

by Gary L. Barr

Waste Land

**The antideficiency rule in foreclosures
does not apply in cases of bad faith waste**

An unassuming commercial building known as the Jewelry Center, situated in an older section of downtown Los Angeles, seems an unlikely object of the attentions of real estate lenders and their counsel in a federal case. When the owner of the Jewelry Center defaulted on its loan secured by a deed of trust on the property, the property was sold to the foreclosing lender at a nonjudicial foreclosure sale. Shortly thereafter, the lender also sued the borrower to recover damages for bad faith waste to the property caused by the borrower during its ownership of the property.¹ This attracted attention because California's antideficiency rules are usually thought to bar fur-

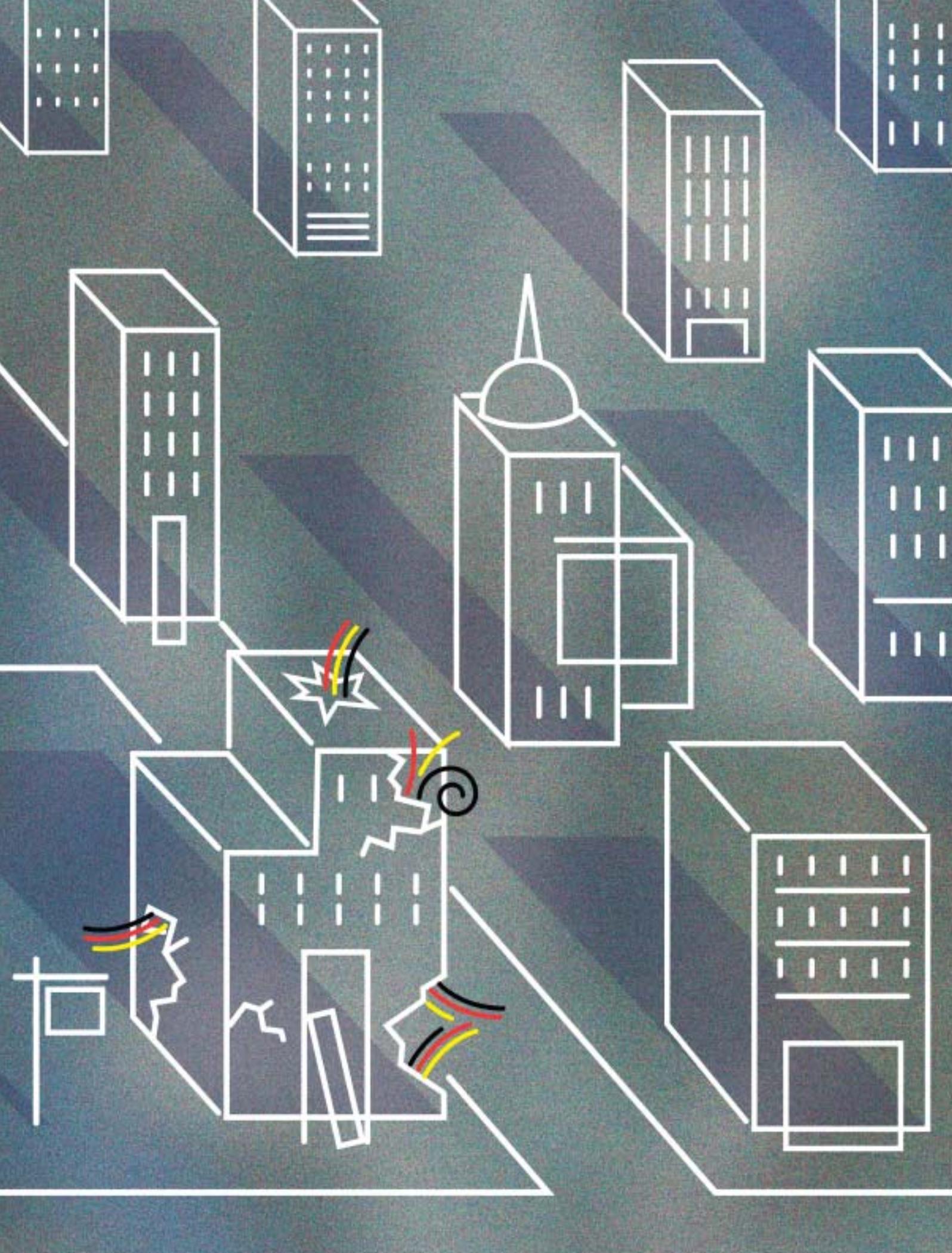
ther loan recovery claims against borrowers following nonjudicial foreclosure sales.

To support its claim for waste in the face of the antideficiency rules, the lender presented evidence of poor or deferred maintenance and service, numerous code violations, unsafe or illegal building conditions, failure to repair, and the borrower's pocketing of millions of dollars from rents and loans secured by the property. This, according to the lender, was not just "waste" but "bad faith waste" under California legal precedent—and the Ninth Circuit agreed. In an unpublished decision, *D.A.N. v. Binafard*, the Ninth Circuit held that the borrower was liable to the lender for losses resulting from diminu-

tion in the value of the collateral.²

Facts similar to those in this case are frequently in evidence in the current real estate market. Lenders are likely to increasingly face the decision of whether to pursue a borrower for committing waste to the collateral securing the loan. As aggregate loan losses mount for lenders, the pressure to increase

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recoveries will grow, and more lenders may take a second look at the heretofore infrequent claim of bad faith waste.

The concept behind the tort of bad faith waste was almost 30 years old by the time of the insightful Jewelry Center decision. Indeed, the distinction between waste and bad faith waste was created in 1975 by the California Supreme Court in *Cornelison v. Kornbluth*.³ The decision established the extent to which the traditional real property action for waste is available to creditors to recover diminution in the value of collateral following the sale of real property used as security for a loan, notwithstanding the protections of California's antideficiency laws that would otherwise protect a debtor from being required to make payments to a lender following a nonjudicial foreclosure.

Armed with the bad faith waste doctrine, creditors of obligations secured by real property have a better chance of obtaining a deficiency judgment against a defaulting debtor when the debtor has—for reasons other than mere pressures of a falling market—caused diminution in the value of collateral through actual damage or lack of care while diverting profits. Moreover, a successful plaintiff claiming bad faith waste may be awarded punitive damages.⁴

The traditional legal definition of “waste” involves conduct by the person in possession of property that impairs the value of the property, which serves as a lender's security.⁵ Waste can either be by commission (often referred to as affirmative conduct)—which occurs when the possessor damages or destroys improvements on the property—or by omission—such as when the possessor fails to care for and maintain the improvements.⁶

“Bad faith waste” is a term that describes the extent to which a Civil Code Section 2929 action for waste⁷ will be allowed to survive the application of Code of Civil Procedure Sections 580b or 580d (sometimes referred to collectively as the Antideficiency Law). Section 580b prohibits a deficiency judgment after any foreclosure sale, judicial or nonjudicial, of property that is securing a third-party purchase money mortgage on owner-occupied residential property or a seller-held purchase money mortgage on any kind of property. Section 580d prohibits a deficiency judgment following a nonjudicial foreclosure sale of real property.

In *Cornelison*, the plaintiff sold a single-family dwelling and took back a promissory note secured by a deed of trust on the property. Subsequently, the property was resold and ultimately condemned as uninhabitable. The original purchasers defaulted on the promissory note, and the plaintiff caused the property to be sold at a trustee's sale. The

plaintiff proceeded to purchase the property at the sale by making a full credit bid. The plaintiff then sued one of the original purchasers for waste.⁸

The *Cornelison* court, after extensive review of the purpose of Section 2929 and the Antideficiency Law, first concluded that for purchase money loans, Section 580b barred recovery for waste committed “solely or primarily as result of the economic pressures of a market depression.” It also held that for nonpurchase money loans, Section 580d barred recovery “when the waste actually results from the depressed condition of the general real estate market.”⁹ Thus, it seemed that the *Cornelison* court would merely reinforce the Antideficiency's Law's preclusion of deficiency judgments. However, the supreme court proceeded to rule that the Antideficiency Law did not bar “recovery in actions for...‘bad faith’ waste.”¹⁰ The court defined “bad faith” in the context of bad faith waste as “reckless,” “intentional,” or “malicious” conduct. It also distinguished this type of waste from the neglect that occurs due to an owner's financial inability to properly maintain his or her property.¹¹

Unfortunately, the court did not specify what specific acts might constitute bad faith, probably because the court elected not to decide whether the defendant in *Cornelison* was in fact liable for bad faith waste. Rather, the court upheld summary judgment for the defendant on the grounds that the lender made a full credit bid for the property at the foreclosure sale. By making a full credit bid, the plaintiff was made whole, thus eliminating any potential liability for bad faith waste.¹²

Parties to a Claim

California law establishes that the plaintiff in a bad faith waste action may either be the mortgagee of the note secured by the damaged property or the beneficiary of a deed of trust for the damaged property. According to Civil Code Section 2929, “No person whose interest is subject to the lien of a mortgage may do any act which will substantially impair *the mortgagee's security*.”¹³ That section applies equally to a deed of trust, since a mortgage with power of sale and a deed of trust are treated similarly in California, and both are considered security interests protected from impairment.¹⁴ Therefore, any mortgagee or beneficiary of a deed of trust should have standing to bring a bad faith waste action.

Section 2929 imposes a duty not to commit waste upon any “person whose interest is subject to the lien.” This duty is imposed by law, independent of the covenants in the deed of trust, and it applies to any person in possession of the property, including the trustor, any successor of the trustor, and a

vendee in possession.¹⁵ Courts have addressed the liability of parties in possession of the property serving as security in three specific instances: nonassuming grantees of the property, assuming grantees of the property, and nonrecourse borrowers.

A nonassuming grantee of property—one who purchases a property “subject to” the existing loan but does not assume the loan—can be sued for bad faith waste.¹⁶ The *Cornelison* court reasoned that although a nonassuming grantee is not personally liable on the debt, his or her interest in the property is subject to the lien.¹⁷ Therefore, pursuant to Section 2929, the court held that the nonassuming grantee has a duty not to commit waste. As a result, a nonassuming grantee of property is a potential bad faith waste defendant.

Similarly, according to *Weaver v. Bay*,¹⁸ a case of bad faith waste may be made against an assuming grantee of property—one who becomes the principal debtor on the loan by expressly assuming the obligation. Although *Weaver* was decided before *Cornelison*, the *Weaver* court noted that damages for waste may be recovered against mortgagors for “failure of an enterprise through inept management, too high a price paid for the property, adverse economic conditions, and the like.”¹⁹ Moreover, it would not make sense for an assuming grantee of property to avoid the liability for bad faith waste that attaches to a nonassuming grantee since both are in possession of the property.

Nonrecourse borrowers are borrowers whose loan documents expressly provide that they have no personal liability on the debt. This group of borrowers also may be held liable for bad faith waste.²⁰ Just as the nonassuming grantee of property is not personally liable for a debt, nonrecourse borrowers are not personally liable for their loan obligations. According to the court in *Nippon Credit Bank, Ltd. v. 1333 North California Boulevard*, nonrecourse borrowers have a “special” responsibility to protect an asset they have pledged to another as the sole security for repayment of a debt: “[T]here are circumstances where a nonrecourse borrower should be liable for waste, including failure to pay real property taxes.”²¹ The court does not explain what makes the nonrecourse borrower's relationship more special than that of any other borrower.

Elements of Bad Faith Waste

Although no single case has set forth the necessary elements for a bad faith waste action, these may be extracted from a review of relevant cases:

- 1) The plaintiff has or had a lien encumbering real property.
- 2) The defendant has or had possession of the

real property.

3) Waste was committed on the real property.

4) The waste on the real property was committed in bad faith.

5) The value of the real property was impaired as a result of the bad faith waste.²²

As is often true with case law, judicial enumerations of the elements of this cause of action do not provide much in the way of specific guidance. Generally, in most cases, elements 1, 2, and 5 either will not be in dispute or will be readily provable without substantial confusion over the meaning of terms. Proving elements 3 and 4, however, requires further case study.

In the *Binafard* decision, in which the defendants were held liable for bad faith waste resulting from the failure to properly maintain a property,²³ the building in question, the Jewelry Center, was subject to an \$8 million promissory note secured by a deed of trust. Upon the default on the note, the Jewelry Center was sold at a nonjudicial foreclosure sale to the plaintiff for \$100,000. Shortly after the sale, the plaintiff sued the defendants to recover damages for bad faith waste.²⁴ The result in *Binafard* seems to suggest that a lender who can present evidence similar to the facts shown by the *Binafard* plaintiff will satisfy the requirement for the existence of waste.

Generally, waste requires physical injury to the real property, but there is also law to the effect that nonpayment of taxes may constitute waste as well.²⁵ Of course, to maintain an action for bad faith waste, it is not enough that the waste is caused by a party. The waste must be committed in bad faith. The *Cornelison* court created a standard for bad faith waste to separate it from general neglect, but it did not provide examples—either by using the facts of the case or by employing more general descriptions. However, several other decisions have done so.

Courts have recognized that taking immediate financial advantage of the security with no regard to its resulting condition—also known as milking—is a form of bad faith waste within the meaning of *Cornelison*.²⁶ A party seeking to show that its opponent has engaging in milking cannot merely present evidence that money was diverted from the property. The party must demonstrate the type of use made of the funds. In *In re Mills*, the trustor purchased a hotel. When the beneficiary of the purchase-money mortgage foreclosed six months later, many of the hotel rooms were uninhabitable because of poor sanitation, vermin infestation, and numerous violations of the building and housing codes.²⁷ The evidence showed that the property had performed poorly financially but also that the trustor had diverted rental income to other properties that also had

financial difficulties. The beneficiary of the mortgage spent \$125,000 in rehabilitation expenses after the foreclosure sale.

The *Mills* court held that neither the mere failure to maintain the property nor the deterioration of the property due to the trustor's financial difficulties constituted bad faith waste.²⁸ The court noted, "We might well have [found bad faith waste] had the evidence shown that [the defendant] put little or no money into the hotel, attempting instead to milk it for as much cash as possible." According to the court, the beneficiary had the burden of proving bad faith waste—and failed

justify the nonpayment of real property taxes—such as a party having to choose between paying taxes or paying for repairs—the defendant debtor partnership had sufficient earnings to pay its tax bill and meet its other obligations and chose instead to contribute a windfall to a trust of one of the partners. The *Nippon* court distinguished *Mills* by noting that the defendant in *Mills* had operated the property for only a few months and "lost the bulk of his investment," whereas it appeared that the *Nippon* defendants did not lose their investment and, in fact, appeared to profit from the secured property.³⁰



to do so.

In contrast to *Mills*, the court of appeal in *Nippon* held the defendant liable for bad faith waste. The debtor partnership failed to pay its tax bill on the property, choosing instead to pay twice that amount to the trust of one of the partners. The court found that this transaction constituted milking.²⁹ In *Mills* and *Nippon*, the defendant diverted funds away from the distressed property—but only the *Nippon* defendant was held liable for bad faith waste. A closer look at the *Nippon* decision may illuminate the reason for this disparity.

The *Nippon* court described milking as the actions of an owner of a distressed property attempting to "squeeze as much money out as possible" before the property was lost, with no regard to the property's resulting condition. The court of appeal noted that while certain circumstances could possibly

When the Ninth Circuit in *Binafard* found the defendant liable for milking,³¹ it observed that the defendants collected millions of dollars from rents and loans secured by the property at issue but failed to make any repairs other than those necessary to keep the structure open and operational. Citing *Mills*, the court noted, "Such 'milking' of the security has been recognized as a form of bad faith waste."³²

Thus, for a court to find a defendant liable for milking, it is not sufficient to simply establish that funds were diverted from the property provided as a security and were not used for the benefit of the security. A plaintiff also must establish that the defendant did not have a justifiable economic rationale for diverting the funds, and possibly the property became distressed in order to benefit the defendant.

Another argument raised by parties seek-

ing to avoid liability for bad faith waste is that neglect is an act of omission, not commission. Therefore, neglect is not a malicious or intentional bad faith act. Acts of omission, such as a failure to repair, are not bad faith acts. However, subsequent appellate court decisions have defined “waste” as conduct, by both commission and omission, on the part of the person in possession of the property that impairs the value of the lender’s security.³³ A plaintiff can demonstrate bad faith waste by proving either that 1) a defendant diverted money from the property provided as security and made ill use of the funds (milking), or 2) a defendant substantially neglected the property that is the security for the loan.

What constitutes waste for the purposes of a bad faith waste action is determined by measuring detriment to the value of the secured property. The measure of damages for waste is the amount of the impairment of the security; that is, the amount by which the value of the security is less than the outstanding indebtedness and is thereby rendered inadequate.³⁴

The *Nippon* court also held that the “full amount” of the outstanding debt may include money the creditor has advanced for the unpaid taxes on the property used to secure its loan.³⁵ In a real estate-secured loan with a traditional lender, advances to protect the collateral will likely also be addressed in the loan documentation. However, a bad faith waste claim gives lenders another avenue to recover these protective advances when the loan documents are deficient.

Substantive Defenses

Several defenses are available in bad faith waste actions. These include the financial insolvency of the debtor, a general decline in real estate values, acts of God, and a full credit bid extinguishing the loan obligation.

An action for bad faith waste may not be sustained when a defendant merely acts “out of inability to make ends meet financially” instead of recklessly, intentionally, or maliciously despoiling property.³⁶ The *Mills* court held that the beneficiary has the burden of proving bad faith waste, but the evidence in that case merely showed a financial inability to maintain the property, not the recklessness and malice needed to support a bad faith waste claim.³⁷

The *Nippon* court suggested, in dicta, that the financial condition of the debtor might serve as a defense in a bad faith waste action if the alleged bad faith waste was the failure to pay property taxes: “There may be exigent circumstances which would justify a failure to pay real property taxes; for example, where a choice must be made between paying the taxes and making loan payments or necessary repairs, a tax default might

merely rearrange the lender’s loss without increasing it.”³⁸ However, the dissenting opinion in *Mills* expressed concern regarding a lack of precedent for a debtor’s specific financial condition (as opposed to one caused generally by a depressed real estate market) establishing a viable defense to allegations of bad faith waste: “We would expect any debtor seeking protection of the bankruptcy laws to be in a position of serious economic distress. *Cornelison* does not stand for the proposition that such individual circumstances alone can insulate the debtor from charges of bad faith waste.”³⁹ However, no case on record in California has adopted this distinction when determining whether a financially strapped debtor is liable for bad faith waste.

Moreover, the Ninth Circuit’s decision in *Binafard* restricted the scope of the economic necessity defense. The defendants in *Binafard* sought to submit evidence that they failed to maintain the building at issue because they lost a substantial sum of money invested in a second building. They claimed that they did not act in bad faith. The court of appeal upheld the district court’s exclusion of this evidence on the grounds that it would be prejudicial to the jury.⁴⁰ The *Binafard* court distinguished the economic necessity defense allowed in *Mills* on the grounds that 1) the amount of money removed from the building at issue by the *Binafard* defendants would have been more than enough to prevent the waste and still allow the defendants to realize a return on their investment, and 2) unlike the defendant in *Mills*, the *Binafard* defendants had not made a capital investment that far exceeded the amount of money that they took away from the building.⁴¹

The court in *Hickman v. Mulder* stated that a decline in the value of the security resulting from the depressed condition of the general real estate market would establish a defense to a bad faith waste allegation.⁴² Therefore, if a bad faith waste defendant could prove that the diminution in value of the property was due to depressed property values as opposed to waste, this evidence would serve as a viable defense, or at least a credit against damages. However, the fact that waste occurred during a depressed real estate market is not necessarily controlling. A determination must be made whether the waste was due to the depressed market conditions or as a result of the bad faith actions of the defendant. If the waste resulted from the defendant’s bad faith acts, the defendant would still be liable.

Damages caused by acts of God are not considered to be waste.⁴³ In *Krone v. Goff*, the trustor failed to repair earthquake damage to the property and was sued for waste. The *Krone* court held that damages caused by a fire

or earthquake are not a result of wrongful acts by the trustor and, therefore, the injury to the property did not constitute waste.⁴⁴

At a nonjudicial foreclosure sale in California, the lender-beneficiary is entitled, but not required, to make a credit bid for an amount up to the maximum of its indebtedness, since it would be pointless to require the bidder to tender cash that would only be immediately returned.⁴⁵ If the beneficiary or mortgagee at a foreclosure sale enters a bid for the full amount of the debt together with the costs and fees due in connection with the sale, the beneficiary or mortgagee cannot recover damages for bad faith waste. This is because there has been no impairment of the security, because the lien has been extinguished by the full credit bid.⁴⁶ Similarly, if the property at issue were sold to a third party for the full amount of the debt plus the costs of sale, there would be no diminution of the security and, therefore, no waste. The court of appeal has distinguished between “outstanding indebtedness” and the amount secured by the senior deed of trust, holding that trust holders with both senior and junior liens in deed of trust property do not make a “full credit bid” when they bid only the amount that is secured by their senior deed of trust.⁴⁷

Actions for bad faith waste, while brought infrequently, enable secured creditors a better chance of obtaining deficiency judgments against defaulting debtors. Moreover, as with some other torts, successful litigants have an opportunity to recover punitive damages upon a proper showing. As the *Nippon* court stated, “[E]xposure to punitive damages may be as much a deterrent to bad faith waste as to any other tort.”⁴⁸

Counsel for potential plaintiffs should realize that waste is not just physical injury to the property. It may constitute any act of commission or omission that impairs the value of the property securing a plaintiff’s loan. However, before commencing any bad faith litigation, counsel should take care to see whether the acts of the potential defendant rise to the level of reckless, intentional, or malicious conduct necessary to argue that the impairment of the security constitutes bad faith. ■

¹ D.A.N. v. Binafard, No. 03-55326, 2004 WL 2453053 (9th Cir. Oct. 29, 2004) (unpublished).

² *Id.* at *3.

³ *Cornelison v. Kornbluth*, 15 Cal. 3d 590 (1975).

⁴ *Nippon Credit Bank, Ltd. v. 1333 N. Cal. Blvd.*, 86 Cal. App. 4th 486 (2001).

⁵ *Evans v. California Trailer Court, Inc.*, 28 Cal. App. 4th 540 (1994).

⁶ *See, e.g., Hickman v. Mulder*, 58 Cal. App. 3d 900, 909 (1976) (failure to irrigate, cultivate, fertilize, fumigate, and prune agricultural property constituted waste); *Easton v. Ash*, 18 Cal. 2d 530, 593 (1941) (cutting trees on property constituted impairment of the value of

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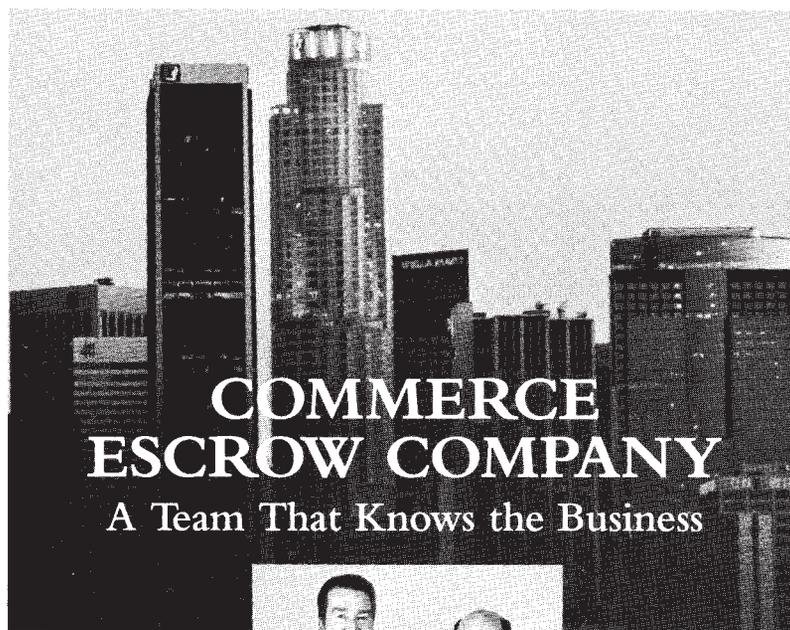
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property used to secure debt).

⁷ Civ. CODE §2929.

⁸ Cornelison, 15 Cal. 3d at 594.

⁹ *Id.* at 604-05.

¹⁰ *Id.* at 604. See also Glendale Fed. Sav. & Loan v. Marina View Heights Dev. Co., 66 Cal. App. 3d 101, 139 (1977) ("Nor [does the Antideficiency Law] bar recovery of damages against the mortgagor for impairment of the security caused by 'bad faith' waste.").

¹¹ Cornelison, 15 Cal. 3d at 604.

¹² *Id.* at 605.

¹³ Civ. CODE §2929 (emphasis added).

¹⁴ Cornelison, 15 Cal. 3d at 599.

¹⁵ *Id.* at 563 n.3. A mortgagee's security interest can be impaired by harm to the property committed by third persons not in possession, and a mortgagee can recover damages in tort for this impairment of its security interest. However, the mortgagee's recovery against third parties involves different considerations and rules because the person sued is not the debtor-mortgagor, who is afforded a variety of legislative and judicial protections. 4 H. MILLER & M. STARR, CALIFORNIA REAL ESTATE §10:53 (3d ed. 2006).

¹⁶ Parrish v. Greco, 118 Cal. App. 2d 556 (1953). See also First Nationwide Sav. v. Perry, 11 Cal. App. 4th 1657, 1665 (1975).

¹⁷ Cornelison, 15 Cal. 3d at 599.

¹⁸ Weaver v. Bay, 216 Cal. App. 2d 559, 562 (1963).

¹⁹ *Id.* at 562.

²⁰ Nippon Credit Bank, Ltd. v. 1333 N. Cal. Blvd., 86 Cal. App. 4th 486, 496 (2001).

²¹ *Id.*

²² Cornelison, 15 Cal. 3d 590; Nippon, 86 Cal. App. 4th 486.

²³ D.A.N. v. Binafard, No. 03-55326, 2004 WL 2453053 (9th Cir. Oct. 29, 2004) (unpublished).

²⁴ *Id.* at *1.

²⁵ See Nippon, 86 Cal. App. 4th at 499 (holding that trustor's intentional nonpayment of an installment of real property taxes can constitute bad faith waste).

²⁶ *Id.* at 497; see also In re Mills, 841 F. 2d 902, 905 (9th Cir. 1988).

²⁷ Mills, 841 F. 2d at 903.

²⁸ *Id.* at 905.

²⁹ Nippon, 86 Cal. App. 4th at 497.

³⁰ *Id.* at 497-98.

³¹ D.A.N. v. Binafard, No. 03-55326, 2004 WL 2453053, at *2 (9th Cir. Oct. 29, 2004) (unpublished).

³² *Id.*

³³ Evans v. California Trailer Court, Inc., 28 Cal. App. 4th 540 (1994) (allegation that the defendants allowed the property "to become seriously dilapidated and in a state of gross disrepair" sufficiently raised the issue of bad faith waste); Hickman v. Mulder, 58 Cal. App. 3d 900 (1994).

³⁴ Cornelison v. Kornbluth, 15 Cal. 3d 590, 606 (citations omitted).

³⁵ Nippon, 86 Cal. App. 4th at 497.

³⁶ In re Mills, 841 F. 2d 902, 905 (9th Cir. 1988).

³⁷ *Id.*

³⁸ Nippon, 86 Cal. App. 4th at 497 (citation omitted).

³⁹ Mills, 841 F. 2d at 906.

⁴⁰ D.A.N. v. Binafard, No. 03-55326, 2004 WL 2453053, at *2 (9th Cir. Oct. 29, 2004) (unpublished).

⁴¹ *Id.* at *3.

⁴² Hickman v. Mulder, 58 Cal. App. 3d 900, 907 (1994).

⁴³ Krone v. Goff, 53 Cal. App. 3d 191, 194-95 (1975).

⁴⁴ *Id.* at 194-95.

⁴⁵ Romo v. Stewart Title of Cal., 35 Cal. App. 4th 1609, 1614 (1995) (citations omitted).

⁴⁶ Cornelison v. Kornbluth, 15 Cal. 3d 590, 606 (1975).

⁴⁷ Evans v. California Trailer Court, Inc., 28 Cal. App. 4th 540, 554 (1994).

⁴⁸ Nippon Credit Bank, Ltd. v. 1333 N. Cal. Blvd., 86 Cal. App. 4th 486, 503 (2001) (citation omitted).