Mortgages and Deeds of Trust

Partnership-borrower's liability for bad faith waste under specific provision in nonrecourse loan documents did not encompass personal liability for lender's attorney fees.

Aozora Bank, Ltd. v 1333 N. Cal. Blvd. (2004) 119 CA4th 1291, 15 CR3d 340

Aozora Bank (Bank) lent $73 million to 1333 North California Boulevard, a limited partnership. After the partnership defaulted, Bank sued it for bad faith waste. A jury found that the partnership committed waste by failing in bad faith to pay an installment of taxes on the property, and Bank was awarded $394,713 in compensatory damages. Bank moved for an award of attorney fees under CC §1717, and the trial court awarded Bank attorney fees of $1,434,212, including a 1.5 multiplier for "the complex and cutting edge nature of the issues litigated."

The court of appeal reversed the order awarding attorney fees, because the nonrecourse loan documents provided that the partnership was liable only "to the extent that" it committed waste. Stating that Bank's entitlement to fees hinged entirely on the terms of the parties' contracts, the court noted that bad faith waste was a "carve-out" of personal liability in the nonrecourse loan. The court concluded that the language of the carve-out did not implicitly encompass attorney fees in prosecuting a waste action, and that those fees were recoverable only from the collateral. Because borrower liability for the lender's attorney fees incurred in enforcing such a nonrecourse carve-out is usually a key concern of the lender in negotiations, it was unlikely that the carve-out would be silent on attorney fees if they were intended to be included.

THE EDITOR'S TAKE: Under current deed of trust forms, attorney fees are recoverable for just about every kind of litigation related to the loan or the security, and this decision should not generate any need to redraft those clauses. However, carve-out provisions—*i.e.*, exceptions to the nonrecourse limitation—in nonrecourse loans, which tend to be more tailor-made and negotiated, may need to be reconsidered in light of this decision.

Rather than think about all this myself, I turned to the two prominent national experts that I know on this matter: Gregory Stein, Professor of Law at the University of Tennessee (whose article, *The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan* in 55 Wash & Lee L Rev 1207 (1998), was cited in both *Aozora* and its predecessor, *Nippon Credit Bank v 1333 North Cal. Blvd.* (2001) 86 CA4th 486, 103 CR2d 421), and Joshua Stein (no relation to Greg), a partner at Latham & Watkins LLP in New York (whose piece, *Lender's Model State-Of-The-Art Nonrecourse Clause (With Carveouts)* in the October 1997 issue of Practical Lawyer—and reprinted and updated in many other journals—is what we all turn to in drafting these things. I asked Messrs. Stein how this case had influenced their thinking. Gregory Stein's Comment follows below, and is followed in turn by Joshua Stein's. Thanks to both of them for taking the time to give us all the benefit of their views. —*Roger Bernhardt*

COMMENT: I can think of at least two ways to draft a clause that includes a nonrecourse carve-out for attorney fees and other costs incurred in connection with enforcing a nonrecourse carve-out. First, if the loan documents already include a provision requiring the borrower to pay attorney fees and other costs—as they ordinarily will and as the *Aozora* note and deed of trust both did (see fn 1 of the opinion)—then you could simply reference this provision as one of your nonrecourse carve-outs. So, when you list your carve-outs, such as fraud, waste, and real estate taxes, you would also include "any of the costs incurred under paragraph *X*," where paragraph *X* is your more general attorney fee provision. Step one makes the borrower liable for these costs, as *Aozora* did, and step two clarifies that this obligation is an exception to the more general nonrecourse provisions, which the court held that *Aozora* failed to do.

Alternatively, you could state the "attorney fees and other costs" provision in full as one of your carve-outs. The *Aozora* opinion gives some sample language in fn 2, where it quotes from a 1999 PLI publication (authored by Lester M. Bliwise in a book that my co-commentator Mr. Stein edited; but the footnote acknowledged neither of them). That provision refers only to costs incurred as a result of enforcing the waste carve-out, but you would want to expand it to cover costs incurred with enforcing any carve-out (as Mr. Bliwise did on the page after the page the court cites).

The important thing is to make sure that your nonrecourse carve-out for attorney fees is every bit as broad as your more general attorney fee provision, because the court has just announced that the carve-outs are only as broad as they specifically state they are.

I have a slight preference for the first approach, even though cross-references can be annoying to read, because this way you ensure that your carve-out is as broad as your general provision. If you take the second approach and restate the same language in two different places, you may end up modifying this language during the negotiations and forgetting to conform the nonrecourse provision. In other words, you increase the risk of having a carve-out that does not match the more general attorney fee provision.

—Gregory Stein

COMMENT: I think the *Aozora* case is right. It's traditional black letter law that a loser in litigation has to pay the winner's attorney fees only if the contract expressly provides for it (or, in California, if the contract provides for a reciprocal obligation). Here, the borrower was the only party obligated to pay attorney fees, not the guarantor. So the bank could collect attorney fees from the borrower. But the nonrecourse carve-outs referred only to the substantive underlying liability (*e.g.,* liability for waste)—not the additional ancillary liability for attorney fees. I think this omission is fairly typical in nonrecourse carve-outs. They tend to refer to the substantive obligations for which personal liability will arise, but not also to the costs of collection. The guaranty itself might cover those costs, but either (1) that wasn't the case here or (2) the guaranty covered only costs of collection from the guarantor, but not costs of collection from the borrower, and the bank's attorney fees represented only the latter.

This case gives us another example of how "standard language" often has glitches and gaps that don't come to light until a particular weird confluence of facts exposes them. Well over 50 percent of nonrecourse carve-outs suffer from the exact same infirmity because they do not make the obligor personally liable for attorney fees and costs of collection (at least those the lender incurs in chasing the borrower). Big picture: It doesn't really matter all that much. The thinking behind nonrecourse carve-outs is to achieve behavior control, and only secondarily to make the lender whole. ("I'm a poet and I know it; hope I don't blow it," to quote Bob Dylan.) Typically, the carve-outs identify a "bad act" or a "risk" and say, "Let's make the guarantor liable for it," to give the guarantor the right incentives. A lender can achieve that goal without necessarily making the guarantor liable for attorney fees and costs of collection, too, although I certainly recommend it.

In the latest few iterations of my model nonrecourse carve-outs, I have a separate component of liability, in which any personal obligor is also personally obligated to pay costs of collection and attorney fees—whether the lender incurs them in chasing the borrower or in chasing the guarantor. (A borrower/guarantor might negotiate them down to just the latter.)

The *Aozora* court could have said the parties must have intended to make the guarantor liable for attorney fees. After all, if the bank had included such language in the draft guaranty, it would have been regarded as routine and no guarantor would have tried to negotiate it out. It's industry standard. It's unobjectionable. It's "obvious" that an obligation to pay for waste must have included an obligation to pay for attorney fees arising from waste. So the court could have said, "Let's just pretend the attorney fees obligation was there, because surely if the parties had thought about it they would have added it." But they didn't.

I had raised my eyebrows at the first *Nippon Credit Bank* case, as I am skeptical about whether nonpayment of real estate taxes should be a species of "waste" and hence a basis for personal liability. I would limit "waste" to damage or destruction of the collateral. I would argue that nonpayment of real estate taxes is a mere payment risk, much like failure to pay principal or interest, and if the lender wants personal liability for this default they should expressly say so. This is much like saying that, if the lender wanted the guarantor to be personally liable for attorney fees, the lender should have said so. If nonpayment of real estate taxes is "waste," then so is failure to comply with just about every other collateral-preservation covenant in the loan documents. And I had always understood "waste" to include some element of egregious conduct, not just mere failure to comply with contractual covenants in the loan documents. I seem to be fighting the tide on that issue, though, as evidenced by the Restatement and by the first *Nippon Credit Bank* decision.

—Joshua Stein