

MORTGAGES: COURT REFUSES TO EXTEND DOCTRINE OF “WASTE”

By: Harris Ominsky, Esq.

A recent case illustrates how far lenders will go in trying to nail borrowers when lenders come up short in a foreclosure sale. The tactic did not succeed in Boucher Investments, L.P. v. Annapolis-West Limited Partnership, 2001 Md. App. LEXIS 162 (October 31, 2001), but the case serves as a lesson for both lenders and borrowers.

Boucher held a second deed of trust (“mortgage”) encumbering a small office building that depended on an adjacent shopping center for parking. When the first mortgage lender foreclosed, the proceeds of the sale were insufficient to pay Boucher under its second mortgage.

To make matters worse, the second mortgage and the note contained non-recourse provisions, exculpating the borrower and its partners from any personal liability. However, to circumvent that, the lender tried to capitalize on a clause that “the borrower shall keep the Property in good repair and shall not commit waste or permit impairment or deterioration of the Property.”

“Waste of Parking”

The borrower had depended on a twenty-year contract for the adjacent parking, but that contract had expired. A few years after the expiration, the shopping center owner erected a fence

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which prohibited any further unauthorized parking. In this setting Boucher came up with what might be labeled a “creative argument” to hold the borrower liable for the mortgage debt. It maintained that the failure of the borrower to negotiate the continued off-site parking for the Property constituted “permissive waste” of the Property because the lack of parking there resulted in a “loss of tenants [and] ... income to the property.”

Boucher’s argument was undercut by its admission that it could find no court decisions in which the failure to negotiate a lease for parking space constituted “waste.” Also while it claimed that the municipality would rescind the property’s operating permit unless additional parking spaces were provided, it presented no evidence to that effect.

Among other things the borrower argued that the non-recourse provisions in the loan documents prevented any action for personal liability whether or not there was waste, and that no physical waste had been actively inflicted against the property. The lower court had ruled, as a matter of law, that there was no waste because there had been no “destruction, misuse, alteration or neglect.” And that none of the Restatement’s criteria for waste had been met “because there [was] no allegation that the property [was] in disrepair, that [taxes] had not been paid, or that any other monies [had] been wrongfully withheld.” See RESTATEMENT (THIRD), OF PROPERTY.

Law of Waste

The appellate court affirmed the trial court, and noted that the law of waste has been applied only where physical damage was inflicted against the property, and to an extremely narrow

last year by the Pennsylvania Bar Institute.

range of other cases where there was no actual physical damage. Those other cases have almost uniformly involved failure to pay taxes and insurance premiums, or interest on a senior mortgage. It held that the failure to secure off-site parking had no relationship to the preservation of the property, and neither increased the debt nor impaired the value of the property (by subjecting it to superior liens, or the risk of loss from damage to, or destruction of the property). The court also found that Boucher's argument that the borrower had a duty to supply parking rested on a series of "shaky inferences: that off-site parking was needed; that had [the borrower] negotiated for it, [it] would have secured it; that [its] failure to do so resulted in a loss of tenants; and that the loss of those tenants substantially affected the value of the property."

In short, the lender was grasping for straws to overcome the non-recourse provisions in the loan documents -- and the court handed it the short straw. The court made the correct decision, particularly in light of the ability of the lender to cite any comparable case.

However, the opinion highlights the potential liability of a borrower for waste, even in the face of a non-recourse loan. The opinion cited with approval two other recent cases of waste in connection with non-recourse loans: Travelers Ins. Co. v. 633 Third, Associates, 14 F.3d 114, 123 (2nd Cir. 1994); and Nippon Credit Bank, Ltd. v. 133 North California Boulevard, 86 Cal. App. 4th 486 (2001). These cases found mortgagors personally liable under a tort theory of "bad-faith" waste. See John C. Murray, Non-Payment Of Taxes As Tortious Waste In Non-Recourse Mortgage Loans, 19 Cal. Real Prop. J. 22 (Spring, 2001).

Lessons

These cases tell us that while courts may be reluctant to find personal liability for waste in

connection with non-recourse loans, borrowers had better act in good faith when dealing with non-payment of real estate taxes, insurance premiums or interest on senior mortgages. Except if it is otherwise stated in the loan documents, their liability for waste may not go much further than that. However, the whole concept that non-recourse borrowers might be liable for non-physical waste will surprise many lawyers.

Lenders should understand that if the value of the secured property depends on parking or other amenities, they had better make sure that those rights are protected under the mortgage documents. For example the mortgage should cover a parking easement or lease for parking in the same way as the office building. Also, the lender should make sure it has adequate notice and a right to cure before parking rights may be terminated.

In addition, the personal-liability provisions and the guarantees by the borrower's principals should at least include liability to keep up required parking standards. In many cases carve-outs from non-recourse language include liability for "failure to comply with laws and regulations applicable to the property." The Boucher case presents just one small example of why a mortgage lender might need broad carve-outs in its documents.