many states not having had the occasion to reach this issue in this context.

Compare *In re Boston Harbor Marina Co.*, 157 B.R. 726, 737-38 (Bankr. D. Mass. 1993) (concluding that nonrecourse borrower's failure to pay real estate taxes does not violate note provision prohibiting misapplication of gross revenues), with *HomeCorp*, 659 So. 2d at 20-21 (concluding that nonrecourse lender is entitled to recover from its borrower all net profits that were supposed to be escrowed and applied to ad valorem taxes), and *Vista Dev. Joint Venture II v. Pacific Mut. Life Ins. Co.*, 822 S.W.2d 305, 306-08 (Tex. App. 1992) (concluding that, because of exception to nonrecourse language found in note, nonrecourse lender may recover personally from its borrower that failed to pay real property taxes). See generally *Travelers*, 14 F.3d at 123 (surveying law in several states); *North Am. Sec. Life Ins. Co. v. Harris Trust & Sav. Bank*, 859 F. Supp. 1163, 1165 (N.D. Ill. 1994) (observing that "[r]elatively few courts have had occasion to consider whether waste includes nonpayment of real estate taxes by the mortgagor" before concluding that Illinois law considers such omission to be waste).

A similar analysis should apply to a nonrecourse borrower that fails to make payments on a senior mortgage or on another senior lien. See, e.g., *Berks Title Ins. Co. v. Haendiges*, 772 F.2d 278, 281 (6th Cir. 1985) (concluding that allowing title insurance company to enforce three mechanics' liens to which it became subrogated against foreclosed owner of mortgaged property would violate nonrecourse language in mortgage that title company had insured); see also *Travelers*, 14 F.3d at 123 n.8 (observing that failure of nonrecourse mortgagor to keep senior mortgage current will not support waste action by junior mortgagee) (*dicta*). But cf. *id.*

will argue that passive financial waste is as damaging to the property as passive physical waste is and that the borrower that fails to pay its property taxes should be personally liable for those taxes in spite of the nonrecourse language in the documents.

The failure to pay real estate taxes can be seen as the financial mirror image of the rent prepayment hypothetical discussed above.<sup>166</sup> In that hypothetical, the nonrecourse borrower approached one of its tenants and agreed to accept a large, but discounted, rent prepayment in lieu of future rent for a period of months.<sup>167</sup> A court would be likely to see this behavior as fraudulent, designed to convert a stream of future rental receipts, which might benefit the nonrecourse lender, into a lump sum paid by the tenant immediately, which would benefit only the distressed nonrecourse borrower.<sup>168</sup> Nonpayment of taxes is the financial inverse of this arrangement. The borrower decides not to make a large payment that it owes now, preferring instead to pay off the debt in smaller installments over time, with interest and penalties. It converts a lump sum current debt, which it alone must pay, into a series of future payments, which the nonrecourse lender ultimately may have to pay.<sup>169</sup> In each case, the borrower pays a premium, in the form of a discount or interest, in return for the benefit of receiving or retaining cash now with a heightened likelihood that the cash will not end up in the lender's pocket.

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at 121 (suggesting different result if mortgagor allows mechanics' liens to arise).

166. See *supra* notes 77-79 and accompanying text; *supra* note 85.

167. See *supra* notes 77-79 and accompanying text; *supra* note 85.

168. The nonrecourse lender may suffer no matter who buys the property at foreclosure. Any purchaser, including the lender, will receive less in rent than it otherwise would have, as the tenant continues to occupy space for which it has already paid the original borrower. Such a purchaser will reduce the amount it is willing to pay at foreclosure by an amount equal to the discounted present value of this foregone rent. As a result of this reduced bid, the lender may receive less at the foreclosure sale. The lender suffers no loss only if the devalued property still sells for at least the amount of the debt, in which case the issue of a deficiency judgment does not arise. Moreover, the fact that the borrower is in distress when it negotiates this loan from its tenant suggests that the imputed interest rate will be high.

169. Again, the nonrecourse lender may suffer a loss no matter who buys the property at foreclosure. Any purchaser, including the lender, will reduce the amount it is willing to pay at foreclosure by an amount equal to the amount of the tax lien, which will include overdue taxes, interest, and penalties. As a result of this reduced bid, the lender may receive less at the foreclosure sale. See, e.g., *Smart v. Tower Land & Inv. Co.*, 597 S.W.2d 333, 339 (Tex. 1980) (noting that "[t]he mortgagee who purchases the property with delinquent taxes owed by the mortgagor, may account for the delinquent taxes in determining his bid"). Again, the lender avoids a loss only if the property, subject to the tax lien, still sells for no less than the debt.

The interest and penalties charged by the taxing jurisdiction are likely to be high. The fact that the distressed borrower is willing to pay so dearly for funds reflects its desperation, and the foreclosure sale purchaser may elect to pay off the arrearages immediately rather than continuing to pay this high cost for funds.



Nonpayment of real estate taxes is of particular concern to the lender because it is one of the few borrower defaults that leads to a lien on the property that is prior to that of the lender's mortgage.<sup>170</sup> This priority of the taxes results even if the mortgage was recorded before the beginning of the period for which the taxes are owed. The seniority of the subsequently arising tax lien has the potential to harm the mortgage lender in two distinct ways. First, the fact that the taxes, including interest and penalties, are senior to the mortgage increases the likelihood that a sale will generate insufficient funds to satisfy all of the mortgage debt.<sup>171</sup> In effect, every lender implicitly subordinates its debt to the right of the taxing authority to place and enforce a lien on the property at any time in the future. The financial devaluation that a property tax lien causes is analogous to an emergency repair in that a bidder will deduct the full cost of remedying it when deciding how much to bid. Few other liens can attain such priority after the mortgage is recorded, and of those that can, most are likely to arise only in the early stages of the loan and many will not diminish the value of the property.<sup>172</sup> Second, the existence of the

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170. See, e.g., *BW Village, Ltd. v. Tricon Enters., Inc.*, 879 S.W.2d 205, 206-07 (Tex. App. 1994) (noting how existence of real property tax lien demotes priority of nonrecourse mortgage).

171. A property tax lien lowers the priority of all other liens, whenever they arose, thereby increasing the likelihood that any given mortgage will not be satisfied in full. See, e.g., *A.C. Fin., Inc. v. Salt Lake County*, 948 P.2d 771, 776 (Utah 1997) (holding that "because an owner in fee simple nevertheless remains subject to the State's claim on the property for taxes, it should follow that the owner cannot grant a lender a greater interest — one which is not subject to that claim"). This is true whether the tax lien is foreclosed, the mortgage is foreclosed, or the owner sells the property voluntarily. If the taxing authority forecloses on its tax lien, then it gets paid in full before any other lienor receives anything. If the sale comes about through a foreclosure of the mortgage or through a voluntary sale by the owner, then the tax lien will not automatically be paid off but the purchaser will adjust its bid or offer to reflect the amount of the unpaid taxes, including interest and penalties. See generally *Jackson v. Stonebriar Partnership*, 931 S.W.2d 635, 640 (Tex. App. 1996) (concluding that "the existence of the tax lien [arising under Texas law] on January 1 requires a mortgagee to take into account, in calculating its bid at foreclosure, the amount of taxes attributable to the time period of January 1 to the date of foreclosure, if it expects to collect that sum"). Either way, the chances of the mortgage lender recovering in full are reduced, and reduced by exactly the same amount.

172. The most straightforward example is the mechanics' lien. Unpaid mechanics may be able to "jump in front" of a recorded mortgage by recording a lien that relates back to a date before the mortgage recordation date. See, e.g., N.Y. LIEN LAW §§ 1 to 79-a (McKinney 1993 & Supp. 1998). However, the right of a mechanic to place a lien on the property usually expires within a short period after it fails to receive payment; mechanics' liens usually must be enforced quickly or lost; a physical inspection of the property often will reveal the presence of recent work; and title insurance companies generally are willing to insure against the risk that mechanics have not been paid if provided with a satisfactory affidavit and indemnity from the borrower or its seller. Moreover, mechanics' liens may reflect dollar-for-dollar increases in the value of the property occurring after the mortgagee appraised the property, so that there is no net loss to the lender.

senior lien reduces the mortgage lender's control. The taxing authority may opt to enforce its lien under circumstances in which the mortgagee might rather wait or attempt to resolve the dispute in a different way.<sup>173</sup>

Property tax delinquencies should worry the lender for other reasons, as well. Bills for unpaid property taxes are large to begin with and increase quickly once the typically onerous interest and penalties begin to compound. This danger is enhanced by the fact that many jurisdictions are extremely slow to enforce real property tax liens, often allowing taxes to accrue for years before determining that enforcement is worthwhile. The local government may be content to allow the principal, interest, and penalties to accumulate for a prolonged period, a luxury that lower priority creditors often do not enjoy. Once the taxing authority chooses to act, the lender may find itself junior to an enormous lien. This last danger is enhanced still further by the fact that borrowers are well aware that government entities are slow to enforce their property tax liens. This knowledge might encourage the property owner in

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Tenants with unrecorded leases may possess occupancy rights that are prior to the mortgagee's rights. Technically, this is not an example of a subsequently arising property interest that takes priority over a previously recorded mortgage, because the tenant's property interest already exists at the time the mortgage is recorded. However, the interest of the tenant with the unrecorded lease, like the right of the unpaid mechanic to place a lien on the property, cannot be discovered by a title search, and the lender may not learn of the lease until after the mortgage is recorded. Occupants such as these usually can be discovered at the time of the mortgage by a physical inspection of the premises. In addition, title insurers often are willing to remove the standard policy exception for parties in possession after inspecting the property or receiving an affidavit and indemnity from the borrower or its seller. Furthermore, leaseholds often enhance rather than diminish the value of the property.

Violations of building codes, health codes, or environmental laws may have a similar economic effect, depending on the substance of the law and the timing of the violation. Under these laws, the applicable authority may have the power to compel the owner to make repairs, or may make the repairs itself and place a lien on the property in the amount of the cost. Government action subsequent to the recording of the mortgage, taken to remediate a pre-existing but undiscovered violation of one of these types, may have the effect of notifying the lender that the property actually is worth less than it appeared to be worth. Any later bidder will reduce its bid by an amount equal to the amount it will have to spend in order to comply with the law or remove the lien. In this sense, these violations are somewhat analogous to emergency repairs. *Cf. supra* notes 154-62 and accompanying text.

173. Proper foreclosure of a lien on property will expunge that lien and all liens junior to it. *See, e.g.,* *Sumitomo Bank v. Davis*, 6 Cal. Rptr. 2d 381, 385 (Ct. App. 1992) (observing that "[t]he judicial sale removes liens from the property junior to the one being foreclosed if the junior lienors are made parties to the action" (citations omitted)). Whatever priority the mortgage may have had, it is sure to be junior to the lien of the real property taxes, which means that the taxing entity will have the power to demand a sale of the property at which the lien of the mortgage will be wiped out, whether or not it is paid in full. A mortgage lender that might prefer to wait for the property to appreciate or for the owner to recuperate will be unable to overrule the senior taxing authority that disagrees. The presence of an unpaid senior lien such as a tax lien also increases the complexity and reduces the likelihood of a settlement.

severe distress to ignore the tax bill first, fully cognizant that the consequences of nonpayment, though serious, can be deferred.

If a court decides that the failure to pay real property taxes is another form of passive waste, then its analysis of the liability of the nonrecourse borrower should proceed just as it would for any other type of passive waste. The lender must demonstrate that the borrower would not have failed to pay the taxes if it were personally liable, that the borrower's decision to defer the taxes fell outside the range of its permitted discretion, and that the lender suffered actual loss as a result of this nonpayment. The Wisconsin Court of Appeals offered an analysis in *Spencer's* that is partly correct and partly incomplete.<sup>174</sup> The analysis is correct in concluding that a lender can recover from a party that appears not to be personally liable under the documents<sup>175</sup> and that the failure to pay real estate taxes may constitute waste,<sup>176</sup> and in recognizing that the lender's total recovery cannot exceed the amount of the debt.<sup>177</sup> It is incomplete in failing to discuss the burden of proof, failing to discuss whether the borrower might properly have chosen not to pay the property taxes, and neglecting to ask whether the lender suffered any avoidable loss as a result of this borrower omission.<sup>178</sup>

A more complete analysis would examine carefully the central question of whether the borrower behaved any differently than it would have if it were personally liable, recognizing that the borrower retains significant management discretion and that the lender must prove actual loss. How would the distressed, but fully liable, borrower have behaved under similar circumstances? It is possible to venture plausible answers to this question by extrapolating from the facts in *Spencer's*. The Wisconsin Court of Appeals paints a grim picture of the final days of *Spencer's* Kenosha Bowl, days in which the roof is leaking, ceilings are collapsing, electrical facilities have gone unrepaired, and the property taxes are significantly in arrears.<sup>179</sup> The lender might have argued that the owner had allowed the property to deteriorate for years, so as to extract from the business as much cash as it could for as long

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174. See *Prudential Ins. Co. of Am. v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109 (Wis. Ct. App. 1987); *supra* notes 34-40 and accompanying text.

175. See *Spencer's*, 404 N.W.2d at 111-12. *Spencer's* was a nonassuming grantee and not a nonrecourse borrower, but the analysis is similar. See *infra* Part IV.C.3 (comparing nonassuming grantees to nonrecourse borrowers).

176. See *Spencer's*, 404 N.W.2d at 111 (listing components of waste found by trial court); *id.* at 114 (affirming judgment).

177. See *id.* at 113-14.

178. The court implicitly considered this last issue, in part, when it placed an upper limit on the lender's recovery. See *id.* Under the analysis recommended in this Article, however, even this reduced award may have been too high.

179. See *id.* at 111, 114.

as it could before abandoning ruined security to the lender.<sup>180</sup> The owner could have responded that the magnitude of its bills exceeded its ability to pay them all – people simply were not bowling enough – and that it did what it could to survive for as long as possible, hoping that business would improve, until it finally was forced to close its doors.

In deciding which of these versions of the facts to accept, the court must continue to recognize the great extent of the discretion that Spencer's, a nonassuming purchaser of previously mortgaged property, legally was permitted to exercise. The decision not to pay the taxes may have been a sensible one under exigent circumstances. Spencer's, apparently facing more debts than it could meet while struggling to keep its doors open, seems to have opted to defer those expenses that could most easily be deferred. There is a significant chance that it would have acted in just the same way if it had been personally liable for the debt, although the lender should be permitted to make a contrary showing.<sup>181</sup> As previously discussed, the lender that agrees to lend without personal recourse displays greater than average confidence in the borrower's skills<sup>182</sup> and hardly can complain when that borrower exercises those skills in a manner designed to preserve itself under adverse conditions.<sup>183</sup> Anxiety about a potential borrower's judgment under pressure is best addressed by constraining that judgment in the loan documents, not by seeking judicial intervention after a material default, and the lender that fails to address this point prospectively will bear a very heavy burden later.<sup>184</sup>

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180. There is some language in the opinion to support this claim. The court points out that while the roof had not outlived its expected life, it needed total replacement because of prolonged failures to make minor repairs. *See id.* at 114.

181. The failing limited partnership sometimes may be highly motivated to avoid a personal judgment even if the obligation is nonrecourse because of its fear that a court will refuse to enforce the nonrecourse provisions and will hold the partnership and its general partners personally liable. In contrast, the corporation may see little reason to avoid a personal judgment once the business seems to be doomed, whether the obligation is nonrecourse or not: The entity will have no assets left to protect, and its shareholders will be insulated by the corporate form. The fact that Spencer's, which was a corporation and not a partnership, litigated this case so strenuously implies that the entity still possessed some assets that it hoped to shield from the lender. It is not possible to determine from the facts whether Spencer's was able to retain these assets because it was milking the property or because it was managing the property wisely.

182. *See supra* text accompanying note 20; *supra* note 132; *infra* note 212.

183. The same analysis should apply to Prudential, which here faced a nonassuming grantee. Had it wished to avoid this situation, which is similar to that faced by a lender that initially agrees to nonrecourse terms, it could have insisted in the original loan documents that any grantees must assume or it could have made the debt due upon transfer of the property. *See infra* Part IV.C.3.

184. Another option for the lender is to seek the appointment of a receiver. *See, e.g., Straus v. Wilsonian Inv. Co.*, 17 P.2d 883, 883 (Wash. 1933) (affirming appointment of receiver

*Spencer's* also suggests that the lender would have lost money no matter how the borrower behaved. The property sold at foreclosure for \$635,000 at a time when the debt was approximately \$994,000, resulting in a deficiency of about \$359,000.<sup>185</sup> The trial court found that physical and financial waste, including a property tax arrearage of nearly \$199,000, had devalued the property by approximately \$445,000.<sup>186</sup> The trial court awarded the lender only \$359,000, however, as that was all that the lender needed to receive to be made whole; and the appellate court affirmed.<sup>187</sup> The owner could have argued that had it paid its taxes, it would have had to defer that much more maintenance, with the property neither benefiting nor suffering from this reallocation of resources. The owner also might have pointed out that it could have funded its tax payment by remitting \$199,000 less in principal and interest to the lender. Whatever bills it decided to pay, however, the owner would have been unable to pay them all. As a result, the owner's failure to pay taxes rearranged the lender's loss without increasing it.<sup>188</sup> The non-assuming grantee, like the nonrecourse borrower, is insulated from liability for unavoidable financial shortfalls, with the lender taking the risk that the property will sell for less than the debt.<sup>189</sup> If a deficiency was inevitable, then the loss should fall on the lender that accepted this risk rather than on the insulated borrower that tried to minimize the damage.

The lender might respond to this contention by arguing that the owner camouflaged a default and lulled the lender into the belief that nothing was wrong by electing to pay principal and interest while allowing the physical and financial condition of the property to deteriorate, and that this ploy actually increased the amount of the lender's loss. By pushing back the date on which the lender learned of the owner's distress, the owner delayed the lender's ability to exercise any of its pre-foreclosure remedies and exacerbated the physical and financial waste.<sup>190</sup> Although the *Spencer's* court does not make it clear whether this actually happened, the facts cause this argument to

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after nonassuming purchaser paid debts to insider creditors but failed to pay its real estate taxes at time when mortgage debt exceeded value of property); *supra* notes 27, 135.

185. See *Prudential Ins. Co. of Am. v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109, 111 (Wis. Ct. App. 1987).

186. See *id.*

187. See *id.*

188. In fact, this type of damage control may reduce a lender's loss. If the owner is competent (and on the facts of *Spencer's*, that can be doubted), then its selection of the least-bad option may minimize a loss that is inevitable.

189. In the case of a nonassuming grantee, the lender also has the right to proceed against the original borrower, a right that may turn out to be of little practical value.

190. See *supra* notes 123-26 and accompanying text.

seem plausible. The owner had allowed the property to slide into a condition of significant disrepair and had permitted a large real estate tax liability to accrue. If the insulated owner is able to keep its loan payments current only by devaluing the property, and thereby postpones the day when the lender discovers the problem, it may increase the lender's loss. Even if some portion of the loss was inevitable, the owner should be required to compensate the lender for that portion that the lender can show is attributable to the borrower's foot-dragging, assuming that this part of the loss might otherwise have been avoided.

The lender, then, has an opportunity to prevail, but its burden is heavy. It must show that the owner acted differently than it would have if it were personally liable, that these differences exceeded its allowed discretion, and that these differences, including those that delayed the lender's discovery of the problem, resulted in actual loss to the lender. If the lender cannot carry this burden, then neither the nonrecourse borrower nor the nonassuming grantee should be held personally liable for losses arising from the owner's failure to pay its real estate taxes.

The failure to pay real property taxes is, in some ways, one of the more difficult breaches for a borrower to defend. While there may be disagreement as to the scope of the borrower's obligation to maintain the property physically, particularly if the documents are imprecise, there can be little question that the borrower, as owner, is expected to pay all real estate taxes.<sup>191</sup> The mortgagor's covenants usually are clear on this point. Unlike maintenance obligations, which often arise erratically, property tax payments are due at predictable intervals in amounts that are easily obtained in advance.

The fact that the nonrecourse borrower covenants to pay its property taxes does not necessarily establish that it should be held personally liable for failing to do so, and the lender still must convince the court to hold its nonrecourse borrower personally liable if a deficiency results from the borrower's failure to pay real estate taxes.<sup>192</sup> It is so easy to spell out the scope of the

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191. Cf. *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 123 (2d Cir. 1994) (stating that failure to pay taxes constitutes waste only when it is intentional). It is difficult to imagine how any failure to pay real property taxes could be unintentional. See *supra* note 47.

192. Breach of the covenant to pay principal and interest should not lead to personal liability, as this is the type of core financial obligation that the parties presumably intended to fall within the documents' nonrecourse protections. Conversely, breach of the covenant not to damage the property intentionally should lead to personal liability, as the parties would not have intended (and a court would be unlikely to enforce) an agreement allowing the borrower to destroy the security.

A covenant to pay property taxes does not fall squarely within either of these categories, and the presence of an express payment covenant in the documents is not enough to reveal to a court whether the parties intended for a breach of that covenant to lead to personal liability.

borrower's personal liability for tax payments in the documents and so easy to monitor compliance with these provisions that a court may infer from the lender's failure to take these steps prospectively that it did not intend them. The nonrecourse lender should periodically confirm that the borrower has paid its property taxes. The lender also should insist that the borrower expressly assume personal responsibility for its obligation to pay taxes and should back up this agreement with a mandatory monthly escrow.<sup>193</sup> An escrow assures the lender that the annual tax payment has been made, because it is the lender itself that turns the escrowed funds over to the taxing authority. A tax escrow requirement also reduces the likelihood of an unexpected year-end shortfall by compelling the borrower to set aside one-twelfth of the annual taxes every month.<sup>194</sup> If the borrower should default, the lender will have

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*See* Federal Home Loan Mortgage Corp. v. Inland Indus., 869 F. Supp. 99, 100-02 (D. Mass. 1994) (addressing question of whether late fees and related costs, default interest, and prepayment premiums constitute interest, for which there would be no personal liability under nonrecourse note); Heim v. Kirkland, 356 So. 2d 850, 851 (Fla. Dist. Ct. App. 1978) (allowing nonrecourse lender to recover amount of unpaid real estate taxes from land but not from borrower); Smart v. Tower Land & Inv. Co., 597 S.W.2d 333, 336-37 (Tex. 1980) (holding that lender that pays its nonrecourse borrower's real estate taxes may recover through foreclosure only and is not entitled to personal judgment against borrower). *Compare* Travelers, 14 F.3d at 121 (confessing uncertainty as to whether breach of obligation to pay real estate taxes leads to personal liability on part of nonrecourse borrower under New York law) *with id.* at 121-23 (concluding that New York and several other states seem to answer this question affirmatively).

193. *See, e.g.,* Hinckley v. Eggers, 587 S.W.2d 448, 450-51 (Tex. App. 1979) (recognizing enforceability of note that provides for personal liability for property taxes and interest even though it is nonrecourse with respect to principal).

Lenders that agree to nonrecourse loans may protect themselves in other ways. If the borrower objects to a tax escrow requirement – an objection that the nonrecourse borrower will have to work fairly hard to justify – then the lender may agree to reduce the impact of this requirement by holding tax payments in escrow only after some evidence of distress surfaces, such as a default. Concerned lenders that do not insist upon tax escrows always can request proof that the borrower's tax payments are current and can verify payment independently if they desire.

A lender may prefer to pay overdue taxes itself and to add the amounts of these payments to the loan principal, thereby averting the possibility that the taxing jurisdiction can sell the property over the lender's objections. This last option may provide no net financial benefit to the lender unless the lender also insists upon personal recourse for breach.

The *Restatement* allows lenders to expend funds reasonably necessary to protect the property, including funds necessary to prevent the assertion of senior liens such as real property tax and assessment liens. *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 2.2(a) & cmt. a (1997). A lender that spends funds for this purpose, however, will be able to recover personally from the nonrecourse borrower only to the extent that the documents allow. *See id.* § 2.2(c).

194. Requiring the borrower to escrow funds for tax payments monthly increases the risk of some other default, as the escrowed funds no longer are available to the borrower for other purposes. This may be exactly what the lender wants, as it prevents the borrower from paying

collected all but the most recent month's payments and will become aware of the borrower's financial difficulties when they arise rather than when the borrower later misses a much larger payment.

A court may view the lender's failure to take these obvious precautions as confirmation that it did not intend to take them and may conclude from this omission that the nonrecourse borrower should not be held personally liable for its failure to pay real property taxes.<sup>195</sup> This point emphasizes once more the importance to the lender of clarifying in the documents exactly what obligations the nonrecourse borrower has and when it will be personally liable for deficiencies that result if it breaches them, precautions that would be unnecessary if the loan provided for full recourse.<sup>196</sup> Boilerplate language in which the borrower covenants to maintain the property and to meet all of its financial obligations will not be enough. Language such as that is present in many mortgages, and the more specific and unusual nonrecourse terms should be seen as taking precedence over it. The lender should take care to state precisely what the borrower's obligations are, how much discretion the borrower has in choosing how to meet them, and, for each obligation, whether the borrower will be personally liable if a breach leads to a deficiency.<sup>197</sup>

The borrower's failure to make required premium payments for property insurance raises many of the same issues as the borrower's failure to make required property tax payments. An act of God can be seen as the ultimate superlien, and an uninsured loss impairs the lender's security in much the

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its other obligations from funds it should be reserving for the tax payments to come due. Any shortfall will become evident sooner, thereby providing the lender with early notice of impending problems. Such an escrow is, in essence, a reserve fund for a limited purpose.

The lender also may demand establishment of an escrow fund for other senior obligations, such as prior mortgage debt and ground lease rental payments.

195. *Cf.* *Camden Trust Co. v. Handle*, 26 A.2d 865, 867 (N.J. 1942) (holding that "[u]nless it constitutes a breach of duty arising out of contract, the unassuming grantee of mortgaged lands is not liable to the mortgagee for permissive waste, even though the mortgage security is thereby rendered insufficient"). *But cf.* *Prudential Ins. Co. of Am. v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109, 112 n.2 (Wis. Ct. App. 1987) (finding "no logical or practical reason for support of this rule").

196. The requirement that the borrower pay real estate taxes offers a particularly clear example of the need for unambiguous nonrecourse language, because this obligation is a hybrid. In some senses, the failure to meet this obligation resembles other types of waste, for which the nonrecourse borrower should be held liable in certain instances. *See, e.g., Spencer's*, 404 N.W.2d at 111-13. In other respects, the tax payment is just another check that the borrower must write, resembling the obligation to pay principal and interest for which the nonrecourse borrower is not personally liable. *See supra* Part III.A. *See generally supra* note 192.

197. *See generally* J. Stein, *supra* note 105, at 40-54 (offering detailed form nonrecourse clause, along with shorter alternative form); J. Stein, *supra* note 17, at 4 (observing that "today's nonrecourse clauses are longer than they used to be").



same way as a prior tax lien, and often in a much greater amount. At the same time, the lender's ability to reduce or avoid this risk equals or exceeds its ability to reduce or avoid the risk that the borrower will not pay its property taxes. Lenders ordinarily insist upon evidence of adequate insurance at the time the loan is extended; acceptable loss payee provisions, most often in the form of a standard mortgage clause; monthly escrows of insurance premiums by the borrower; advance notice from the insurer if the policy is to be canceled; and the right to cure defaults at the borrower's expense. Anticipating and avoiding this risk has become a standard part of modern lending practice. Nonrecourse lenders not only need to take all of these precautions, but also need to ensure in the documents that the borrower's breach of any of these commitments leads to personal liability.<sup>198</sup>

### *C. Additional Issues that May Arise in Applying the Proposed Test*

A court that analyzes cases in the way this Article recommends is likely to discover that other, related issues frequently arise. A brief discussion of three of these issues follows.

#### *1. Improper Distributions to Partners and Fraudulent Conveyances*

Some of the examples offered above portray cases in which the nonrecourse lender is destined to lose no matter how the borrower behaves. There are not enough funds to meet all obligations, and the question arises whether the borrower should be held liable for attempting to minimize a loss that could not be wholly avoided. That will not always be the case. Sometimes, the nonrecourse borrower will have inadequate resources to meet its expenses because it transferred funds out of the partnership and did not receive anything of comparable value in return. One common example of this type of behavior is the thinly capitalized partnership that makes a distribution to its partners<sup>199</sup> or meets a contractual obligation to an affiliated entity and subsequently defaults on its loan obligation. The lender may argue that any such distributions or payments are improper and, if bankruptcy laws become relevant, constitute fraudulent conveyances.<sup>200</sup>

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198. The issue of personal liability may remain significant after a casualty or condemnation occurs. If any funds are disbursed directly to the borrower, the lender may need the threat of personal liability as a way of reminding the borrower to apply insurance proceeds and condemnation awards toward restoration of the security or reduction of the debt.

199. *Travelers* illustrates this point well. See *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 117-19 (2d Cir. 1994).

200. See, e.g., *id.* at 117 & n.2, 126 (discussing lender's fraudulent conveyance argument).

The fraudulent conveyance analysis offered by the district court in *Travelers* is entirely inadequate.<sup>201</sup> That court found that there was no fraudulent conveyance because the loan was a nonrecourse loan and concluded that the lender therefore had no claim to the funds that were distributed to the partners.<sup>202</sup> This circular analysis overlooks the facts that the distributed funds previously were partnership assets and that the partnership may have been obligated to spend them on the mortgaged property.<sup>203</sup> By answering the question as it did, the district court effectively decided that the borrower may commit this type of financial waste at will, a conclusion that led to a reversal on appeal.<sup>204</sup>

A lender should be allowed to recover on these facts if it can make the difficult showing that this Article recommends. The lender may be able to prove that the borrower would have used its funds to preserve the property had it been personally exposed, that distributions to the partners or payments to insiders were not within the limits of the borrower's retained discretion, and that the lender suffered actual loss. This example provides another illustration

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201. See *Travelers Ins. Co. v. 633 Third Assocs.*, No. 91 Civ. 5735 (CSH), 1991 WL 236842, at \*1-3 (S.D.N.Y. Oct. 31, 1991).

202. The district court noted that, plaintiff, "in the governing documents, foreswore any recourse against monies such as the Cash Reserve. Accordingly the proposed distribution would do no more than place beyond plaintiff's reach property that he would not be able to subject to payment of his debt in any event." *Id.* at \*1.

203. See *Travelers*, 14 F.3d at 126 (noting that action for waste could have been maintained against borrower partnership prior to time receiver was appointed).

204. The Second Circuit, in eventually reversing and reaching the correct result, observed:

Because the partnership might have been enjoined from distributing cash reserves to the partners on the grounds that such a distribution would have prevented it from paying property taxes, the distribution injured *Travelers*. Therefore, *Travelers* has standing to challenge the distribution under New York fraudulent conveyance law insofar as *Travelers'* claims related to the portion of the distributions against which an equitable action for waste could have been brought.

*Id.* Determining "the portion of the distributions against which an equitable action for waste could have been brought" will be a complex task, as this Article has shown throughout, but the appeals court answered the question of law correctly.

See also *Travelers Ins. Co. v. 633 Third Assocs.*, 973 F.2d 82, 87 (2d Cir. 1992) (noting that "to the extent plaintiff would have been entitled, absent the conveyance, to obtain an equitable decree enjoining the Partnership to apply its cash assets in a manner to preserve the property's value, it may likewise 'reach' the cash assets for the same purpose in the fraudulent conveyance action"). But see *Barnes*, *supra* note 62, at 674 (criticizing result in *Travelers* and expressing concern over its impact on nonrecourse lending in future).

See generally UNIF. FRAUDULENT TRANSFER ACT § 7, 7A U.L.A. 660 (1985) (allowing creditors opportunity to satisfy their own claims by avoiding certain fraudulent conveyances or by obtaining other equitable relief); UNIF. FRAUDULENT CONVEYANCE ACT § 9, 7A U.L.A. 577 (1985) (reaching same result under older uniform act that is still in force in several states).

of the ease with which careful drafting can reduce the likelihood of litigation. Before funding the loan, the lender should insist upon satisfactory limitations on distributions to partners and on contractual arrangements with insiders. The loan documents should provide that any breach of these restrictions leads to personal liability on the part of the partnership and its general partners and, where possible, any other recipients of the distributions or payments.<sup>205</sup> The lender should demand that the documents specify the priority of the borrower's various obligations, including the mortgage loan itself. If the partnership cannot pay tradespersons, the property tax collector, or the lender, then it should not be paying its own partners.<sup>206</sup>

## 2. Allocation of Income and Expenses Among Multiple Projects

Another problem that may arise is the question of how to allocate income and expenses in cases in which the borrower owns more than one asset and the mortgage does not cover all of them. For example, imagine a borrower that operates ten real estate projects, nine of which prove to be successful and one of which does not. By obtaining a separate nonrecourse loan on each property, the borrower insulated the successful projects while avoiding the need to create a separate entity for each operation. After the lender forecloses on the unsuccessful mortgage, however, a court may find it tremendously diffi-

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205. See *supra* notes 115, 119, 136-38 and accompanying text.

206. This is not to suggest that every penny of principal and interest must be paid before any funds can be returned to the partners. The documents may provide that the partners will receive dividends, returns of equity, or any other funds before the lender's debt has been fully satisfied, as long as the lender agrees that the priority of distributions is acceptable. The lender needs to avoid leaving this discretion entirely with the partnership, however, in the same way that it needs to restrict its borrower's discretion with regard to other business matters. Just as the lender insists that the partnership contribute a certain amount of equity to the project initially, it also must limit the partners' abilities to take that equity (and, perhaps, some or all of the return on it) out of the project before the debt has been fully paid.

In *Thompson v. United States*, the court found the general partners of a nonrecourse borrower liable after they improperly withdrew funds from the borrower partnership, and concluded that any other result "would deny the claim of the party having security in the assets of the project in favor of defaulting entrepreneurs who happened to have immediate control over the checkbook." 408 F.2d 1075, 1080-81 (8th Cir. 1969). See also *Micuda v. McDonald (In re Evergreen Ventures)*, 147 B.R. 751, 759 (Bankr. D. Ariz. 1992), *aff'd in part*, 174 B.R. 350 (B.A.P. 9th Cir. 1994):

While cash flow from the project deteriorated, [the general partner of the owner] retained a net worth in excess of \$1.6 million. He had the ability, despite the project's economic difficulties, to reasonably maintain the project and chose not to do so. Moreover, during good times preceding the bankruptcy, [the owner partnership] had taken \$478,975.00 in dividends from the project.

*Id.*

cult to allocate income and costs to individual projects. The borrower may have blanket contracts with suppliers and service providers that are difficult to apportion and may have employees that divide their time among all of the entity's real estate projects. The lender may fear that the borrower has applied income from the failed property, with its nonrecourse debt, to benefit other properties on which the lender has no direct claim.<sup>207</sup> Once again, the lender must either address the problem in advance or face a demanding burden later.

### 3. *Nonassuming Grantees*

This Article has treated the nonassuming grantee much like the nonrecourse borrower,<sup>208</sup> but there are differences between parties in these two situations. The nonassuming grantee, such as Spencer's Kenosha Bowl,<sup>209</sup> purchases property that is subject to an existing mortgage but does not assume personal responsibility for performance of the mortgage obligations. The lender retains its rights against the property and the original borrower but has

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207. See, e.g., *In re Boston Harbor Marina Co.*, 157 B.R. 726, 736 (Bankr. D. Mass. 1993) (noting problem of tracing unsegregated rents to specific properties from which they derive); *Provident Nat'l Assurance Co. v. Stephens*, 910 S.W.2d 926, 929 (Tex. 1995) (concluding that "the single sale price [for two foreclosed parcels] may be reasonably allocated between the two properties by using a ratio derived from a comparison of the individual fair market values of those properties"); *Reid & Maniscalco*, *supra* note 20, at 29 (describing several variants of this allocation problem).

A different allocation problem arises if the debt provides for partial recourse or is backed by a limited guaranty. A court may have to decide whether the limited liability of the borrower or guarantor is discharged from the first dollars the foreclosure produces, from the last dollars the foreclosure produces, or on a pro rata basis. See, e.g., *TMG Life Ins. Co. v. Ashner*, 898 P.2d 1145, 1155-56 (Kan. Ct. App. 1995) (finding that the one-third of the outstanding loan amount that guarantors promised to pay is to be calculated as of time guarantors pay, not as of earlier time of default, with result that guarantors remained liable even after foreclosure sale that generated price of approximately one-third of then-outstanding debt). Compare *L&B 57th St., Inc. v. E.M. Blanchard, Inc.*, 143 F.3d 88, 91-92 (2d Cir. 1998) (concluding, under New York law, that defaulting tenant's security deposit must be credited first against that portion of its rent that is subject to third-party guaranty), and *Rhoden v. FDIC*, 619 So. 2d 480, 481-82 (Fla. Dist. Ct. App. 1993) (deciding, in case in which borrower signed two notes, only one of which provided nonrecourse protection, that net rental profits accumulated by receiver after default should be applied entirely to deficiency judgment due under full recourse note rather than prorated between two notes), with *Weinstein v. Park Funding Corp.*, 879 P.2d 462, 465 (Colo. Ct. App. 1994) (finding that, "when a creditor has received collateral covering the entire debt, and a personal guaranty on part of it, there is a presumption . . . that the personal guaranty is an additional protection for the creditor," and concluding from this that "the creditor may apply any [foreclosure sale] proceeds to that part of the debt not covered by the personal guaranty").

208. See *supra* notes 34-40 and accompanying text.

209. See *Prudential Ins. Co. of Am. v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109, 111, 112, 114 n.4 (Wis. Ct. App. 1987) (discussing relevance of owner's status as nonassuming grantee); *supra* notes 34-40 and accompanying text.

no contractual relationship with the grantee, although the grantee is liable to the lender for torts, including waste.<sup>210</sup> Thus, there frequently will not have been any direct negotiations between the nonassuming grantee and the lender.<sup>211</sup> This last fact may suggest that this Article's heavy emphasis on advance preparation and careful drafting cannot be applied to the nonassuming grantee with the same ease with which it can be applied to the nonrecourse borrower.

The lender, however, always has the ability to draft the initial documents in a way that ensures that there will be a direct relationship between itself and any subsequent buyers of the mortgaged property. The lender may make the mortgage due on sale, so that any buyer wishing to leave the financing in place must negotiate with the lender for that right,<sup>212</sup> or the original documents may allow grantees to leave the financing in place only if they assume some measure of personal liability when they acquire the property. By purchasing with record notice of the terms of the original documents or by being compelled to negotiate modifications at the time of the transfer, the grantee can be forced to assume certain responsibilities personally. Either way, the lender can ensure that any future grantee has the same obligations that it would have had if it had been a new nonrecourse borrower.<sup>213</sup>

### V. Conclusion

The common law has had centuries to develop rules that apply to ordinary full recourse loans, but the courts are only beginning to address the questions that arise when parties voluntarily reject this body of law and

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210. See, e.g., *Cornelison v. Kombluth*, 542 P.2d 981, 985-87 (Cal. 1975) (en banc) (stating that grantee who purchases property subject to existing financing does not become personally liable for debt without assuming liability, but nonetheless can be charged with waste).

211. See generally *Leipziger*, *supra* note 32, at 1129-35 (discussing liability of subsequent grantees and third parties, with emphasis on California law).

212. The commercial lender that extends credit to a borrower on a nonrecourse basis probably has a high degree of confidence in the expertise of the borrower's key equity holders and management personnel: It can live with less extensive remedies if it believes it is less likely to need any remedies at all. This implies that nonrecourse lenders always should make their loans due-on-sale. The failure to do so means that the lender's only security may be real property that comes to be owned and operated by strangers. In fact, loan agreements often go a step further, by restricting the ability of even the original owner to change its internal management structure. See *supra* text accompanying note 20; *supra* note 132; *supra* note 182 and accompanying text.

213. The fact that the original loan is a full recourse loan increases the likelihood that the lender simply will not consider nonrecourse issues. In the nonrecourse loan, the borrower places the issue of its own liability directly on the table. In the full recourse loan, however, the borrower is unlikely to care about these issues, and they may not occur to the lender.

replace it with an ill-defined substitute of their own creation. The most direct way for borrowers and lenders to avoid disputes is to define their relationship precisely, a course that only some parties follow. Others will agree to a document that waives a key remedy without clarifying what options remain to the lender. As several recent cases have shown, this second approach breeds unnecessary litigation.

Judges, who may be unfamiliar with the intricacies of real estate finance, need to recognize several points before they can decide these cases fairly. They must appreciate that a nonrecourse loan differs from both full recourse and zero recourse loans. They must realize that a nonrecourse loan is one in which the lender must look solely to the mortgaged property in far more cases than it otherwise would, but not necessarily always. In addition, they must acknowledge that the definition of the mortgaged property may not be clear. The mortgaged property is an asset with a legal characterization that can be uncertain and with a value that fluctuates, and the borrower has the capacity to transform some of this secured property into unreachable personal property.

Judges facing litigation about the scope of the lender's recourse may find themselves wondering exactly what the parties agreed to and concluding that they did not agree to anything helpful. Nonetheless, once a nonrecourse loan goes into default, a court may find itself forced to decide exactly how much protection the inadequate documents provide to the borrower. In doing so, the court must recognize that the parties intended to protect the borrower financially to some degree but probably did not intend to let the borrower disregard the lender's interests entirely. The court, then, must strive to reach a result that preserves the borrower's motivation to protect the security but that limits the losses facing the borrower that fails to do so.

This Article recommends that courts adopt an approach that compares the way in which the nonrecourse borrower actually acted with the way in which it would have acted had it been personally responsible for performance of the mortgage obligations, holding nonrecourse borrowers liable only for the results of any differences. This standard insulates the borrower from the market risks that the lender probably expected to assume, but leaves the borrower liable for the costs of any actions that it took only because it believed that it would not have to pay for their consequences. This test should ensure that nonrecourse borrowers will not act foolishly or recklessly, or at least not any more so than they would if their own funds were at risk. This approach also will help guide borrowers and lenders earlier in their relationship, as they attempt to negotiate documents that are mutually acceptable.

The test proposed here places a heavy burden on the lender. The lender must prove that the nonrecourse borrower behaved differently than it otherwise would have, demonstrating along the way that the borrower exceeded the

scope of the discretion that it retained as owner of the property and that the lender suffered actual loss as a result of the borrower's acts or omissions. Most lenders will not be able to make this showing. This difficulty demonstrates the importance to lenders of addressing these issues in advance, in the documents, rather than trying to place limits on their borrowers' behavior after the project becomes troubled. Borrowers and lenders that wish to avoid participating in the slow and costly development of the case law may do so easily, by reflecting carefully on the repercussions of their proposed business arrangement and then drafting their documents thoughtfully.

In one sense, the typical dispute that this Article addresses is little more than a private law disagreement between a borrower and a lender with an unnecessarily vague business relationship. If the parties end up litigating their differences, a judge will have to interpret their imprecise documents. The consequences of these disagreements, however, can affect parties beyond the borrower and the lender. Every time a borrower defaults, title to its property may become clouded, the condition of the property may deteriorate, tenants may vacate the premises, and the local community may endure hardship as a result of the owner's distress and the lender's inability to terminate it swiftly. Every time a lender must write off a bad loan, its owners suffer; if this happens too often to the same lender, others—such as the federal government and the taxpayers that support it—may end up paying for the cost of the parties' errors. The rule proposed here should allow judges to resolve these issues fairly and in accordance with the probable expectations of the parties while also creating incentives for these and other parties to avoid similar disputes and similar consequences in the future.

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# NOTES

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