

FINANCING

Commission of 'Waste' Can Trap Unwary Borrower

With the availability of fewer financing sources and generally lower levels of leverage, the current economic climate has forced real estate developers with impending loan maturities and balloon payments to examine their options carefully. In some instances, decreased commercial real estate values or development plans that are no longer viable have left borrowers with no alternative but to rely upon the key principle in non-recourse lending whereby a borrower and its principals may escape continuing liability so long as they surrender the real estate collateral to the lender. Other owners, however, may seek to hold onto to their property, even in the face of negative current equity, possibly based on the knowledge (or hope) that some expected future event such as a large lease signing or entitlement approval will allow the property to support a successful "take-out" financing. Such borrowers may seek to modify or extend the terms of their existing financing in order to delay maturity or impending default by engaging their lender in "workout" of such loans.

A borrower may encounter difficulties when trying to persuade its lender to commence workout negotiations in the period before the subject loan goes into default and during which several options may still be available to it. While borrowers have tried a variety of strategies to force a reluctant lender into a restructuring or workout, such tactics are often fraught with potential hazards, including claims of waste by the lender, and a rash borrower may quickly find itself and its principals in a worse position than simply facing a default.

As existing mortgage loans mature, many industry analysts foresee a deepening of the current crisis in which a significant number of borrowers may be unable to refinance their outstanding debt. In addition to lower available leverage, many commercial properties have lost significant value since the last time debt was issued



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thereon. As such, there are many commercial borrowers with currently performing loans that will be unable to refinance such loans, and therefore are moving toward clearly foreseeable maturity defaults.

Numerous actions that a frustrated borrower may be tempted to take in order to force default (and therefore, a transfer to special servicing and a potential restructuring or workout) may, in certain jurisdictions, be held to constitute waste.

There are also other instances in which a borrower may look to restructure the terms of its loan well before a lender calls a default. The loss of a major tenant, unexpected construction problems or the failure to sell condominium units according to schedule, among many other issues, may cause a borrower to request changes to the terms of its debt before a default has technically occurred. While a borrower may recognize that its outstanding debt is heading inevitably towards default, from the lender's perspective if the monthly debt service is being timely paid (whether from property cash flow or a debt service reserve), there is no immediate need to restructure or otherwise enter into workout negotiations; in fact, a lender may have several accounting or regulatory incentives not to commence workout negotiations for a performing loan, even one where a maturity default is seemingly inevitable. These

disparate interests may frustrate a borrower into a course of action it later comes to regret.

As many borrowers have recently come to realize, servicers of securitized loans have limited authority to change the terms thereof, limited both by certain sections of the Tax Code known as the REMIC Rules¹ and by the pooling and servicing agreements governing such securitizations. For a securitized loan to be modified in any meaningful way, it must first be transferred to the so-called "special servicer." Special servicers, who generally have considerable experience with troubled loans, are retained by securitization trusts to maximize the timely recovery of principal and interest for loans which are not performing as anticipated. Typically, however, a securitized loan can only be moved into the jurisdiction of a special servicer if a default under the loan documents has occurred or is imminent.² Some borrowers, frustrated by these legal and contractual impediments, have taken affirmative steps to either intentionally default or convince the servicer that a default is forthcoming and therefore that a transfer into special servicing is appropriate. While such an action may in fact effectuate a servicing transfer, it is also this type of short term thinking which may have unintended consequences that ultimately come back to haunt the borrower.

Although a significant portion of securitized loans are non-recourse in nature, the principal (frequently a deep-pocket individual) behind the borrower is generally required to execute a non-recourse carve-out guaranty that is drafted to prevent the borrower from purposely undertaking certain acts that decrease the value of the lender's collateral or otherwise jeopardize the ability of the lender to reap the benefit of its bargain. A standard non-recourse carve-out guaranty creates personal liability to the guarantor if the borrower were to, among other things, commit fraud or waste, divert proceeds of the collateral property, admit its inability to pay its debts, fail to maintain insurance, wrongfully remove or destroy any portion of the property, or file for bankruptcy.

A borrower seeking a transfer to special servicing may attempt to circumvent the REMIC Rules and Pooling and Servicing Agreement restrictions by intentionally failing to pay real estate taxes, condominium common charges or

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insurance premiums or discharge mechanic's liens, thereby triggering a default under the loan documents. This may be especially true in situations where the borrower cannot simply withhold debt service, such as where tenant rents are paid directly into a lender-controlled lockbox (as is often the case in securitized loans). However, such a course of action may, contrary to the borrower's expectations, be held to violate the prohibition against waste contained in its non-recourse carve-out guaranty, thereby creating personal liability (either to the extent of the lender's losses or, in certain circumstances, for the full amount of the outstanding balance of the loan) for the guarantor. Therefore, even in the face of the borrower maintaining the property to the extent that no material physical deterioration has occurred, the borrower's actions are nonetheless sufficient to constitute actionable waste.

The commission of waste as a trigger for the violation of a non-recourse carve-out guaranty can create a trap for the unwary borrower. Numerous actions that a frustrated borrower may be tempted to take in order to force default (and therefore, a transfer to special servicing and a potential restructuring or workout) may, in certain jurisdictions, be held to constitute "waste."

The courts of New York generally define waste as an act which results in a "decrease in value" to a property.³ Waste may also be defined as "an action or inaction by a possessor of land causing unreasonable injury to the holders of other estates in the same land" including "[an] omission of duty touching real estate by one rightfully in possession, which results in substantial injury to the real estate."⁴ A claim for waste may be brought by a party with an equity interest in the property against a party with physical control, including the right of use, over such property. For example, the Fourth Circuit has held that "a person who has a specific lien against real estate has a right to restrain waste by the owner of the real estate."⁵

In New York, courts have ruled that there are two separate categories of actionable waste. The first category covers physical waste—that is, allowing the property to materially deteriorate and decrease in value—and fits the commonly understood definition of the term "waste." The second category of waste is defined as the intentional impairment of the security of a mortgage by a mortgagor.⁶ This definition may run contrary to a borrower's preconceptions regarding waste, and it is in this category that a borrower's actions to force default may result in negative and unintended consequences.

The leading New York case on mortgage impairment constituting waste is *Travelers Insurance Company v. 633 Third Associates*.⁷ Prior to *Travelers*, New York courts adhered to the "minority view that non-payment of real property taxes [did] not constitute waste."⁸ However, courts in Illinois, among others, had previously found waste to occur where a party in lawful possession of real property committed an act resulting in "the interest of persons having a subsequent right of possession [being] prejudiced in some way or [resulting in] a diminution in the value of the land being wasted."⁹ In *Travelers*, the mortgagor engaged in a series of cash distributions to its partners which resulted in a depleted cash reserve and consequently the

inability on the part of the mortgagor to pay its real estate taxes. The mortgagee brought an equitable action against the mortgagor, claiming that its failure to pay the real estate taxes constituted waste (thereby impairing the mortgage lien) in violation of the non-recourse carve-out guaranty.

The *Travelers* court agreed, noting that "New York courts recognize a cause of action for waste by a mortgagee against a mortgagor who impairs the mortgage."¹⁰ The court explicitly connected the actions of the mortgagor to waste by declaring that "an owner's willful failure to pay taxes due on mortgaged real property has been held to be actionable waste remediable at equity in other jurisdictions."¹¹ In an attempt to circumscribe its own holding with regard to waste, the court added a caveat which may nevertheless have significantly expanded the universe of actions comprising "waste." The court declared that while the "failure to pay property taxes where there is an obligation to do so or where the failure is fraudulent constitutes waste under the law of New York," such impairment of the mortgage could only be considered actionable waste if it was also "intentional or fraudulent."¹² It should be noted that the "mere failure to pay principal and interest" does not constitute waste and will not "impair the mortgage."¹³ In the absence of intentionality, willfulness, fraud or a similar deliberate act, such failures to pay real estate taxes would generally not be considered actionable waste or a violation of the non-recourse carve-out guaranty, but rather a simple event of default triggering the mortgagee's remedies available under the loan documents.

These circumstances suggest that borrowers need to consider the relative risks carefully when deciding whether to cease paying real estate taxes or take other actions which might constitute a form of economic waste and must be careful that such actions do not trigger personal liability under a non-recourse carve-out guaranty.

Although there is no case law directly on point, there may be a number of other actions undertaken by a borrower to push a loan into special servicing which, if intentionally undertaken, may impair a mortgage, and could also be deemed waste in violation of a non-recourse carve-out guaranty. For example, borrowers should be vigilant in discharging mechanics' liens. Such liens may be held, under the laws of certain states, to prime the lien of a first mortgage. In the event of a foreclosure in such a jurisdiction, a mechanic's lien may decrease the amount of the recovery a lender can obtain through a sale of the collateral property. The possibility of such reduction may be viewed as impairment of the mortgage rising to the level of economic waste. Likewise, the intentional failure to pay condominium common charges or other fees assessed for the purpose of property maintenance may result in the impairment of the security of a mortgage and a claim of actionable waste.

Might a court extend the definition of actionable

waste to the intentional failure by a borrower to pay required insurance premiums? It certainly could be argued that such a failure might impair a mortgage by decreasing the value of the collateral real property in the event of a casualty, though it may be difficult, absent an actual casualty, for the court to find economic waste for the failure to pay casualty insurance premiums. Where environmental insurance is required, however, a court may see more compelling circumstances to find waste. Underlying environmental issues can take years to discover and the initial cause may be problematic to identify. As such, any gap in environmental coverage could be the basis for an insurance company to deny a claim.

Two challenges are presented when determining whether an owner's failure to pay taxes or take other economic action constitutes an actionable case for waste under the existing state of the law. First, in New York, the *Travelers* case has not been extensively followed, and in other states some courts explicitly reject economic waste as actionable without any evidence of fraud. Second, the facts surrounding the current economic climate are sufficiently unique that a court may reach decisions that don't necessarily follow existing precedent under either the "majority" or "minority" rules. These circumstances suggest that borrowers need to consider the relative risks carefully when deciding whether to cease paying real estate taxes or take other actions which might constitute a form of economic waste and must be careful that such actions do not trigger personal liability under a non-recourse carve-out guaranty.

1. I.R.C. Sections 860A-G.

2. It should be noted that in September of 2009 the IRS issued certain clarifications to the REMIC Rules intending to allow greater flexibility in workouts. As of the date of this article, there has been much debate about the effects of the IRS clarifications and several industry organizations have submitted comment letters to the IRS requesting further explanation.

3. *300 West Realty Co. v. City of New York*, 350 N.Y.S.2d 147, 148 (N.Y. App. Div. 1973).

4. 78 Am. Jur. 2d, Waste §1.

5. *Jaffee-Spindler Co. v. Genesco Inc.*, 747 F.2d 253, 257 (4th Cir. 1984).

6. *City of New York v. New York Cross Harbor R.R. Terminal Corp.*, 2006 WL 140555 (E.D.N.Y. 2006) ("New York courts recognize a cause of action for waste by a mortgagee against a mortgagor who 'impairs the mortgage.'"); *Syracuse Sav. Bank v. Onondaga Silk Co.*, 14 N.Y.S. 2d 356, 358 (N.Y. Sup. 1939) ("The cause of action alleged in the complaint is for the impairment of the security of the mortgages and was formerly called an action on the case in the nature of waste... the essence of an action of this kind is the impairment of the security of the mortgage.")

7. *Travelers Insurance Company v. 633 Third Associates, Tower 41 Associates, Joseph T. Comras, Stanley Stahl, Robert Carmel and Citibank, N.A., as Trustee of Citibank, N.A. Commingled Employee Benefit Trust*, 14 F. 3rd 114 (2nd Cir. 1994).

8. J. Philip Rosen and Stephen B. Kaplitt, "Travelers": Confusion in Non-Recourse Arena?, NYLJ, Feb. 11, 1993, at 1, col 1.

9. *Pasulka v. Koob*, 524 N.E.2d 1227, 1239 (Ill. 1988).

10. *Travelers* at 120.

11. *Id.* at 121.

12. *Id.* at 123.

13. *Id.*