

# What a Waste!

## WHAT'S A PRUDENT LENDER TO DO?

By Marsha Baumgarner<sup>†</sup> and Michael Hentrel<sup>††</sup>

In the midst of the deepest housing and credit crisis in decades, multifamily lenders and owners must equally face some tough decisions. In a typical multifamily mortgage transaction, the lender has two equally important, but sometimes competing, issues to manage: timely payment of the debt, and maintenance of the revenue producing property as collateral, the primary driver for multifamily loan transactions. In a perfect world, landlord/borrowers would be able to pay debt service and maintain the property in pristine condition thereby maintaining or increasing the value of the lender's collateral. However, in a down market with less capital available, borrowers must often choose between servicing the debt and maintaining the property.

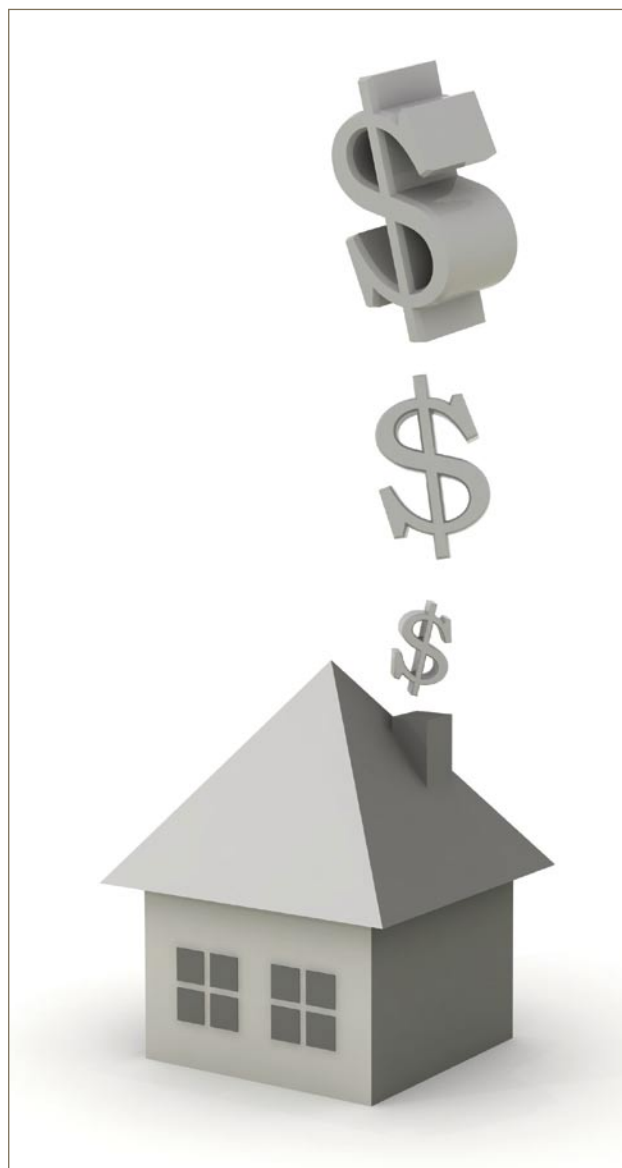
Some examples are helpful in illustrating this dilemma. First, consider the effects of a property owner in a cash-flow crunch tearing out functioning appliances from vacant units to replace non-functioning appliances in occupied units. What happens if that property owner never replaces the non-functioning appliances and subsequently defaults, causing the lender to foreclose? How does the lender get the cannibalized appliances replaced? Now, imagine a property owner bulldozing buildings in preparation for redevelopment of a property and the redevelopment sputters before anything is built. Is the lender stuck with a bulldozed lot at foreclosure?

These are just two examples of the real challenges faced by multifamily lenders. How does a typical nonrecourse lender protect both its income stream (debt service on the loan) and the value of the collateral that generates that stream (the property) when waste has been committed on the property? The fact that most multifamily borrowers are single asset entities (mostly limited partnerships or limited liability companies) with the property being the only asset adds to the challenge. The first part of this note will discuss the general concept of waste. The second part will discuss some of the various approaches regarding a mortgagee's standing to sue for waste and the remedies associated. The third part will discuss specific issues in nonrecourse transactions and possible contractual solutions that protect the lender's standing and remedies.

### I. WASTE DEFINED

"Waste" is defined as any act or omission that causes lasting damage or permanent loss of the fee or that destroys or lessens the fee's value.<sup>1</sup> More specifically, waste is an act or omission by one in rightful possession of land who has less than a fee simple interest in the land, which decreases the value of the land or the owner's interest or the interest of one who has an interest in the estate that may become possessory at some future time.<sup>2</sup> There are three elements essential to a cause of action for waste: (1) there must be an act or omission constituting waste, (2) the act must be done by someone legally in possession of the property, and (3) the act or omission must harm the estate or the interest of another in the property.<sup>3</sup>

Under the law generally, there are three kinds of waste: voluntary waste, ameliorative waste, and permissive waste. Voluntary waste is a deliberate and intentional change made to the



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property that harms the property or diminishes its resources, unless such use is a continuation of a current use.<sup>4</sup> Under generally established common law principles, owners have a duty to avoid committing waste and an obligation to surrender the premises in the same condition as when the tenant took possession of the premises, normal wear and tear excepted.<sup>5</sup> In the United States, it is generally accepted that a tenant may “make changes in the physical condition of the leased property which are reasonably necessary in order for the tenant to use the leased property in a manner that is reasonable under the circumstances.”<sup>6</sup> In other words, the reasonableness of the use is determined by the agreement between the parties and the prior use of the property. To the extent that the parties contemplate a particular use of the property, the presumption is that they are implicitly agreeing that all of the ordinary incidents of that use are reasonable.<sup>7</sup> For example, if the property contains a coal mine and the parties agree to this use, a tenant can continue to mine the property for all of its coal without committing waste. Conversely, if the land was leased as a goat pasture, the tenant’s use as a coal mine would constitute waste.

Ameliorating waste is an improvement or modification to the property that changes the nature or character of the property. In most cases, such an improvement or modification actually increases the current value of the property.<sup>8</sup> In the United States, a landlord cannot generally recover damages for ameliorating waste as the common law seeks to promote improvements to unproductive property.

Under the definitions provided above, it is obvious that an “act” by the owner or tenant can constitute waste. For example, if a tenant rips out appliances and fixtures upon vacating the premises, it is a clear act of waste. However, common law and some states have expanded the definition and the cause of action to include instances where the owner or tenant neglected to act in such a way to preserve the property.<sup>9</sup>

Permissive waste is an intentional or negligent failure to maintain the property physically or otherwise—it does not require a bad act on the part of the tenant.<sup>10</sup> Permissive waste



is actionable in the same way as active waste, because both can hinder and diminish the value of the real estate.<sup>11</sup> Thus, passive situations in which the tenant is not paying expenses he or she is responsible for or is not maintaining the property in a reasonable manner constitutes permissive waste. For lenders on multifamily properties, permissive waste is the most challenging type of waste to address.

Once a tenant or owner is found liable for waste, there are three main remedies. The court may require the defendant to pay monetary damages to the injured party to compensate for the loss resulting from the waste. The court may require the person liable for the waste to restore the property to the condition it was in before the waste was committed. Finally, the court may dispossess and divest the tenant of the property and vest it immediately in the landlord (this is not common in mortgagee cases).

## II. MORTGAGEE’S STANDING AND REMEDIES FOR WASTE

Over the years, legal concepts and theories have evolved in some states to protect mortgagees from waste. The common theme is that a borrower/mortgagor has an obligation to the lender/mortgagee to maintain the property in a manner that does not decrease the value of the collateral. “A person who has

a specific lien against real estate has a right to restrain waste by the owner of the real estate.”<sup>12</sup> In essence, the mortgage can create a property right separate and apart from the loan itself. “The security is not the indebtedness itself, and the right to recovery for waste arises simply from the existence of the mortgage relationship [...]”<sup>13</sup>

Of course, the lender (and lender’s counsel) clearly must pay particular attention to the laws of the state where the property is located. Certain states limit a lender’s remedies regarding waste on leased property while others punish a party for committing waste.<sup>14</sup> Lien states, generally, provide that the lender/mortgagor owns the debt but only has a lien on the property and that possessory or ownership rights do not “vest” until foreclosure.<sup>15</sup> This concept embodies the theory that the holder of executory lien cannot sue for waste because its interest is a future interest and not a vested interest. However, some lien states have taken legislative steps to protect the lender, implicitly acknowledging that these rights do not accrue until foreclosure.<sup>16</sup> Also, lien states generally only allow a mortgagor to recover for waste if the value of the collateral goes below the amount of the outstanding debt.<sup>17</sup> The combined recovery for waste and by foreclosure (or other means) cannot exceed the amount of the debt.<sup>18</sup> In essence, the amount of the debt serves as a cap for recovery.

Conversely, title states allow the lender to recover for any diminution in the value of the security.<sup>19</sup> Title states generally provide that a present non-possessory vested interest is passed when a mortgagor executes a mortgage or a deed of trust for the benefit of the mortgagee. In other words, the mortgagee’s interest is more than a simple lien on the property. While this interest is not quite possessory title, it is a vested interest that warrants protection. Title states generally allow the person having the next immediate estate of inheritance to bring an action of waste against a tenant.<sup>20</sup> In practice, this right has also extended to mortgagors on the premise that they have the right to unimpaired security and that its present vested non-possessory interest can be construed as potential future title.<sup>21</sup> Other states expressly give the beneficiary of a deed of trust (or a mortgage holder) the right to sue for waste when the waste is committed.<sup>22</sup>

### III. SOLUTIONS FOR NONRECOURSE LENDERS

The differences between the remedies and the limits on recovery among the states necessitates that prudent multistate lenders implement contractual remedies that can be consistently applied from state to state. Relying on each individual state’s law is a risky, uncertain proposition for any lender. Therefore, a careful lender should draft loan documents in such a way that either the landlord/borrower or the tenant is accountable for any decrease in the value of the security or gives the lender the right to pursue direct remedies against the tenant.

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One solution is for the lender to insert a “waste related” nonrecourse carve-out provision in its form loan documents. A nonrecourse loan is a loan where a borrower or its equity holder is not personally liable for the debt—the lender’s primary remedy is against the property itself.<sup>23</sup> This nonrecourse status is accomplished by inserting express language in the loan documents by which the lender agrees to look solely to the property for satisfaction of the secured loan. However, most lenders have nonrecourse carve-outs in their form loan documents.<sup>24</sup> These provisions list the situations where the borrower will be personally liable on an otherwise nonrecourse loan and, in most cases, provide that certain bad conduct by the borrower will result in recourse treatment. Some situations that can trigger recourse treatment in a nonrecourse loan include fraud by the borrower in obtaining the loan and unauthorized transfers of the controlling interest in the borrower.<sup>25</sup>

Furthermore, many lenders have added carve-outs related to the management and economic aspects of the property. As discussed earlier, courts have begun to find that owners that fail to maintain their property or to pay taxes commit the tort of waste.<sup>26</sup> In light of this, this concept is now being included in



these carve-out provisions. Other examples include environmental damage to the land, misappropriation of income from the property,<sup>27</sup> and failure to preserve the property. A borrower that fails to pay the principal and interest on its loan may be protected by the nonrecourse language in the loan documents, but courts may be less willing to allow a borrower to use nonrecourse as an escape from liability for bad conduct.<sup>28</sup>

Adding a nonrecourse carve-out provision for situations where the borrower commits waste, permits the tenant to commit waste or otherwise decrease the value of the collateral would incentivize the landlord/borrower to be vigilant in managing the asset because the provision gives the lender the ability to put the loan in default and exercise available remedies in the event that the value of the property is diminished. The remedy for breach of the carve-out can also be tailored to the specific breach. Alternatively, some nonrecourse carve-out provisions provide that the entire loan becomes recourse to the borrower if any breach occurs, while others state that the borrower is specifically liable for the actual damages resulting from the breach.

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The lender must also evaluate its ability to recover against the borrower if the borrower becomes personally liable as a result of the breach. Most multifamily borrowers are single asset entities where the subject property is the entity's only asset, making a cause of action for breach of a nonrecourse carve-out against such an entity almost worthless. A prudent lender will always require the key principals of a single asset borrower (i.e., a deep pocket limited partner) to execute a personal guaranty that includes the breach of nonrecourse carve-outs as a subject of the guaranty. The guarantor in a guaranty contractually promises to pay a debt or perform an obligation if the person liable in the first instance fails to pay or perform.<sup>29</sup> A guaranty is a separate contract between the lender and guarantor and has its own set of remedies for breach.<sup>30</sup> A prudent lender requires a guaranty from the key principal because it gives the lender a separate set of rights and remedies in the event there is waste on the property. The lender can proceed under the loan documents with the borrower and also under the guaranty against the key principal.

Another solution is for the lender to require that the landlord/borrower execute an assignment giving the lender an express right to pursue a cause of action for waste against the tenant. It is very typical for landlords to include a provision in the lease that

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holds a tenant liable for damage beyond normal wear and tear. However, this provision is not generally a covenant that runs with the land, but is instead a covenant impacting the tenant's use of the leasehold. Thus, these provisions are not often enforceable by non-landlords or third parties with a non-possessory interest in the land.

Title states allow the mortgagor to pursue damages for waste but other states limit a non-owner's right to pursue remedies for waste. For example, some states do not allow a subsequent owner to recover for waste that occurred prior to ownership, unless there is an assignment.<sup>31</sup> Similarly, some states have held that there is no automatic right for a third party interest holder (lien-holder or insurer) to seek damages for tenant waste. Therefore, an express assignment or contractual grant may give the lender more protection than the common law of the particular state.

## Conclusion

Lenders must understand that if the property's value (and the income stream) depends on the maintenance of the property and the prevention of waste, they must ensure that they have adequate contractual rights and remedies to protect (or recover) this value. The daunting challenge of managing multistate portfolios requires lenders to have a consistent approach to contracting around various issues. Waste is a good example of such an issue because states have taken different approaches in addressing standing and remedies for waste. The proffered solutions attempt to protect the lender's standing and remedies by contract instead of relying on the various state courts and legislatures. The current market requires that lenders diligently and actively monitor and manage collateral. Consistent contractual fixes that can be applied in the various states and often can expand a lender's remedies will facilitate this endeavor. **BLB**

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<sup>1</sup> ILL. JURIS., *Property*, § 24:45.

<sup>2</sup> BLACK'S LAW DICTIONARY 1425 (5th ed. 1979).

<sup>3</sup> Archon v. Patel, No. 99-15364, 2000 U.S. App. LEXIS 12810, at \*3(9th Cir. June 7, 2000).

<sup>4</sup> BLACK'S LAW DICTIONARY (8th ed. 2004), waste.

<sup>5</sup> Camden Trust Co. v. Handle, 21 A.2d 354, 358 (N.J. Ch. 1941) (holding that rightful possession of the wrongdoer is essential and constitutes the material distinction between waste and trespass), *rev'd on other grounds*, 26 A.2d 865.

<sup>6</sup> RESTATEMENT (SECOND) OF PROP.: LANDLORDS AND TENANTS § 12.2(1) (1977).

<sup>7</sup> Jedediah Purdy, *The American Transformation of Waste Doctrine: A Pluralist Interpretation*, 91 CORNELL L. REV. 653, 659 (2006).

<sup>8</sup> See BLACK'S LAW DICTIONARY 74 (5th ed. 1979).

<sup>9</sup> See Capitol Bankers Life Ins. Co. v. Amalgamated Trust and Savings Bank, No. 92 C 4480, 1993 U.S. Dist. LEXIS 6032, at \*16 (ND Ill. 1993) (concluding that waste can include neglect and held that non-payment of real estate taxes payable by the tenant was waste), *appeal denied*, No. 92 C 4480, 1993 U.S. Dist. LEXIS 8585.

<sup>10</sup> See BLACK'S LAW DICTIONARY 1428 (5th ed. 1979).

<sup>11</sup> See Prudential Ins. Co. of America v. Spencer's Kenosha Bowl Inc., 404 N.W. 2d 109 (Wis. Ct. App. 1987) (holding that the owner and nonrecourse borrower committed nine instances of passive waste—eight of them related to maintenance of the property and the ninth was related to a failure to pay taxes). See also Travelers Ins. Co. v. 633 Third Associates, 14 F. 3d 114 (2d. Cir. 1994) (holding that under New York law, failure to pay real estate taxes was waste); Nippon Credit Bank, Ltd. v. 133 North California Boulevard, 86 Cal. App. 4th 486 (2001) (holding that under California law, failure to pay real estate taxes while the loan is delinquent was waste).

<sup>12</sup> Jaffe-Spindler Co. v. Monumental Life Ins. Co., 747 F.2d.253 (1984) citing 78 Am. Jur. 2d Waste § 13 (1975).

<sup>13</sup> *Id.* at 256.

<sup>14</sup> See KY. REV. STAT. ANN. § 381.350 (LEXIS 2006) (requiring that a finding of unpermitted voluntary waste warrants payment of treble damages to the future interest holder and automatic termination of the current interest). See also MO. REV. STAT. § 537.420 (2008) (mandating payment of treble damages).

<sup>15</sup> See S.C. CODE ANN. § 29-3-10 (2007) (providing that the mortgagee is not entitled to a possessory interest in the mortgaged land—the mortgagor is the owner of the land and the mortgagee is the owner of the loan. The mortgagee can recover satisfaction for such money out of the land by becoming the owner by foreclosure or other legal sale).

<sup>16</sup> See COLO. REV. STAT. § 38-39-105 (2008) (providing that the owner of property subject to a mortgage or a deed of trust must obtain the consent of the most senior lien holder before it removes any improvement on the property).

<sup>17</sup> See Jaffe-Spindler Co., 747 F.2d. at 257.

<sup>18</sup> *Id.* at 257.

<sup>19</sup> *Id.*

<sup>20</sup> See MASS. GEN. LAWS ch. 242, § 1 (2008).

<sup>21</sup> See Delano v. Smith, 92 N.E. 500, 501 (Mass. 1910) (finding that mortgagee has an interest in the property and its preservation, and may maintain an action in his name for injury to it).

<sup>22</sup> See ARIZ. REV. STAT. § 33-806(b)(2) (2007) (“The trustee of beneficiary shall have a right to maintain the action . . . for damages or to prevent . . . waste”). See also Archon v. Patel, 2000 U.S. App. LEXIS 12810, at \*3-4 (9th Cir. June 7, 2000) (applying the Arizona statute and holding that a former deed of trust beneficiary had standing to sue for waste although the deed of trust had been released by the time the action was filed and concluding that the former beneficiary could sue because the deed was in effect when the waste was committed).

<sup>23</sup> Gregory M. Stein, *The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan*, 55 WASH. & LEE L. REV. 1207, 1209 (1998).

<sup>24</sup> *Id.* at 1210.

<sup>25</sup> See Fannie Mae Multifamily Fixed Rate Nonrecourse Note Form 4100, available at <http://www.efanniemae.com/mf/loandocs/fixednonrecourse.jsp>.

<sup>26</sup> See Prudential Ins. Co. of America v. Spencer's Kenosha Bowl Inc., 404 N.W. 2d 109 (Wis. Ct. App. 1987) (holding that the owner and nonrecourse borrower committed nine instances of passive waste—eight of them related to maintenance of the property and the ninth was related to a failure to pay taxes). See also Travelers Ins. Co. v. 633 Third Associates, 14 F. 3d 114 (2d. Cir. 1994) (holding that under New York law, failure to pay real estate taxes was waste); Nippon Credit Bank, Ltd. v. 133 North California Boulevard, 86 Cal. App. 4th 486 (2001) (holding that under California law, failure to pay real estate taxes while the loan is delinquent was waste).

<sup>27</sup> *Id.*

<sup>28</sup> See First Nationwide Bank v. Brookhaven Realty Assocs., 637 N.Y.S. 2d 418, 420-21 (N.Y. App. Div. 1996) (holding that borrower violated a nonrecourse carve-out by filing for bankruptcy). See also FDIC v. Prince George Corp., 58 F. 3d 1041 (4th Cir. 1995) (holding that a bankruptcy filing violated a nonrecourse carve-out regarding acts or omissions that impaired the lender's rights and remedies).

<sup>29</sup> See BLACK'S LAW DICTIONARY 634 (5th ed. 1979).

<sup>30</sup> See e.g., Fannie Mae Multifamily Form 4501, available at <http://www.efanniemae.com/mf/loandocs/nonrecourseguaranty.jsp>.

<sup>31</sup> Hill v. Pinque, 204 P. 1097, 1097 (Cal. Dist. Ct. App. 1922) (“Title to the property at the time of the commission of the waste is necessary to sustain the right to an accounting for such waste”).