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Faithful Waste

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MIDCOURSE CORRECTION

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Based on its aftermath, *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, has been a most remarkable case. Since its promulgation 26 years ago, it has generated two significant lines of decision. One—regarding the effect of a full credit bid—is represented in this issue in *Kolodge v Boyd* (2001) 88 CA4th 349, 105 CR2d 749. The other—concerning a mortgagor's liability for waste—is covered in *Nippon Credit Bank, Ltd. v 1333 N. Cal. Blvd.* (2001) 86 CA4th 486, 103 CR2d 421 (reported in 24 CEB RPLR 132 (Apr. 2001), which is the subject of this column.

Cornelison held that one of the effects of California's antideficiency policies is to bar lenders' actions for waste (technically, impairment of security) in all cases except when the waste is committed in bad faith. (This entire point was unnecessary, since the California Supreme Court took it all away in the final page of its opinion by holding that, even if the mortgagor had committed waste, it didn't matter because the mortgagee had made a full credit bid. Had the full credit bid issue been decided first, we might have been spared the court's thinking about waste.)

Background: *Cornelison*'s Economic Inventions

It is important to separate *Cornelison*'s conclusions about waste from the reasoning it employed to get there. The opinion was written in the days when the supreme court often used a kind of pseudo-economic logic to justify its interpretations of California's antideficiency statutes. This began with *Roseleaf v Chierighino* (1963) 59 C2d 35, 27 CR 873, in which Justice Traynor found economic justifications underlying the antideficiency rule of CCP §580b that no economist has ever been able to replicate.

Cornelison took that type of thinking one step farther by holding that our antideficiency laws also had an effect on the law of waste, because of a perceived similarity of the two (15 C3d at 603):

It is clear that the two judgments against the mortgagor, one for waste and the other for a deficiency, are closely interrelated and may often reflect identical amounts. If property values in general are declining, a deficiency judgment and a judgment for waste would be identical up to the point at which the harm caused by the mortgagor is equal to or less than the general decline in property values resulting from market conditions. When waste is committed in a depressed market, a deficiency judgment, although reflecting the amount of the waste, will of course exceed it if the decline of property values is greater. However, when waste is committed in a rising market, there will be no deficiency judgment, unless the property was originally overvalued; in this event, there would be no damages for waste unless the impairment due to waste exceeded the general increase in property values.

I have never been able to understand how the two judgments would be for identical amounts when there is both a general decline in market values and harm to the particular property; their effect should be cumulative, not identical. Nor can I see how a deficiency judgment in a depressed market would exceed a waste judgment only if the market decline is greater. The deficiency judgment should be larger in any case, because it combines both losses. Finally, it is

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not clear to me why waste committed in a rising market would lead to a waste judgment but not a deficiency judgment when the impairment loss exceeds the market gain (if that is what the final quoted sentence means).

On these shaky foundations, even shakier conclusions were drawn. First, the purchase money bar of CCP §580b was held to prohibit recovery for waste because it "would burden the defaulting purchaser with both loss of land and personal liability," the so-called anti-depression second prong of the *Roseleaf* rationale for CCP §580b. Of course, the fact is that the debtor has failed to both pay the debt and care for the property. Furthermore, as the supreme court itself pointed out elsewhere, that loss has to be borne by somebody, and giving the debtor protection merely transfers it to the creditor, often a sold-out junior seller. See *Spangler v Memel* (1972) 7 C3d 603, 102 CR 807. Second, the court then held that this prohibition did not apply if the waste was committed in "bad faith," without explaining why the same depression-aggravating double loss would not then occur.

The same logic was also applied to the nonjudicial sale bar of CCP §580d, which the court applied to bar a mortgagee from recovering for waste after a trustee sale because that would have given him "the double benefits of an irredeemable title to the property and a personal judgment against the mortgagor for the impairment of the value of the property." 15 C3d at 604. And, again, this consequence was held acceptable in the case of bad faith waste.

The overall effect of these rules is that a mortgagee confronted with ordinary ("good faith") waste cannot do anything about it. If she holds a nonpurchase money mortgage, she can judicially foreclose and get a deficiency judgment covering her entire shortfall, but if her mortgage is purchase money or if she conducts a trustee sale rather than a judicial foreclosure, she is barred from a waste recovery. On the other hand, if she can demonstrate that the waste was committed in bad faith, she can avoid both deficiency barriers and obtain a waste judgment even though she holds a purchase money note and conducts a trustee sale.

What Is Bad Faith?

Under the *Cornelison* standard, the critical inquiry is not whether waste occurred, but whether it was done in bad faith. This is a fact question, and seems to depend mainly on motive. The court's statement 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" (15 C3d at 604) suggests that waste committed solely because of economic stress may be good faith waste, while bad faith waste requires evidence of evil intent.

There certainly was ready evidence of such intent in the *Nippon* case. The mortgagor's outrageous behavior, together with his own damning testimony, made it easy for the jury to find him malicious. Any mortgagor who admits to having sufficient funds (indeed, with enough extra to siphon some off as well), and yet decides not to pay the taxes to "punish" the mortgagee, should not expect to do well on the good/bad faith issue. Clearly, this client should have been told to keep his mouth shut—during the workout negotiations and while on the stand. Threatening bankruptcy may be acceptable, but threatening nonpayment of property taxes is not. (It may still be safe to threaten to default on the debt payments, because there is as yet no such tort as "bad faith mortgage default," but that could extend to threatening to withhold payments on the senior mortgage!) Moreover, the bad faith in this case consisted of missing only one tax payment.

We can assume that future debtors will be more cautious in what they say, but economic data may still get them in trouble. Even in the absence of intemperate language, can bad faith be found from the mere fact that the cash flow was sufficient to pay both the taxes and the mortgage debt? Would previous draws by the mortgagor make it bad faith for him not to reach into his own

pocket to pay such expenses, even when the cash flow is insufficient? If a general market downturn can help prove the debtor's bona fides, can that be offset by showing that he is generally solvent, even though this particular project is losing money? The *Nippon* facts were so lopsided in favor of the lender that they don't give us much guidance for future, closer cases of this sort.

What Is Waste?

The bad faith features of *Nippon* should not obscure its counterpart holding that waste is not limited to physical noncare of the property. The trend toward including financial waste within its ambit is growing steadily, much supported by the new Restatement of Mortgages on that issue. I assume that failure to keep the property insurance in force will also be regarded as waste, perhaps even in the absence of any casualty loss. I have hinted above at the possibility that a junior mortgagee may successfully claim that the mortgagor's failure to keep the senior loan current constitutes the same kind of waste as hurts the senior lienor when the property taxes are not paid. Once financial waste becomes a respectable concept, its contours are going to need a lot of mapping.

Tort Law Versus Contract Law

The *Nippon* debtor was held liable for compensatory and punitive damages despite the fact that his mortgage was nonrecourse and his foreclosure was nonjudicial, which shows how little contract law and conventional mortgage law have to do with the outcome. But there are still considerations that should affect loan document drafting.

In nonrecourse loans, carve-out clauses should be checked to make sure that they compel the debtor to behave properly. Even under California's antideficiency rules, a carve-out is better than nothing, because it gives the mortgagee the option of judicially foreclosing and seeking a deficiency judgment (at least in nonpurchase money cases), whereas no such relief is available if the loan is completely nonrecourse. In California, a completely nonrecourse loan is like a purchase money loan, precluding both deficiency liability and ordinary waste liability.

On the other hand, improved care-of-property covenants in the deed of trust won't help too much (in California) because *Cornelison*'s reading of our deficiency rules denies mortgagees any basis for recovery in tort or contract. Bad faith waste is tortious, with or without covenants by the mortgagor to care for the property, so it doesn't matter too much what the clauses say on this issue.

Pay the Mortgage or Pay the Taxes?

Everybody is wondering about liability for waste in the case of the mortgagor who lacks sufficient income to pay both the mortgage and the taxes; might he be guilty of bad faith waste if he uses the rents for mortgage payments instead of the taxes?

A clause in the loan documents requiring tax payments to come first might have an impact here. Lenders treat tax defaults as early warning signs of potential trouble, and such clauses might make the case for waste somewhat stronger. Furthermore, in other states, carving out tax defaults from the general nonrecourse nature of the debt can subject the borrower to personal liability for nonpayment of taxes even though nonpayment of the debt itself remains nonrecourse. Under such circumstances, for his own sake, the mortgagor should be sure to pay the taxes first.

Finally, to moralize a bit, as a society, shouldn't we want to induce mortgagors to put the upkeep of their property ahead of keeping current on their debt. As the Ninth Circuit said, when it refused to follow *Cornelison* in the case of federal loans, "[t]he aggravation of the downturn caused by such judgments is probably no worse than the deleterious influence on the neighborhood of the deterioration which such judgments are designed to prevent." *U.S. v*

Haddon Haciendas Co. (9th Cir 1976) 541 F2d 777, 785. It may be one of the great ironies of California mortgage law that at the same time our antideficiency rules have pushed housing prices beyond the reach of many buyers, they have also contributed to the physical decline of that same housing stock.