3-2001

When Can a Nonrecourse Lender Reach the Personal Assets of Its Borrower

Gregory M. Stein

When Can a Nenrecourse Lender Reach the Personal Assets of Its Borrewor?

Gregory M. Stein

A nonrecourse loan actually is o loan with limited recourse. Defining these limits with precision is critically important in avoiding unpleasant surprises—and litigation.

IN A NONRECOURSE LOAN, the lender agrees to seek satisfaction solely from the mortgaged property and not from the borrower or any of its equity holders personally. The lender presumably receives some sort of consideration for its relinquishment of this important remedy, and it would be unfair for a court later to award the lender a personal judgment against the borrower solely because the foreclosure sale proceeds were insufficient to satisfy the debt.

Because the nonrecourse lender cannot reach the borrower's personal assets, distinguishing between the mortgaged property and the borrower's personal assets assumes much greater importance in the nonrecourse loan than in the full recourse loan. Unfortunately, the legal definition of the mortgaged property may be hazy at its edges, and borrowers may be able to shield assets from nonrecourse lenders by transforming real estate into personal property.

Gregory M. Stein is a Professor of Law at the University of Tennessee College of Law. This article is excerpted from Gregory M. Stein, *The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan*, 55 Wash. & Lee L. Rev. 1207 (1998). An earlier version of this article was presented at the American Bar Association's Annual Meeting in July 2000. The author can be reached at: gstein@utk.edu

Borrowers and lenders that believe nonrecourse loans are just like other loans except for the waiver of a significant remedy soon may discover that nonrecourse borrowers have a greater tendency to allow or cause the condition and value of the property to deteriorate once foreclosure appears inevitable. This article proposes a standard that will encourage nonrecourse borrowers in distress to act as they would if they were personally liable while also preventing lenders from enjoying the benefits of a remedy they agreed to forego.

TAXES AND PERSONAL LIABILITY: A BRIEF INTRODUCTION • Real estate professionals participate in the commercial real estate market for a wide variety of reasons. Some investors plan to construct buildings or renovate existing structures, while others intend to operate and manage commercial property as an ongoing business. Whatever their goals, real estate professionals typically form business entities to hold investment property rather than holding that property personally. Investors will seek an ownership structure that minimizes their taxes and that shields them from personal liability on contract and tort claims.

Traditionally, the limited partnership has been the favored entity for holding investment property. Partners historically have faced a substantially lower effective federal tax rate than have corporate shareholders. Nonetheless, some investors form corporations and forego the enormous tax advantages of the partnership. This acquiescence to the tax collector arises primarily out of concerns about personal liability: Shareholders of corporations ordinarily cannot be sued personally by creditors of the business, but general partners of partnerships can. Thus, if someone is injured on the property or if the real estate entity does not pay its debts, general partners may encounter unlimited liability in tort or contract that corporate shareholders escape.

Real estate professionals often attempt to finesse this decision by forming limited partnerships and then trying to avoid the unlimited liability that this ownership form creates. In some cases, partnerships can minimize these risks easily. A partnership that secures adequate amounts of workers' compensation, property, and liability insurance, for example, virtually eliminates any chance that its general partners will have to pay for the costs of accidents. The partners enjoy the tax benefits of partnership status while avoiding most of the tort risks of that form of ownership.

The Mortgage Loan

Real estate owners also face potential contract liabilities. The largest obligation that most real estate partnerships confront is their mortgage loan. If the property owner fails to pay its lender and the property sells at foreclosure for less than the outstanding amount of the debt, the partnership and its general partners are personally liable for the deficiency. Thus, one bad investment can poison an otherwise successful real estate portfolio, and the unpaid lender on this bad investment can eventually have its debt repaid from the partnership's more successful projects or from the general partners' personal assets.

Nonrecourse Loans

For this reason and others, real estate partnerships often seek nonrecourse loans, in which the lender agrees that the mortgaged real estate is the only asset of the partnership and its partners that the lender will pursue if the debt is not repaid. The other assets of the partnership and its partners are shielded, and each partner can lose no more than he or she agreed to invest. This nonrecourse status is accomplished by including exculpatory language in the documents, by which the lender agrees to look solely to the property for satisfaction of the secured debt.

Why Would a Lender Agree to a Nonrecourse Loan?

Real estate lenders readily agree to nonrecourse loans in spite of their greater risk. Lenders are aware of the liability and other concerns facing partners in real estate ventures and may be willing to accommodate their partnership clients rather than risk losing business to competing lenders. If these lenders furnish an amount that does not exceed 70 to 80 percent of the value of the property, they generally are comfortable that the property can be sold at foreclosure for an amount sufficient to repay the debt. The slightly greater risk may translate into a modest increase in the interest rate. Lenders also may seek other forms of assurance that the debt will be repaid, such as limited personal guaranties or letters of credit. Nonrecourse loans have become a staple of the commercial real estate lending industry, with their prevalence and scope fluctuating with business conditions in much the same way that interest rates and other business terms do.

Delinquent Nonrecourse Loans

Lenders are considerably less accommodating after the loan becomes delinquent. Once a borrower defaults, its lender is likely to look for gaps in the nonrecourse provisions so it can reach the other assets of the partnership and the personal assets of the general partners if the foreclosure sale should fail to generate sufficient funds to satisfy the entire debt. If the borrower committed fraud in obtaining the loan, for example, courts ordinarily will disregard the exculpatory language and allow the lender to recover from the partnership and perhaps from its partners. *See, e.g., Manson v. Reed*, 231 Cal. Rptr. 446, 451 (Ct. App. 1986) (observing, in the related context of antideficiency legislation, that "[a] recognized exception to [California's] anti-deficiency statute is a suit for fraud"). In the typical case, however, a lender that agreed to a nonrecourse loan will find itself with few attractive options if the loan turns out poorly and the value of the property has dropped below the outstanding amount of the debt.

Several recent cases from different parts of the country reveal that courts are becoming more willing to circumvent nonrecourse provisions in loan documents. In particular, courts have begun to find that owners that fail to maintain the mortgaged property or to pay real estate taxes commit the tort of waste. The borrower that fails to repay principal and interest is protected from the lender by the remedial provisions of the nonrecourse note, but a court may be less willing to apply these same provisions to absolve the borrower for the consequences of its tortious acts. The result of these recent cases is that partnerships and their individual partners that believe themselves immune from personal liability may be in for a surprise when the project fails, while lenders that agreed in advance not to pursue their borrowers' personal assets sometimes recover nonetheless.

In some cases, this result seems proper: Imagine the property owner who sees financial disaster looming and starts tearing out appliances, fixtures, and building components to raise cash, to the ultimate detriment of the foreclosing mortgage lender. This example illustrates the more straightforward case of active waste, in which the owner intentionally damages the lender's security for the owner's personal benefit. No court should shield a partnership that behaves in this fashion or any of its general partners. In contrast, the failure to maintain the property or to pay real estate taxes constitutes, at most, passive waste, and a court may be more inclined to treat these omissions by the borrower as falling within the protection of the nonrecourse note.

CHOOSING THE RIGHT ENTITY: A CLOSER LOOK • Real estate professionals, like other business people, want to maximize their profit and to minimize their risk. To attain these ends, they must minimize their federal tax obligations while exposing themselves to the least possible tort and contract liability, two goals that in some ways demand contradictory actions. The first and perhaps the most important decision that any real estate professional must make is the selection of the entity that will hold title to the real estate.

The Corporation

The corporation offers the greatest protection available against personal liability. The corporate property owner, a separate legal entity under state law, is fully liable for all contracts into which it enters and for all torts for which the law imposes liability on an owner, but the individual shareholders of the corporation are not. Investors who hold shares of corporations that own real estate can cap their losses at the amount they agree in advance to invest and need not worry that they will be called upon to make unanticipated contributions in the future. No other form of ownership better limits its investors' personal liability, a privilege that corporate owners pay for when they calculate their taxes. As a separate entity, the corporation must file its own tax return and pay taxes on any income at the corporate level. Distributions to individual shareholders then are taxable to those shareholders, with the result that each shareholder effectively pays a double tax.

The General Partnership

The general partnership lies at the other extreme, offering major tax advantages to its partners but exposing them to greater liability. The general partnership is not taxed separately at the partnership level, and the double tax problem vanishes. Each general partner, however, is personally liable in full for all partnership liabilities, including those incurred on behalf of the partnership by the other partners. Taxes are kept to a minimum, but liability is unpredictable and potentially limitless.

Statutory Variants

At their simplest, the general partnership option and the corporate option both offer investors a major advantage paired with a major flaw, which is to say that the entrepreneur confronted with only these two options would need to make an important initial choice. This harsh choice has been softened, however, by statutory relaxation of these two forms, with S corporations, limited partnerships, and, most recently, limited liability entities offering investors greater flexibility.

The S Corporation

The major drawback to the business corporation from the perspective of the real estate investor lies in its heavier tax burden. These extra costs can be eliminated if the corporation qualifies as an S corporation. If the corporation so qualifies, it is taxed like a partnership but provides its investors with the limited liability of a corporation. The S corporation has never become as popular as these dual advantages might suggest, however, because of the numerous restrictions Congress placed on S corporations and the burdensome record keeping involved.

The Limited Partnership

Just as S corporation status softens the tax blow for certain corporate shareholders, the use of the limited partnership form softens the liability exposure of some partners in partnerships. Limited partnerships possess two classes of partners, limited and general. General partners of limited partnerships, like general partners of general partnerships, still face unlimited liability. Limited partners, in contrast, are treated much like corporate shareholders and may lose only those amounts that they invest initially or commit to contribute in the future.

Unlike the S corporation, the limited partnership form has been enormously popular within the real estate industry. It is an excellent choice for the partnership that has at least one general partner willing to live with the risk of unlimited personal liability but that also has other investors that insist on both limited liability and the tax advantages of a partnership. This form of ownership is not without its own drawbacks, however. The general partners of a limited partnership retain unlimited liability in contract and tort, and those limited partners that participate in the management and control of a limited partnership risk being treated as general partners for tort and contract liability purposes.

The Limited Liability Company

The limited liability company has become an important option for real estate investors during the last several years. While the contours of this entity are less consistent from state to state than are those of the other available entities, limited liability companies are designed to allow their investors both limited liability and partnership tax treatment. In addition, recent regulatory changes have simplified the process by which the Internal Revenue Service will classify business entities for tax purposes. Under the new "check-the-box" regulations, many noncorporate entities such as limited liability companies and limited partnerships will more easily qualify for partnership tax treatment.

Real estate investors have been quick to recognize that limited liability companies can offer the combination of favorable tax treatment and limited liability that they previously had to struggle to attain. If the limited liability company has not already surpassed the limited partnership as the entity of choice for real estate investors, it is likely to do so soon. Nonetheless, limited partnerships, including the large number of limited partnerships established before the growth in popularity of the limited liability company, will remain important for many years to come.

Maximizing the Advantages; Minimizing the Disadvantages

The business corporation and the general partnership each possess one major advantage accompanied by one major drawback. Statutorily created variants of these two entities—the S corporation and the limited partnership—are hybrids, each offering the major advantage along with a less undesirable drawback. Investors seek to improve on these two variants by maximizing the advantages of each of these forms while paring back still further on the disadvantages of each. The disadvantages to the S corporation are created by the Internal Revenue Code and cannot be modified in the corporate charter or in the corporation's contractual arrangements, although careful planning and oversight will reduce some of these negative effects. Investors who plan ahead carefully, however, are more likely either to turn to the limited partnership and then look for ways to eliminate or minimize the liability risks that characterize this type of entity or, more recently, to choose the limited liability company.

REDUCING THE RISKS OF THE LIMITED PARTNERSHIP • Most of the liability risks that general partners in limited partnerships encounter fall into the two broad categories of torts and contracts.

Tort Risk: Insurance

Tort risks cannot be eliminated, of course. Accidents and disasters happen, and the universe of potential plaintiffs is limitless. But the magnitude of these risks can be minimized through the use of insurance. Prudent purchases of sufficient liability, property, and workers' compensation insurance convert small risks of devastating liability into modest and easily quantified periodic premium payments. Well-run partnerships will obtain adequate amounts of each type of insurance, particularly if state or local law, or their lender, so requires.

Contract Risk: Nonrecourse Provisions

Avoiding contractual liability is more problematic. The only way to reduce the risk of contract liability is for the limited partnership to ask each party with which it contracts to agree in advance not to look to the personal assets of the partnership or its partners if the partnership should breach the contract. Most parties with which a partnership contracts would not seriously entertain such a request. But for the largest liability the typical commercial real estate limited partnership faces, this problem has an amazing tendency to vanish. For, much to the surprise of anyone unfamiliar with the real estate market, lenders routinely agree to precisely such provisions, when they lend on a nonrecourse basis. In short, if a real estate limited partnership asks its largest creditor for a promise not to sue the partnership or its partners personally, the creditor often will agree without much argument.

Why Would a Lender Agree To Lend on a Nonrecourse Basis?

There are several reasons why a lender would agree to provide a nonrecourse loan. To begin with, lenders understand exactly why general partners of limired partnerships are so concerned with obtaining nonrecourse financing and are willing to provide nonrecourse loans as a business enticement, particularly if competing lenders are doing so. In addition, in a real estate mortgage loan, the primary security is the real estate itself. Most lenders recognize that their borrowers may be unable to satisfy a personal judgment by the time of any default on the note and lend under the assumption that they will have nothing else to look to beyond the secured real estate. That, after all, is one of the reasons lenders insist on a mortgage in the first place.

Moreover, in evaluating applications for loans to be secured by commercial real estate, lenders are most concerned with the income stream that tenant leases will generate and with the owner's expertise in managing commercial real estate. This contrasts sharply with the residenrial real estate loan market, in which the lender is more likely to scrutinize the income and assets of the individual borrower. If the commercial lender is more concerned with the income stream from the property and with the skill of the property manager than with the net worth of the partnership and its partners, then the lender that agrees to a nonrecourse loan is relinquishing a remedy that it sees as relatively unimportant. Lenders also realize that extending a nonrecourse loan to a single-asset real estate partnership places them in a position that is little worse than the one they would be in if they had lent with full recourse to a single-asset corporation.

Lenders that agree to exculpatory language also may insist on extra comfort in the form of a larger equity contribution or additional consideration in the form of a higher interest rate. The lender's determination of what the loan-to-value ratio should be for any given loan factors in its assessment of the risks of that loan. For a nonrecourse loan, which by definition is at least as risky as a loan with recourse, the lender may insist on a lower loan-to-value ratio, which is to say a higher equity investment by the borrower. Similarly, the lender may charge a slightly higher interest rate to reflect the slightly increased risk that its voluntary waiver of an available remedy creates.

Lenders also may assent to lending on a nonrecourse basis if their risk is reduced through the use of an external credit enhancement device, such as a standby letter of credit or a personal guaranty. If the lender surrenders the right to seek personal recourse from the partnership and all of its general partners and receives in exchange a letter of credit issued by a bank or a personal guaranty from a specific partner or a creditworthy third party, the lender actually may be in a better position than before, with two or more different remedies now available against two or more different sources of repayment. This may be an imperfect option from the borrower's perspective, because at least some of the partners, or the entity itself, are likely to retain some personal liability under a letter of credit reimbursement agreement or a personal guaranty. However, alternative obligations such as these may be limited as to duration, dollar amount, types of risk covered, and types of assets that can be reached. Most general partners would be extremely pleased if they and their partnership could avoid unlimited liability in exchange for, say, an agreement under which one specific partner is liable for the first two years of the loan, up to a maximum amount of $500,000, for any liabilities arising under federal and state environmental laws. In addition to limiting the liability of the partnership and its general partners, these alternative forms of credit enhancement also may protect those parties' balance sheets, thereby enhancing their access to further credit if they should need it in the future. From the lender's point of view, even the limited use of credit enhancement devices provides partial insurance against the most worrisome hazards during the periods of highest risk, such as construction.

Finally, until 1986, limited partners received substantial tax advantages when their partnerships borrowed on a nonrecourse basis rather than on a recourse basis. A partner can deduct allocable partnership losses up to the amount of that partner's basis in the partnership, and a limited partner's basis is increased to account for nonrecourse debt but generally not for recourse debt. This advantage caused passive investors to favor limited partnerships with nonrecourse debt. Partnerships that wished to attract capital almost had to borrow on a nonrecourse basis, a fact which lenders understood fully. *See Restatement (Third) of Property: Mortgages* §1.1 reporters' note (1997) (discussing tax consequences of nonrecourse loans). The tax shelter benefits of nonrecourse debt were reduced significantly by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended in scattered sections of 26 U.S.C.).

Note that this article generally assumes that a nonrecourse loan to a limited partnership is one in which the creditor agrees not to seek personal recourse against the partnership borrower or its general partners. Borrowers and lenders sometimes may agree to a more limited type of nonrecourse debt, in which the lender is permitted to pursue other assets of the partnership but not the assets of its partners. The same issues that arise in the broader type of nonrecourse loan also are relevant in this narrower type, and this article's analysis applies equally well to both types of loans. If the limited partnership owns just one real estate asset, the difference between the two types of nonrecourse debt turns out to be largely insignificant, with protection of the partners being the main goal of the nonrecourse provisions either way.

WHAT RECOURSE DOES A NONRECOURSE LENDER HAVE? • The prevalence of the limited partnership form in the real estate industry, the validity of the many reasons limited partnerships have for insisting upon nonrecourse debt, and the lack of grounds for lenders to object have combined to ensure that much commercial real estate is subject to nonrecourse debt. If a project is successful and the borrower pays that debt, the nonrecourse provisions turn out to have been immaterial. But that is not always what happens, and a nonrecourse lender holding a loan in default must decide which of its available remedies to pursue.

Pre-Foreclosure Remedies

In the short term, the lender may attempt to employ one or more of the pre-foreclosure remedies provided for in the mortgage or under state law, such as:

- The appointment of a receiver;
- The activation of an assignment of leases and rents; or
- The seeking of possession.

The lender's use of these pre-foreclosure remedies may alert the borrower to the seriousness of the lender's concerns, may preserve the value of the property, and may reduce the magnitude of the default, thereby lessening the need for the lender to foreclose and reducing the risk that it will come up short if it must.

Workout or Deed-in-Lieu

Even if these pre-foreclosure remedies do not accomplish their goals, the lender still may not need to foreclose if the parties are able to negotiate a workout agreement or if the partnership deeds the property to the lender in lieu of foreclosure. If none of these less extreme alternatives prods the borrower into curing the default or satisfying the lender's concerns in some other way, the lender ultimately may decide to foreclose the mortgage or deed of trust in accordance with state law.

Foreclosure and Deficiency Judgment

In the worst case for all the parties, the foreclosure sale will fail to generate proceeds sufficient to pay off the outstanding debt, which by then will have been augmented by overdue interest, late fees, legal fees, and other related costs, and the lender next must seek a deficiency judgment. It is this last option—pursuit of a deficiency judgment—that generally is unavailable to the nonrecourse lender. The lender that accepts a nonrecourse note risks coming up short if the borrower defaults and the proceeds of the ensuing foreclosure sale are less than the outstanding amount of the debt. Antideficiency legislation and procedural limitations such as one-action rules can have the same effect.

Arguments for the Inapplicability of Nonrecourse Provisions

By this time, counsel for the lender will have examined the loan documents carefully, searching for legal arguments that might allow the lender to reach other assets beyond the mortgaged real estate. If the lender may make a claim against a guarantor or bonding company or may draw on a letter of credit, it will seek to do so. If the borrower committed some impropriety, such as misrepresenting its financial condition in the documents or the loan application or diverting funds to other projects in violation of the terms of the loan, the lender may succeed in arguing that the nonrecourse provisions are inapplicable. If the nonrecourse provisions were drafted poorly, then the lender may argue that the loan allows for some recourse against the borrower. But in the ordinary case, the nonrecourse lender that expects the foreclosure sale to generate insufficient funds is in a real quandary by this point: It has knowingly waived a remedy that, as things turned out, it needs to use. Some lenders facing this dilemma have looked to the courts, which occasionally will permit nonrecourse lenders to recover. Judicial treatment of this type raises the question of just how nonrecourse a nonrecourse loan is.

CASE LAW ON NONRECOURSE LENDING

- Three leading cases on nonrecourse lending examine the question of what actions constitute waste in the setting of a nonrecourse loan.

Prudential: ***Waste Found***

From the property owner's perspective, *Prudential Insurance Co. of America v. Spencer's Kenosha Bowl Inc.*, 404 N.W.2d 109 (Wis. Ct. App. 1987), presented something even better than a nonrecourse loan. The original owner of commercial real estate borrowed funds and granted a mortgage, and subsequently sold the property to the defendant, which did not personally assume the obligation to repay the debt. The lender's only recourse was against the property and the original borrower, and it does not appear that the borrower's grantee had any contractual relationship with the lender at all. At foreclosure, the property sold for $360,000 less than the debt. The trial court listed nine different forms of waste that it found the grantee to have committed, causing total damage to the property of $445,000. Eight of the nine listed items were failures to maintain the property physically; the ninth and largest, in the amount of $199,000, arose from the grantee's failure to pay property taxes. The trial court held the grantee personally liable for all nine of these items but limited the total award to the amount of the deficiency.

The Wisconsin Court of Appeals affirmed the judgment in full. In reaching this result, the court had to resolve two separate issues, neither of which had been precisely presented before in Wisconsin.

First, the court decided that "the waste doctrine permits a mortgagee to maintain an action for waste against a nonassuming grantee of a mortgagor." *Id.* at 112. If the lender was permitted to use a waste argument to recover personally from a property owner such as this one, with which it had no privity of contract, then a court would likely find that a lender also could recover personally from a nonrecourse borrower, with which it would have a detailed, though limited, contractual relationship.

Second, the court concluded that the failure to pay real estate taxes constitutes passive waste, which is actionable in just the way that active waste is, because either type of waste impairs the lender's security. *See id.* at 113.

Travelers: ***Waste Found***

Travelers Insurance Co. v. 633 Third Associates, 14 F.3d 114 (2d Cir. 1994), raised similar issues, but with more money at stake and a less sympathetic group of investors. The borrower, a limited partnership, distributed $4 million to its partners in 1990 after it learned that its office building would lose some major tenants and prepared soon afterwards to distribute another $17 million. The lender that had provided a $145 million nonrecourse loan sued to set aside the first distribution and to enjoin the second as fraudulent conveyances. The federal district court, applying New York law, denied a temporary restraining order and dismissed the claims because the loan was nonrecourse and the lender had no claim to the partnership's cash assets, but the United States Court of Appeals for the Second Circuit vacated the district court's dismissal and remanded the case. *See Travelers Ins. Co. v. 633 Third Assocs.*, 1991 WL 236842, at *1 (S.D.N.Y. Oct. 31, 1991) (declining to enter temporary restraining order); *Travelers Ins. Co. v. 633 Third Assocs.*, 973 F.2d 82, 83 (2d Cir. 1992) (noting prior disposition of case); *id.*at 86 (noting that, while plaintiff may not have direct access to funds already distributed by defendant, "plaintiff nonetheless may have standing under New York's Fraudulent Conveyance Act to set aside the conveyance if the conveyance caused a diminution in the value of the real property, to which plaintiff *is* entitled to look in the event of default").

The landowner's troubles continued, and on January 1, 1992, it failed to remit its semiannual installment of real estate taxes in the amount of $3.8 million, as well as its monthly loan payment. Twelve days later, the partnership distributed the $17 million to its partners. The lender filed for foreclosure the next day and then amended its complaint to allege that the borrower's distribution to its partners rendered it incapable of performing its obligations under the loan, including its obligation to pay property taxes. The amended complaint added claims for equitable relief from waste and for specific performance of the borrower's obligations. The district court dismissed the complaint once again, but the Second Circuit reversed. *See Travelers Ins. Co. v. 633 Third Assocs.*, 816 F. Supp. 197, 206 (S.D.N.Y. 1993) (referring to funds previously distributed by borrower to its partners as "monies which are placed beyond Travelers' reach by the non-recourse provisions of the mortgage"), *aff'd in part and rev'd in part*, 14 F.3d 114 (2d Cir. 1994). In its decision, the Second Circuit affirmed portions of the district court's opinion that are not relevant here, reversed the rest of the lower court's opinion, and remanded once again. *See Travelers*, 14 F.3d at 126.

The Second Circuit reached two related conclusions: The failure to pay real estate taxes constitutes waste under New York law; and the lender could bring claims for waste, for specific performance, and for setting aside the distributions, notwithstanding the nonrecourse provisions in the loan documents. The court focused its attention on the first issue. After reviewing the largely inapposite precedent and several cases from other jurisdictions, the Second Circuit determined that "the intentional 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." *Id.* at 123. The court did not explain how one's failure to pay real property taxes when required can ever be unintentional. *See id.* at 126 n.1 (Mishler, J., dissenting) (noting that "[t]he mere failure by a mortgagor in possession to pay property taxes is willful since the mortgagor is chargeable with knowledge that taxes are due and constitute a prior lien").

The court did not discuss the second issue and appears to have assumed that the actions could be maintained in spite of the nonrecourse language in the mortgage.

Chetek: *No Waste Found*

Conversely, in *Chetek State Bank v. Barberg*, 489 N.W.2d 385 (Wis. Ct. App. 1992), *review denied*, 491 N.W.2d 769 (Wis. 1992), the Wisconsin Court of Appeals concluded that the failure to pay real estate taxes and mortgage interest does not constitute waste. *Chetek* involved the foreclosure of a nonrecourse mortgage that led to a deficiency of $1.4 million. Conceding the validity of the nonrecourse provisions, the lenders nonetheless sought $192,000 in unpaid real estate taxes and $151,000 in unpaid mortgage interest from two of the general partners of the partnership that had owned the property. The appellate court held in favor of the two general partners, concluding that the lender had not proven that the borrower had committed all of the elements of the tort of waste. *Chetek* cited *Spencer's* in passing but failed to give any explanation for its contrary result.

WHAT DOES "NONRECOURSE" MEAN? • The use of the adjective "nonrecourse" suggests that a real estate lender agreeing to this type of loan waives all of its rights to seek satisfaction from the personal assets of its borrower. This suggestion is misleading. One of the sources of this confusion that borrowers, lenders, and courts may face is a linguistic one, with the use of the word "nonrecourse" causing the parties to overlook the fact that these loans do not fully insulate borrowers. The so-called nonrecourse loan actually provides the lender with partial or limited recourse to the borrower's personal assets.

The Starting Point: Loans with Full Recourse

In a typical real estate loan with full recourse, the documents will not expressly state the parties' intentions as to the personal liability of the borrower. By not departing from settled law in the loan documents, the borrower and the lender implicitly agree to abide by the state's default rules, which usually are clear. The borrower effectively guarantees to the lender that the net foreclosure sale price will be no lower than the total obligation of the borrower at the time of the sale. If the foreclosure sale proceeds turn out to be insufficient to pay the outstanding debt, the lender next may obtain a deficiency judgment and seek satisfaction from the borrower's other assets. If the borrower happens to be a partnership, each of its general partners will be personally liable for payment of this partnership obligation.

The borrower's liability may be limited by substantive laws such as antideficiency legislation and by procedural foreclosure restrictions such as one-action rules, limitations that vary depending on the state and on the type of property involved. The scope of the borrower's liability also may be somewhat fuzzy at its edges, with the body of state law on which the parties rely certain to contain some ambiguities and open questions not yet addressed by the legislature or by the courts. But while the parties to a full recourse loan may not know precisely what they have agreed to, they will have acceded to a fairly predictable body of doctrine, however ill-defined at its borders and however changeable as new issues arise.

The Contrast: Zero Recourse Loans

Imagine now a mortgage loan with the strongest possible nonrecourse language. To what extent do the parties to this nonrecourse loan plan to deviate from the traditional full recourse model? A court might presume from this forceful language that the parties intended to reverse the standard full recourse rules completely. By shifting from a full recourse loan to a loan with no recourse, the parties must have intended to benefit the borrower in all of those circumstances in which the lender otherwise would have been protected. As a result, the lender's only option is to pursue the secured property, and the borrower and its partners are completely absolved of all personal liability in all instances. I will refer to loans such as these as "zero recourse" loans, to distinguish them from the partial or limited recourse loans discussed below.

Even if a zero recourse provision accurately reflects the parties' mutual intent, a court may have valid reasons for refusing to enforce it. An obvious illustration of a case in which enforcement would be inappropriate is one in which the borrower proves to have engaged in fraud. If a nonrecourse borrower were to lie when applying for credit and then bribe an appraiser to overstate the value of the property, a court would allow the lender to recover any resulting damages. The court would be correct in assuming that neither these parties nor any hypothetical reasonable parties could have intended, or should be allowed to agree to, an arrangement shielding the borrower from the consequences of its own criminal and intentionally tortious actions. The parties, or at least one of them, probably did not intend to depart from the traditional recourse rules to this degree, and even if they did, a court should not implement that agreement indiscriminately. In fact, if the nonrecourse provision is negotiated at all, one of the first carveouts the lender is likely to demand is a fraud exception.

The Realistic Nonrecourse Loan: Limited Recourse

A document that contains nonrecourse language manifestly intends to deviate from the usual full recourse model to some extent, and a court ought not allow the lender full recourse in a case in which the parties plainly agreed to something else. At the same time, most borrowers and lenders probably do not intend a complete reversal of the full recourse rules in all circumstances, and even if they do, courts properly are reluctant to enforce a provision that invariably absolves the borrower. The term "nonrecourse," as commonly used, often proves to be misleading. Parties that diverge from the standard full recourse model usually recognize that the borrower will remain personally liable in some more narrowly defined set of circumstances. This article sometimes will refer to these more realistic types of loans as "partial recourse" or "limited recourse" loans, although it should be evident that they are nothing more than standard, if inaccurately named, nonrecourse loans. Once it becomes apparent that a nominal nonrecourse loan usually is a loan with some limited recourse, the obvious next problem is the determination of how limited that recourse is.

In a realistic nonrecourse loan, which actually is a limited recourse loan, the parties jettison the default package of state liability rules and supersede it with doctrine they create themselves. The lender agrees to waive a powerful remedy in some circumstances. In exchange, the borrower presumably offers the lender some consideration such as a higher interest rate, a larger equity contribution, or, perhaps, nothing more than its resolution to borrow from this lender rather than from a competitor. If the parties refine this new set of rules carefully and reasonably in their documents and limit the lender's remedies with some precision, a court ordinarily will enforce their agreement as written.

Problems arise, however, when the parties fail to specify all of the details of their limited recourse relationship. The borrower and the lender may inadvertently fail to clarify the meaning of their agreement due to haste, sloppiness, or a lack of legal sophistication. Alternatively, the parties may deliberately decline to address all of these complexities for a variety of reasons. They may fear delaying the transaction and losing a short-lived business opportunity over an issue that they optimistically view as unlikely to arise. They may wish to keep their legal fees as low as possible. One party may prefer not to draw attention to some subtle ambiguity in what the other believes they have agreed to, thereby accepting an uncertain "maybe" rather than risking a certain "no." Whatever the reason, the parties may have agreed upon an incomplete legal relationship by employing a legally significant term without concurring as to its definition. Any document can contain such a failing, of course, but by opting out of well-defined state recourse rules and choosing instead to create their own, the parties increase their chances of reaching an agreement that is incomplete.

A court called upon to resolve a dispute that results from this type of omission must place this set of loan documents at an appropriate point on the spectrum between full recourse and zero recourse, recognizing all the while that the parties meant to depart from the standard full recourse rules to some extent. In order to infer the level of personal liability that the parties intended, the court will need to contemplate more carefully the nature of nonrecourse loans. A nonrecourse loan proves to be a loan in which the lender agrees to look solely to the mortgaged property in far more instances than otherwise would be the case. This more precise definition of a nonrecourse loan emphasizes that the nonrecourse lender agrees to waive its access to other assets of the partnership and its partners in many more cases than it would in a full recourse loan. The remainder of this article addresses the question of just how many more cases.

In many, but not all, of the factual situations that might arise, the lender has agreed prospectively to relinquish its access to the borrower's other resources, with the inevitable result that the mortgaged property takes on additional importance. The court cannot estimate accurately how much personal recourse the parties might have intended for the lender to retain until it considers more closely the nature of the mortgaged property, which is the only security that unquestionably is available to the lender in all cases. Once it understands just what the mortgaged property is, the court is in a better position to decide when the lender may look beyond the mortgaged property and how far.

Defining the Mortgaged Property with Care

The property that a borrower mortgages to its lender is a collection of physical and financial attributes. The physical traits of the mortgaged property generally are well understood and agreed upon by both parties, consisting of corporeal, property-like features such as the land itself. Other tangible property attributes frequently included within the scope of a mortgage are the improvements that are on the land or that will be constructed on the land, timber, and crops, even though these may not yet exist at the time of the grant of the mortgage. While not every borrower intends to grant its lender rights in all of these physical aspects of the property, the parties to any particular mortgage are likely to agree which physical property rights the borrower is mortgaging to its lender and will draft the granting clause of their mortgage accordingly.

The mortgaged property is more than just a collection of physical traits, however, and also includes financial attributes that are less tangible than bricks, mortar, coal, or timber. In a commercial real estate loan, one of the most important characteristics of the real property security is its capacity to produce rental income. A lender is likely to decide whether and how much it will lend on the basis of the overall value of the property, and this value will largely be a function of the property's ability to generate rents. The commercial lender is sure to inspect the land and to estimate the replacement cost of the buildings on it, but likely will be at least as concerned with the identities of the tenants, the amount of rent that each of these tenants is paying, and the number of years remaining in each lease term. Both parties will understand from the outset that the lender is concerned with these components of the property's value, and the borrower typically will provide all relevant documents to the lender at the time it requests the loan so that the lender may undertake a due diligence review. In addition, the loan may be conditioned on the lender's receipt of tenant estoppel letters, which authenticate and verify the major provisions of the leases; an assignment of leases and rents from the borrower, which provides the lender with a security interest in this important income stream; and subordination, nondisturbance, and attornment agreements from the major tenants, which assure the lender that these tenants will remain after a foreclosure.

A lender considering extending a loan will instruct its appraiser to scrutinize the entire collection of physical and financial property rights that the borrower has offered to mortgage and then to place a value on that set of rights. The lender well knows that subsequent buyers such as foreclosure sale purchasers are likely to calculate value in much the same manner. Particularly in a nonrecourse loan, in which the proceeds of a future foreclosure sale may be the sole source of repayment to the lender, the lender will want to guess at how potential future bidders will value the property and then will decide how much it is willing to lend on the basis of that calculation. The lender will determine how much it can lend against the mortgaged property only after its appraiser has examined the entire web of physical and financial features that together constitute the property and then has placed a value on this tangled collection of attributes.

Converting Mortgaged Property into Personalty

More worrisome to the lender is the fact that the borrower possesses the power to transform elements of the mortgaged property into personalty. Owners easily can convert physical components of the mortgaged property into personal assets of the borrower partnership. A shopping center owner might remove physical components of the structure and sell them for scrap, or a developer could purchase building materials with the proceeds of a construction loan and then sell them for cash before they are incorporated into the building. In each case, items that were a part of the mortgaged property or that were intended to become a part of the mortgaged property are transformed into or left as personal property. These personal assets, and the cash they later are exchanged for, might appear to be beyond the nonrecourse lender's reach.

Property owners also can transform financial components of the mortgaged property into personalty. The owner of a distressed shopping center might offer its anchor tenant a substantial rent discount in exchange for a prepayment of two years of that reduced rent. The owner thereby transforms a stream of 24 future monthly payments, to be enjoyed by the owner or owners of the center over that extended time period, into a discounted prepayment, to be fully enjoyed now by itself or by its partners. Any entity considering bidding on the property at a foreclosure sale during the next two years should discover that the anchor tenant will not be paying any rent for the duration of that period and should factor that foregone portion of the income stream into its calculation of the property's value, downgrading its bid accordingly. The nonrecourse borrower converts the rent that a particular tenant would pay over a protracted future period, which was a financial component of the security, into a lump sum cash prepayment to the borrower, which the lender or a subsequent owner of the property may be unable to recover.

This is not to say that a court will always enforce such agreements. *See* 11 U.S.C. §548 (allowing bankruptcy trustee to set aside certain constructively fraudulent transfers); *Restatement (Third) of Property: Mortgages* §4.4 (1997) (allowing receiver to disaffirm this type of "sweetheart" agreement if it contravenes provisions of senior mortgage or if mortgage was in default when agreement was made and agreement is not commercially reasonable). Borrower actions of this type often are prohibited in the loan documents, as well, but a court may grant the lender a remedy even if the documents do not specifically authorize it. Actions of this type appear to meet the definition of waste, and a court may enjoin the borrower from acting in a way that will harm the property or may allow the lender to recover personally from the borrower after the borrower acts in a way that has harmed the property.

The mortgaged property turns out to be a form of security that is both blurry and permeable. It is legally blurry in that the parties operate against a background of uncertainty to the extent that there are any pertinent unsettled questions of state law: The edges of the legal definition of this asset may not be sharp. It is financially blurry in the sense that its value can fluctuate dramatically from time to time. The mortgaged property is permeable in that the borrower easily may transform elements of this property, which appear to be part of the lender's security, into personal property, which may seem to be beyond the lender's grasp.

Even scrupulously honest and fair parties may disagree over whether seemingly well-meaning borrower actions transform vulnerable property into shielded property, given how porous the membrane between them is and given the compelling incentives for the borrower to traverse it. The nonrecourse lender will be more concerned than the full recourse lender about these legal and financial uncertainties because the nonrecourse lender has a great deal more to lose. The blurriness and permeability of the mortgaged property translate into higher risk for the nonrecourse lender.

Moral Hazard and the Indispensability of Some Borrower Liability

Many lenders are willing to tolerate the financial risks of nonrecourse loans, granting their borrowers the financial security and tax advantages that those borrowers demand by agreeing not to seek personal recourse. These same lenders, however, probably wish to preserve the psychological characteristics of full recourse loans, particularly the strong motivation that the fear of personal liability produces in most borrowers. Stated bluntly, even those lenders willing to forego personal claims against their borrowers want those borrowers to behave as though they believe and fear that their loans provide for full personal recourse. The previous discussion began to illuminate the inherent inconsistencies between the financial and psychological aspects of nonrecourse loans. The discussion that follows examines this moral hazard problem in greater detail.

If a borrower defaults, its lender forecloses, and the debt exceeds the net foreclosure sale proceeds plus the value of any backup security, then the nonrecourse lender may suffer a loss that a full recourse lender might have avoided. The reason why the property sells for less than the debt may be important, however. At one extreme, the nonrecourse lender bears the risk that external market conditions will degenerate to the point at which it suffers a loss that it would not have suffered had the loan provided for full recourse. Both parties recognize from the beginning that good planning, careful negotiation, and skilled professional management might be wholly undercut by rising interest rates, mounting local unemployment, and the insolvency of an anchor tenant. The nonrecourse lender gives up its personal claims against the borrower arising from these market conditions, with the result that a large portion of the lending risk that ordinarily resides with the borrower migrates to the lender.

Conversely, the nonrecourse lender never should bear financial responsibility for intentional bad acts or gross negligence on the part of the borrower. These types of actions often will run afoul of criminal, tort, or bankruptcy laws. Whether or not they do, the lender should be permitted to recover the damages that it suffers as a result of such misfeasance when a foreclosure sale fails to make it whole, even if the parties previously agreed that the loan would be nonrecourse.

Most cases fall between these two extremes, and a nonrecourse borrower that sees problems looming might begin to respond to these troubles in a variety of ways. First, the borrower might act responsibly, or even altruistically, exerting tremendous effort and perhaps spending additional funds in an all-out attempt to save the property. The altruistic borrower might act in this way even though it knows that the loan is nonrecourse and that it might be better off financially if it simply gives up. Second, the borrower might react more pragmatically, by allowing certain features of the property to deteriorate while still maintaining the property at a reduced level. This more pragmatic borrower recognizes that the finite funds available are insufficient to meet all of the property's needs and that these limited funds must be budgeted to address only the most serious problems. Third, the borrower might react more selfishly, by beginning to transform realty into personalty or simply by failing to transform personalty into realty in situations in which it otherwise would have. This more self-centered borrower acts out of its belief that business failure is nearly inevitable, and sees no reason to expend effort or funds to maintain the value of property it soon will lose.

The fear of this last sort of behavior is one of the rationales frequently given for having a law of waste. As Judge Posner notes in the context of the life tenancy:

"[T]he common law doctrine of waste...mediates between the competing interests of life tenants and remaindermen. A life tenant will have an incentive to maximize not the value of the property, that is, the present value of the entire stream of future earnings obtainable from it, but only the present value of the earnings stream obtainable during his expected lifetime. He will therefore want to cut timber before it has attained its mature growth—even though the present value of the timber would be greater if the cutting of some or all of it were postponed—if the added value from waiting would enure to the remainderman. The law of waste forbade this." Richard A. Posner, *Economic Analysis of Law* 83 (New York: Aspen Law & Business, 5th ed. 1998).

The boundaries between these different types of behavior are indistinct, of course, and many borrowers will act inconsistently. A borrower might choose two or more of these approaches concurrently or change its approach over time. This is not to suggest that borrowers are irrational or foolish, although some of them certainly are. Borrowers may adjust their responses over time as conditions change, and they sometimes will have to act before they have access to all the facts—or time for all the forethought—they might desire.

Any lender will care about how its borrower responds to adverse conditions, but the nonrecourse lender has more at stake than does the full recourse lender. In a full recourse loan, the lender wields an immense psychological stick, stating, in effect, "You may manage the property as you wish, but if I suffer a loss, you will pay." The threat of unlimited personal liability is sure to inspire a significant amount of fear in a borrower partnership and its partners. That fear, in turn, will motivate the borrower to act prudently and with respect for the lender's interests, even if the borrower's assets could not come close to making the borrower whole. The personally liable borrower may see little reason to conserve its funds if it believes that the funds it spends now may save the property while any funds it conserves will end up satisfying the lender's inevitable personal judgment anyway.

The lender that agrees to a detailed limited recourse loan modifies this statement somewhat, stating, "You may manage the property as you wish, but if I suffer a loss in any of the following enumerated ways, you will pay." This modified type of nonrecourse loan falls between the two extremes discussed in the text and eliminates some of the uncertainty that is this article's concern.

The zero recourse loan turns the full recourse loan on its head, with the lender effectively stating, "You may manage the property as you wish, period." The borrower may lose its equity in the property, but nothing more. At one level, the lender is hardly in a position to complain about the unavailability of a remedy that it agreed in advance to waive. But this problem extends beyond the loss of a financial remedy, for once the nonrecourse borrower believes that the property's value has dropped permanently below the outstanding amount of the debt, the borrower simply may resign itself to losing its investment in the property. This problem, a variation of the moral hazard problem described by scholars of law and economics, can be devastating to the lender. *See* Posner, supra, at 121 (noting that "[t]he tendency of an insured to relax his efforts to prevent the occurrence of [a] risk that he has insured against because he has shifted the risk to an insurance company is known as 'moral hazard'").

In a nonrecourse loan, the lender acts as the insurer by promising the borrower that its potential losses are capped. The borrower's equity contribution serves much the same purpose as a deductible and offers the lender some assurance that the borrower will be attentive to the property's needs. If the borrower loses this deductible and is not required to contribute any further copayments, the lender has great cause for worry. The "insured" borrower will have little incentive to preserve the property any further if the entire remaining value of that property is pledged to another.

The borrower may minimize its efforts to care for the property if foreclosure seems inevitable and its own personal losses are limited. It will see little potential for gain from hard work and resourcefulness if any additional investment of time or money will do nothing more than raise the value of the property closer to the amount of the debt, thereby reducing the lender's loss without improving the borrower's position. Moreover, borrower inattention in the future will lead to no further borrower loss because the loan eliminates any risk beyond the amount already committed and lost. Therefore, the nonrecourse borrower is likely to view attempts to salvage troubled property as effort that might help the lender but not itself, and may simply resign itself to losing its previous investment or, worse, may scavenge whatever it can for its own benefit. The absence of any remaining motivation to save the property from foreclosure, such as fear of further losses, may transform the borrower's attitude from one of nervous creative energy to one of disinterest, apathy, or selfishness.

The Second Circuit has recognized this point. In its discussion of the history of waste law in *Travelers*, the court observed that "[a]n action for waste gave the owner a remedy against a tenant who undermined the long-term profit maximizing potential of the property in order to realize short-term gains....In this way, it has been suggested by one commentator, the doctrine of waste developed to force tenants to manage the property as if they were the owner of the property." *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 120 (2d Cir. 1994) (citing Richard A. Posner, *Economic Analysis of Law* 64-65 (3d ed. 1986)). The court further noted that the gradual evolution of the use of the waste doctrine to permit actions by lenders against borrowers "is supported by the same rationale that originally supported the doctrine: it corrects incentives on the part of a mortgagor who anticipates default to deplete the collateral as much as possible before defaulting. Such an incentive leads to the inefficient use of property. Expansion of the doctrine of waste to mortgagor/mortgagee relationships removes this incentive." *Id.* at 120. These statements alone do not resolve the question of how to treat the nonrecourse borrower, however, for in the nonrecourse loan the court confronts the additional fact that the lender has voluntarily relinquished one of its most important remedies.

Thus, there actually are two aspects to recourse, one of them financial and the other one psychological, and the typical nonrecourse lender probably wishes to relinquish only the first of these. This lender is willing, for consideration, to give up its right to a deficiency judgment from the borrower. But this same lender probably is not willing to accept the possibility that its now-shielded borrower will lose interest in the property and will let it deteriorate, or will rescue whatever it can for itself, once the borrower concludes that its equity contribution is lost. What the nonrecourse lender would like to do, if it can think of a way to do so, is to fashion a nonrecourse loan that the borrower does not learn is nonrecourse until after the gavel comes down at the foreclosure sale. It is the lost motivation of the nonrecourse borrower that the test proposed below attempts to recreate.

A Test to Determine When the Lender May Look Beyond the Mortgaged Property

The test can be stated in its simplest form as follows:

The lender may recover from the borrower to the extent that the lender shows it suffered losses caused by actions that the borrower would not have taken had the borrower been fully liable.

This statement does not mean that the lender always may recover—if it meant that, the test would convert every nonrecourse loan back into a full recourse loan. Rather, the test means that the lender may recover only to the extent that it can prove that this borrower, shielded behind the nonrecourse provisions, acted in a way that differs from the way that it would have acted had it been fully exposed to liability, and thereby caused loss to the lender. *See Nippon Credit Bank, Ltd. v. 1333 North California Boulevard*, 2001 WL 51611, at *8 (Cal. Ct. App. 2001) (adopting this test). If the nonrecourse lender cannot show that the borrower would have behaved any differently had it feared personal loss, the borrower should not be held financially accountable.

Test Operates in Absence of More Specific Contractual Provisions

This test attempts to create a reasonable default position for limited recourse loans that lack a specific statement clarifying the scope of the borrower's liability. Nonrecourse borrowers will not routinely be held liable, as that would undercut the financial expectations of many nonrecourse borrowers and would give a financial windfall to lenders who already have been compensated once for their relinquishment of a specific financial remedy. A court that wished to find borrowers liable habitually would, in effect, be adopting a definition of waste that is broad enough to negate the nonrecourse provisions of the loan documents. A more balanced approach is desirable, given that the parties intended for this language to have some meaning, however poorly they drafted it. The fact that a nonrecourse loan is riskier to the lender should not, by itself, make the court any more inclined to rule in the lender's favor.

The Borrower Should Treat the Lender's Interest As Though It Were Its Own

At the same time, nonrecourse borrowers have a special responsibility to protect an asset of theirs that they have pledged to another as the sole security for repayment of a debt. A borrower that wishes to receive the numerous benefits of a nonrecourse loan has the concomitant obligation to treat its lender's concerns with the same degree of seriousness with which it would treat its own. Any nonrecourse borrower that acts just as it would have acted had it been fully liable should not be held responsible for its lender's losses.

Three Corollaries to the Test

Three corollaries follow from this bare statement of the test:

- The nonrecourse lender implicitly agrees to defer to the borrower's professional judgment and generally bears the risk of poor business decisions by the borrower;
- Because nonrecourse loans are loans in which the borrower's losses are capped, the nonrecourse lender suffers those losses that were inevitable no matter how the borrower acted; and
- The lender carries the burden of proof.

Each of these corollaries is explored below.

Lender Defers to Borrower's Judgment

Every lender, whether or not it retains personal recourse against its borrower, knows that it places a large part of its economic fate in the hands of a borrower entity that will have to make numerous business decisions every day. Lenders defer to their real estate borrowers in matters of real property management, because lenders are primarily in the business of evaluating requests for credit and monitoring the loans that result while borrowers possess expertise in operating real estate. Lenders also may fear adverse consequences under tort and environmental laws if they assume too great a role in day-to-day management. *See, e.g.,* 42 U.S.C. §9607(a)(1) (imposing liability for certain environmental cleanup costs on "owner[s] and operator[s] of a...facility"); 42 U.S.C. §9601(20)(E)-(F) (defining "owner or operator").

The lender that agrees to a loan not only has agreed that the mortgaged property constitutes acceptable collateral but also has decided that the borrower's property management skills are satisfactory. In return for receiving funds, the borrower pledges to the lender a significant asset over which the borrower ordinarily retains nearly complete management control.

This issue of control is unusually important in nonrecourse loans, because the property is the sole source of repayment of the debt. The lender that has agreed not to look to the borrower will care far more about the fate of the property than it otherwise would. Once the nonrecourse borrower begins to believe that it is likely to lose the property, however, its time horizon becomes shorter than that of the lender, and it may react to a critical financial emergency by simply reconciling itself to losing its prior financial investment. If the borrower perceives that there is no opportunity to gain and nothing further to be lost, it may take advantage of this absence of any further financial stake by neglecting or even milking the property. In short, management control over this important asset rests with a borrower that may become disinterested in or hostile toward the property just as the property's importance to the lender peaks.

Express Constraints on the Borrower's Discretion

The nonrecourse lender should anticipate that the borrower's interests could diverge from its own and should demand loan covenants that constrain the borrower's management discretion. Lenders that wish to include detailed standards of operation in the documents are as capable of doing so as are sophisticated commercial tenants. Failure by the borrower to meet these detailed standards would trigger an early default that will notify the attentive lender of problems while the borrower still has some equity in the property and will afford the lender the timely opportunity to take advantage of a wide array of pre-foreclosure remedies.

The lender also must remember to insist on partial recourse or some other type of financial assurance that these loan covenants will not be breached. *See, e.g.,* Joshua Stein, *Lender's Model State-of-the-Art Nonrecourse Clause (with Carveouts),* 43 The Practical Lawyer 31, 40-54 (Oct. 1997) (offering detailed form nonrecourse clause, along with shorter alternative form); Joshua Stein, *Nonrecourse Carveouts: How Far is Far Enough?*, Real Est. Rev., Summer 1997, 3, 6-9 (listing items for which lenders might demand carveouts from nonrecourse treatment and other items for which lenders ordinarily would not demand carveouts); John G. Wharton, *Negotiating Carveouts to Non-Recourse Loan Documents,* 13 The Practical Real Estate Lawyer 47 (Nov. 1997) (discussing this issue and offering form language). The nonrecourse lender that remembers to include a covenant requiring the borrower to perform a given obligation but forgets to provide for personal liability for failure to meet that obligation may find itself unable to recover personally for the borrower's failure to perform.

The nonrecourse borrower pressed to make these management concessions may respond that if restraints on its flexibility force it to spend more of its own money or time on the property after trouble strikes than it otherwise would have, then the lender is importing a type of indirect, limited recourse. The assets that a nonrecourse borrower may wish to protect from the lender are not limited just to funds. Those assets also include the borrower's time and attention. If the borrower is subject to personal liability, it may spend more of its own time on the project, thereby transforming an otherwise unreachable personal asset—its labor—into a reachable real asset—the increase in the value of the property that is attributable to that labor. To the extent that a mortgage loan possesses some of the attributes of a personal services contract by the borrower, it would not be unreasonable for the nonrecourse lender to demand performance standards for those services, with some recourse available for failure to meet those standards.

In fact, the lender *is* trying to retain some limited amount of recourse. For if real world nonrecourse loans truly are limited recourse loans, the parties need to establish at the outset just how limited that recourse is or else risk suffering the consequences of this ambiguity later. By specifying exactly what obligations the borrower has toward the property, with effective remedies available for breach of these obligations, the documents are constraining the borrower's discretion and shifting some management control back to the lender. The parties are agreeing on exactly how limited the borrower's recourse is and, in effect, are defining the mortgaged property with precision. It also is possible for the borrower to agree in advance how it will respond after default. For example, the parties might determine that the loan will become nonrecourse if the borrower cooperates during the foreclosure process.

The borrower may decide to take a much different approach, arguing that the lender's relinquishment of a powerful remedy constitutes tacit permission for the borrower to act more aggressively than it otherwise would. If this is what the parties intended, as it might be in some cases, then they should clarify the point in their documents. The nonrecourse borrower that desires more operational freedom than it usually has, like the nonrecourse lender that wants stricter constraints than it ordinarily demands, must raise the issue during the negotiations. The bare presence of the term "nonrecourse," with nothing more, should not be interpreted as sanctioning rash behavior. The default rule proposed here represents an intermediate and balanced starting point, one that reminds both parties that they must specify any departures from it before the documents are signed.

Describe the Borrower's Obligations Precisely

The parties to nonrecourse loans should take great care to describe the borrower's obligations with precision. If they fail to do so, then courts should be wary of holding the borrower liable in cases in which the borrower's unfortunate but nonmalevolent actions devalue the real estate. There is little justification for further penalizing the borrower who proves to be nothing worse than foolhardy, incompetent, or unlucky, particularly when that borrower possessed the initial foresight to insist on a nonrecourse loan and its lender failed to take the precaution of limiting the borrower's flexibility. The nonrecourse lender should suffer the consequences of its original poor decision to place its financial fate so extensively in the hands of a borrower for which things went badly. This is not the type of borrower that treats a nonrecourse loan as a license to act differently than it otherwise would have and is not the type of borrower that this article's proposals are designed to constrain. If the court second-guesses every business decision that the borrower makes and holds the borrower personally liable for every ill-considered or unfortunate choice that turns out to have devalued the property, then the court inappropriately begins to convert the loan back into a full recourse loan.

Some Lender Losses May Be Inevitable

Every decision not to spend money to replace a cracked window promptly is, in some sense, a decision that hastens the conversion of realty into personalty. The nonrecourse borrower opts to preserve its personal assets, which the lender cannot reach, rather than restoring the value of the real property, which might ultimately inure to the benefit of the foreclosing lender. This inaction devalues the property physically, in the sense that a slightly damaged building is worth less than an unblemished one, and it devalues the property financially, as business invitees become less willing to patronize establishments at the property and tenants become less willing to pay their rent or renew their leases. Such a decision may be seen as one in which the borrower commits passive waste by failing to transform personalty into realty in a setting in which such a transformation ordinarily would be expected.

The fact that the loan is nonrecourse, however, means that the parties have expressly or implicitly agreed that the borrower's obligation to spend money is capped at some finite amount —perhaps the amount of cash originally contributed by the partners plus all income generated by the building. This liability ceiling is a chief reason why borrowers request nonrecourse loans. If the amount that the nonrecourse borrower committed to spend is insufficient to meet all the needs of the property, then the borrower need not commit additional funds and some obligations will not be met. Thus, the description of the cracked window disregards the fact that the borrower may have been performing triage in a situation in which some lender loss was inevitable.

This "lockbox" approach seems to offer a reasonable estimate of the maximum financial obligation of the typical nonrecourse borrower, although this estimate raises ambiguities of its own. *Compare Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114, 123 n.9 (2d Cir. 1994) (observing that "the fact that the taxes had to be paid from [subsequent] rental income suggests that the distribution of the Partnership's accumulated cash assets and the Partnership's subsequent failure to pay taxes decreased the value of the Property") *with id.* at 128 (Mishler, J., dissenting) (arguing that damages for waste should be reduced "to the extent that rental income for the [subsequent] period is available for payment of taxes"). Even if a project has not been self-sustaining so far, it might become so in the future, and the judges in *Travelers* seem to disagree over how far into the future the court ought to look to balance the books. This uncertainty highlights once again the importance of detailing in the documents just what the borrower's obligations are and how much money and time it is agreeing in advance that it must spend. The loan documents, and perhaps the borrower's governing documents, should address such questions as whether and when the partners of the borrower are entitled to receive distributions, whether they ever are obligated to contribute additional funds, which capital improvements the borrower must undertake and when, and whether the borrower must maintain a reserve fund.

If the borrower, in spending all the funds it was required to spend, opted for an electrician rather than a glazier, the court must begin with the assumption that the borrower believed the funds spent on the electrician would benefit the property at least as much as the funds spent on the window repair would have. The borrower faced an unenviable decision as to which of two different types of deterioration to suffer, and the court should not penalize it for choosing the one it thought would cause the lesser harm to the property. Both parties benefit if the party charged with maintaining the property, and most familiar with it, uses all of its available but limited funds in the way it believes most beneficial to the property. If the borrower is held liable for a negative result that it attempted to minimize and that may have been inevitable no matter which repair it elected to make, then the borrower is paying for the fact that the property cannot support itself. Nonrecourse provisions are supposed to shield borrowers from these kinds of losses. Even if the failure to repair the window is seen as passive waste, the borrower that already has spent all it is required to spend will have committed a tort without damages.

The distressed borrower's decision whether to pay principal and interest can be a tricky one. The borrower may reason that if its resources are inadequate, it ought to meet all its other commitments first, as its principal and interest burden is the one obligation for which it is not personally liable. However, nonpayment of principal and interest telegraphs the borrower's distress to the lender, and the borrower might choose instead to mask its predicament by meeting its principal and interest obligation and deferring other commitments, the breach of which may be less obvious. The lender that later discovers such behavior might argue that, by neglecting its obligations in this less transparent way, the borrower has been passively liquidating the security and using the proceeds to meet monthly loan obligations. If the cash available to the nonrecourse borrower was insufficient, then the overall monthly shortfall will be the same size as it otherwise would have been, but more months will have passed before the lender was aletted to the problem. This stalling mechanism, the lender will argue, constitutes waste, with the lender suffering damages equal to the amount by which its total losses increased after it otherwise would have learned of the problem and could have taken remedial action. If the lender can prove that its nonrecourse borrower acted in this way because of its insulation from liability, the test proposed here would allow the lender to recover. This point is particularly evident, and the calculation of damages unusually easy, when the deterioration consists of a financial loss, such as a failure to pay real estate taxes, rather than a physical loss.

On the other hand, the borrower need not always spend all available funds. For example, maintaining a reserve fund may represent good business practice, particularly if current demands, while significant, are not emergencies. For a good analysis of the types of expenses that a nonrecourse lender to a single-asset real estate borrower is deemed to have approved in advance, in the context of a Chapter 11 bankruptcy proceeding, *see In re Willowood E. Apartments of Indianapolis II, Ltd.*, 114 B.R. 138, 143-44 (Bankr. S.D. Ohio 1990).

The Lender Carries the Burden of Proof

The lender always has the burden of proof in an action for a deficiency judgment. This burden is fairly light for the typical full recourse mortgagee, and the lender ordinarily can prove what it needs to by introducing easily obtained documents such as the note, canceled checks, and receipts. The burden is far heavier when a nonrecourse mortgage is in dispute, with the lender also having to demonstrate to the court why it should hold the borrower liable in spite of the presence of exculpatory language in the loan documents. Under the test described here, if the nonrecourse provisions are ambiguous, then the nonrecourse lender must show that the borrower acted in a way that it would not have had it been personally liable, that the borrower's actions were more than just the ordinary discretionary activities of a property owner to which the lender is deemed to have consented, and that the lender would have lost less had the borrower acted in some other way. The nonrecourse lender that cannot make all portions of this difficult showing must lose.

In asking whether the nonrecourse borrower acted differently than it otherwise would have and whether those differences fall within the borrower's permitted discretion, a court will need to confront the question of whether the nonrecourse borrower is under any obligation to act reasonably. The borrower-lender relationship is unique in every commercial loan, involving documents that are tailored to a specific transaction and personal relationships between pairs of parties that sometimes act atypically. Given the extent to which the provisions of commercial loans are negotiated, particularly the nonrecourse provisions of loans in which the borrower had the forethought to seek exculpation, it would be improper for a court to intervene and to assume that a particular borrower involved in a distinct transaction should be held to some generic standard. No borrower in such a sophisticated transaction should be presumed to be a "reasonable" borrower, and the nonrecourse lender should be required to prove that this borrower acted differently than *it*, and not some hypothetical median borrower, would have acted had it been personally liable.

At the same time, no borrower should be given license to act in any way it chooses, shielded from liability by its knowledge of how difficult it will be for its lender to prove that it acted differently than it, rather than the typical borrower, would have acted had the loan allowed for full recourse. Instead of rejecting the reasonable borrower standard completely, then, courts should recognize that a wide spectrum of behavior is acceptable within these individualized relationships, while also acknowledging that behavior demonstrably outside of the range that the lender ought to have anticipated should lead to liability.

A prudent lender will undertake a high level of due diligence review and will investigate its borrower's past transactions carefully. A borrower's performance in prior transactions should be highly probative of the type of behavior the parties are agreeing to accept as permissible in the current one. If the lender wants to constrain the borrower's actions any further, it must include these additional constraints in the documents. This difficulty in inferring performance standards demonstrates again why it is so important for the lender to include detailed guidelines in the loan documents, with personal recourse available after a breach. If the lender fails to insist on management and operation standards beforehand, the court should be reluctant to import them later.

Unless the borrower acts in a manner well beyond the range of expected behavior, the lender that attempts to construct a case is likely to have to rely on prior real estate activities by this borrower or by its principals. It may have to show the court how the managing partners of the borrower reacted to financial difficulties in earlier projects for which they were personally liable and how they succeeded in overcoming similar problems in the past. These will be difficult showings and may require the lender to undertake a detailed and complex examination of the borrower's books, as well as the books of other entities in which the borrower's key management personnel have been involved.

The general partner of the borrower, for example, may have earned a reputation for making large cash distributions to its partners at every opportunity and then operating the business with the thinnest of cash cushions. This manager may be willing to take the risk of a cash shortage that leads to default, foreclosure, a deficiency, and personal liability, even in a full recourse loan. The partner might act in this risk-

The test proposed here requires only that the borrower treat the lender's interest as it would treat its own. It does not, however, demand that the borrower treat its own interest with any particular degree of prudence.

preferring way because of its experience of usually coming out ahead, with frequent successes outweighing occasional failures. If a lender, after conducting its due diligence review, lends to this borrower on a nonrecourse basis and without constraining the borrower's discretion over distributions, it does so with full awareness of the risks that this particular borrower presents. Even if most borrowers might act more conservatively, this specific borrower should not be treated as operating beyond the range of its permitted discretion if it behaves this time just as the lender knew it had behaved in the past. Only conduct that is egregious under the standard appropriate for this unusually aggressive borrower should lead to borrower liability.

When the borrower's past behavior does not so plainly reveal how the lender might have expected the borrower to act in the future, the court's only option may be to extrapolate based on the borrower's more generalized past activities. This option is unlikely to prove fruitful for most nonrecourse lenders. In the typical case, a court is likely to recognize a wide range of borrower behavior as acceptable under the circumstances, as it should. If the current project was initially successful, however, the court needs only to observe how the borrower acted in the early days of the loan, when the project was thriving. At that point, the nonrecourse borrower had something of significant value to lose and probably performed much like a full recourse borrower would have performed.

Note that the approach recommended here differs from the prudent person standard familiar to trust lawyers. *See, e.g., N.Y. Est. Powers & Trusts Law* §11-2.3(b) (McKinney Supp. 2001) (describing elements of prudent investor standard under Uniform Prudent Investor Act). A commercial borrower is not a fiduciary for its lender and, like other business persons, is free to act in ways that a fiduciary never could. Prudent trustees shy away from speculative real estate investments due both to personal prudence and fear of liability. Commercial borrowers, in contrast, are entrepreneurs, and often are imprudent even with their own money. The test proposed here requires only that the borrower treat the lender's interest as it would treat its own. It does not, however, demand that the borrower treat its own interest with any particular degree of prudence.

Some borrowers may be particularly rash even when their own money is at risk. The lender that extends credit to these borrowers on a nonrecourse basis should constrain their actions in the loan documents. The test proposed here does limit the behavior of these borrowers to some extent by demanding that they adhere to a weak version of the reasonable person test, but the most reckless borrowers are the ones that will be the least constrained by this limitation. A more significant check on the behavior of these borrowers arises from the fact that lenders that commence waste actions are bringing tort claims and not contract claims. This means that the court can award punitive damages to the lender in extreme cases. *See, e.g., Nippon Credit Bank, Ltd. v. 1333 North California Boulevard*, 2001 WL 51611, at *10-12 (Ct. App. 2001)(recognizing that punitive damages may be awarded for torts such as waste); *Manson v. Reed*, 231 Cal. Rptr. 446, 453 (Ct. App. 1986) (awarding punitive damages in case in which borrower committed fraud). The threat of punitive damages, if they are likely enough and sizable enough, should deter borrowers from engaging in reckless or intentionally makcious behavior. *See generally* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 Harv. L. Rev. 869 (1998) (examining deterrent effect of punitive damages).

The lender's burden does not end when it convinces the court that the borrower acted differently than it would have if it had been personally liable and that these differences went beyond the owner's authorized level of discretion. The lender also must prove that this behavior caused actual loss. The previous section offered a simple example in which the distressed borrower was forced to choose between repairing a broken window and fixing faulty wiring, but the facts facing actual owners will be more jumbled, the losses more gradual, and the challenge of proving those losses more difficult to overcome. The distressed property owner is unlikely to respond outrageously at the first whiff of trouble or to abdicate and allow the property to collapse overnight; more likely, it will be forced to relax standards gradually. As money becomes more scarce, the borrower likely will defer discretionary maintenance and cut back on building services little by little and will allow its reserve fund to stop growing and then begin to shrink.

This management strategy may be designed selfishly to begin the borrower-protective processes of transforming realty into personalty and avoiding any unnecessary transformation of personalty into realty. More likely, it will not be a strategy at all, but a series of context-sensitive, pragmatic decisions made over a protracted period of time. Each of these choices will have been formulated to conserve a slowly evaporating bank account so that funds are available for the inevitable expensive emergencies on which money may need to be spent quickly.

More than at any prior time, the competent manager of distressed property needs to make difficult decisions and to conserve declining resources. Every such action by the distressed borrower likely is motivated by a combination of factors. These factors probably will change in relative significance from month to month, and only one of them will be the borrower's desire to preserve or augnent its personal assets. Moreover, the self-defense component of the borrower's motivation typically will be a fairly minor consideration as the problems begin, when the owner still has significant equity in the property and probably believes that the misfortunes will not persist. It will be difficult for a lender to show that a managing partner's decision to conserve funds has ceased to be primarily a wise business choice under tough conditions and has become primarily an inappropriate personal enrichment measure. It will be just as difficult to prove the resulting damages.

Summary of the Proposed Test

Wise nonrecourse lenders always will include provisions in their documents that specify management standards that their borrowers must meet and future financial obligations that they must undertake. These precautions help to define the mortgaged property and to avoid any uncertainties about the borrower's expected performance. Lenders are not always this prescient, however. The propased test will help courts determine when to allow a nonrecourse lender access to the personal assets of its borrower and the partners of its borrower, a test that will permit some lenders to recover in spite of their failure to include or clarify critical language in the documents. The propased test attempts to recreate the motivation to preserve

This article recommends that courts adopt an approach that compares the way in which the nonrecourse borrower actually acted with the way in which it would have acted had it been personally responsible for performance of the mortgage obligations, holding nonrecourse borrowers liable only for the results of any differences.

the mortgaged property that full recourse borrowers always retain. Those lenders that can make the necessary showing will benefit from a test that recognizes that nonrecourse borrowers may become complacent or aggressively selfish once the loan becomes distressed. *See Nippon Credit Bank, Ltd. v. 1333 North California Boulevard*, 2001 WL 51611, at *8 (Cal. Ct. App. 2001) (recognizing risk that nonrecourse borrower might "milk" property).

A lender that hopes to recover under this test faces an uphill battle. It will have to carry the very heavy burden of showing that:

- The borrower acted in a way that differs from the way it would have acted had it been personally liable;
- The borrower exceeded its significant business discretion; and
- The lender suffered actual loss as a result of these improper borrower actions.

CONCLUSION • The common law has had centuries to develop rules that apply to ordinary full recourse loans, but the courts are only beginning to face the questions that arise when parties voluntarily reject this body of law and replace it with an ill-defined substitute of their own creation. The most direct way for borrowers and lenders to avoid disputes is to define their relationship precisely, a course that only some parties follow. Others will agree to a document that waives a key remedy without clarifying what options remain to the lender. As several recent cases have shown, this second approach breeds unnecessary litigation.

Judges, who may be unfamiliar with the intricacies of real estate finance, need to recognize several points before they can decide these cases fairly. They must appreciate that a nonrecourse loan differs from both full recourse and zero recourse loans. They must realize that a nonrecourse loan is one in which the lender must look solely to the mortgaged property in far more cases than it otherwise would, but not necessarily always. In addition, they must acknowledge that the definition of the mortgaged property may not be clear. The mortgaged property is an asset with a legal characterization that can be uncertain and with a value that fluctuates, and the borrower has the capacity to transform some of this secured property into unreachable personal property.

Judges facing litigation about the scope of the lender's recourse may find themselves wondering exactly what the parties agreed to and concluding that they did not agree to anything helpful. Nonetheless, once a nonrecourse loan goes into default, a court may find itself forced to decide exactly how much protection the inadequate documents provide to the borrower. In doing so, the court must recognize that the parties intended to protect the borrower financially to some degree but probably did not intend to let the borrower disregard the lender's interests entirely. The court, then, must strive to reach a result that preserves the borrower's motivation to protect the security but that limits the losses facing the borrower that fails to do so.

This article recommends that courts adopt an approach that compares the way in which the nonrecourse borrower actually acted with the way in which it would have acted had it been personally responsible for performance of the mortgage obligations, holding nonrecourse borrowers liable only for the results of any differences. This standard insulates the borrower from the market risks that the lender probably expected to assume, but leaves the borrower liable for the costs of any actions that it took only because it believed that it would not have to pay for their consequences. This test should ensure that nonrecourse borrowers will not act foolishly or recklessly, or at least not any more so than they would if their own funds were at risk. This approach also will help guide borrowers and lenders earlier in their relationship, as they attempt to negotiate documents that are mutually acceptable.

The test proposed here places a heavy burden on the lender. The lender must prove that the nonrecourse borrower behaved differently than it otherwise would have, demonstrating along the way that the borrower exceeded the scope of the discretion that it retained as owner of the property and that the lender suffered actual loss as a result of the borrower's acts or omissions. Most lenders will not be able to make this showing. This difficulty demonstrates the importance to the lender of addressing these issues in advance, in the documents, rather than trying to place limits on the borrower's behavior after a project becomes troubled. Borrowers and lenders that wish to avoid participating in the slow and costly development of the case law may do so easily, by reflecting carefully on the repercussions of their proposed business arrangements and then drafting their documents thoughtfully.

In one sense, the typical dispute discussed above is little more than a private law disagreement between a borrower and a lender with an unnecessarily vague business relationship. If the parties end up litigating their differences, a judge will have to interpret their imprecise documents. The consequences of these disagreements, however, can affect parties beyond the borrower and the lender. Every time a borrower defaults, title to its property may become clouded, the condition of the property may deteriorate, tenants may vacate the premises, and the local community may endure hardship as a result of the owner's distress and the lender's inability to terminate it swiftly. Every time a lender must write off a bad loan, its owners suffer; if this happens too often to the same lender, others—such as the federal government and the taxpayers that support it—may end up paying the cost of the parties' errors. The rule proposed here should allow judges to resolve these issues fairly and in accordance with the probable expectations of the parties while also creating incentives for these and other parties to avoid similar disputes and similar consequences in the future.

PRACTICE CHECKLIST FOR
When Can a Nonrecourse Lender Reach the Personal Assets of Its Borrower?

For real estate ventures, the limited partnership remains a favored entity. To protect themselves from personal liability, general partners often are able to negotiate nonrecourse loans—the lender agrees to look only to the collateral for satisfaction of the debt. Because the nonrecourse lender cannot reach the borrower's personal assets, distinguishing the mortgaged property from the borrower's personal assets is far more important in the nonrecourse loan than in the full recourse loan. Unfortunately, the legal definition of the mortgaged property may be unsettled at its edges, and borrowers possess the ability to shield assets from nonrecourse lenders by transforming real estate into personal property.

- A nonrecourse loan actually is a loan with limited recourse. If the borrower, foreseeing a foreclosure, reduces or wastes the collateral, a court may impose personal liability.

☐ To avoid confusion and litigation, the loan documents should spell out the scope of the borrower's duties with respect to the collateral.

☐ Loan documents do not always contain these provisions. When they do not, courts should adopt a test that compares the way in which the nonrecourse borrower actually acted with the way in which it would have acted had it been personally responsible for performance of the mortgage obligations, holding nonrecourse borrowers liable only for the results of any differences. This standard insulates the borrower from the market risks that the lender probably expected to assume, but leaves the borrower liable for the costs of any actions that it took only because it believed that it would not have to pay for their consequences. This test should ensure that nonrecourse borrowers will not act foolishly or recklessly, or at least not any more so than they would if their own funds were at risk. This approach also will help guide borrowers and lenders earlier in their relationship, as they attempt to negotiate documents that are mutually acceptable.

- To prevail under the proposed test, the lender would have to establish that:

☐ The borrower acted in a way that differs from the way it would have acted had it been personally liable;

☐ The borrower exceeded its significant business discretion; and

☐ The lender suffered actual loss as a result of these improper borrower actions.