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The Mortgagee's Remedies for Waste

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A mortgagee faced with the waste of the mortgaged property must deal with conflicting common law, statutes, and recent court decisions in attempting to obtain an adequate remedy. In this Article Professor Leipziger analyzes these conflicts, discovers the lack of a rational policy behind previous judicial attempts to resolve the problems of waste, and offers some suggestions for reform.

Protection against waste is vital to the mortgagee, but its importance may not always be apparent even to the institutional lender, let alone to an unsophisticated seller who takes back a secured purchase money note. Although the secured lender or seller expects the documents of a transaction to include a mortgage[1] and knows that in the event of a default he will want to resort to the encumbered property, the business aspects of the transaction—the rate of interest, the terms of payment and the like—are typically the focus of negotiations. The mortgagee may know that standard forms of mortgages require the mortgagor to obtain insurance, keep the property in good repair, pay taxes, and take other steps to protect the mortgagee's security interest. He is probably unaware, however, whether and how such obligations can be enforced. If the obligations are not fulfilled, he may be similarly unaware of the extent of the liability of the mortgagor, or of other persons responsible for wasting the property.

Until quite recently, the mortgagee's ignorance of his remedies for waste was unlikely to produce serious consequences. The prolonged inflation beginning after World War II had a particularly marked effect

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1. For convenience the words "mortgage," "mortgagor," and "mortgagee" are used throughout this Article to include "deed of trust," "trustor," and "beneficiary," respectively.

on real property values. If waste occurred, usually at a time when the mortgagor was also in default on his note, the mortgagee could buy the property encumbered by his mortgage at a foreclosure sale and resell it at a profit even after paying any delinquent taxes and making necessary repairs.[2] Perhaps as a result of these favorable circumstances, there has been no recent scholarly attention paid to this area of law.[3] During the past few years, however, there has been an increased incidence of defaulting borrowers and damaged collateral,[4] accompanied by a flurry of new cases presenting problems that are difficult to resolve under traditional concepts of waste. Most of the basic principles governing the real property mortgagee's remedies for waste were worked out in the 19th century. It is hardly surprising that these principles are not entirely adequate to deal with conditions encountered in the mid-1970's.

Waste is commonly defined as conduct done or permitted by one in rightful possession of the property that causes physical damage or destruction.[5] It includes both voluntary waste, such as excessive cutting of timber or removal of minerals or permanent structures, and permissive waste, such as allowing the property to fall into disrepair. The mortgagor may also engage in conduct that may be termed "financial waste" when he fails to pay taxes or to service senior encumbrances, thus impairing the mortgagee's security. As will be seen, the courts have not consistently applied the same principles to physical and financial waste cases.

This Article will undertake a critical examination of the traditional doctrines applicable to waste and will propose solutions both to some ancient controversies never satisfactorily resolved by these doctrines and to several significant new issues presented by the more recent cases. The goal is to discover ways to make judicial decisions pertaining to waste both more consistent and more responsive to the needs of the parties. At the same time, it is important that the law of waste not be treated in isolation from other aspects of real property mortgage law. It affects and is affected by recent developments, especially in California, regarding due-on sale clauses and the availability of deficiency judgments. Clarification of the law applicable to waste should also

2. For an example of this process, see G. LEFCOE, LAND FINANCE LAW 591 (1969).

3. The most recently published article or comment discussing the mortgagee's remedies for waste appeared nearly 40 years ago. Denton, *Right of a Mortgagee to Recover Damages from a Third Party for Injury to Mortgaged Property in Ohio*, 3 OHIO ST. L.J. 161 (1937).

4. *See* BUS. WEEK, Oct. 13, 1975, at 108.

5. *See* Halifax Drainage Dist. v. Gleaton, 137 Fla. 397, 410, 188 So. 374, 379 (1939); Hayman v. Rownd, 82 Neb. 598, 118 N.W. 328 (1908).

illuminate these related problems. The Article suggests that the law of waste has been moving somewhat unevenly toward providing greater protection for debtors. In this respect this area of the law is consistent with recent trends affecting other areas of the law, such as commercial law, consumer credit law, and corporate securities law. Those judicial decisions that illustrate the debtor protection tendency sometimes have less impact on the law than they should, because the courts are either unaware of or fail to articulate the underlying bases for their decisions. This Article generally seeks to promote the tendency toward debtor protection by revealing the unexpressed bases of judicial decisions and by linking together areas of mortgage law that have been allowed to develop in isolation. On the other hand, the Article will also point out certain areas in which the courts have unwittingly failed to give adequate consideration to the legitimate needs of lenders.

Part I of this Article offers a brief review of the mortgagee's traditional remedies for waste: damages, injunction, and foreclosure. It continues with an analysis of the theories relied on by courts in granting relief to the mortgagee and the doctrine of substantial impairment, which limits such relief in many jurisdictions.

Part II examines the enforceability of covenants against waste. Courts have been quite willing to allow the mortgagee to enforce covenants against a mortgagor who has failed to make a payment on a senior encumbrance, a tax payment, or some other payment which if not made would result in the mortgage being extinguished. By contrast, when the waste consists of failure to maintain the property in good condition or to repair damages, courts have shown greater reluctance to uphold covenants unless the condition is so serious that it substantially impairs the collateral. Although this distinction between the two kinds of waste can be justified, two recent California cases have undermined it by permitting some mortgagees to obtain indirect relief against waste or threatened waste regardless of its character. This result is accomplished by allowing the mortgagee to enforce a due-on sale clause or due-on encumbrance clause that is otherwise unenforceable, thereby forcing payment of the debt even before waste has occurred.

The remainder of the Article is concerned primarily with problems peculiar to the remedy of damages. Part III discusses the procedural question whether an independent action to recover damages may be brought prior to or after foreclosure. Although most jurisdictions allow recovery of damages without exhausting the security,[6] the analysis in

6. California is probably an exception. *See* CAL. CODE CIV. PRO. § 726 (West Supp. 1975), and text accompanying notes 132-43 *infra*.

Part III suggests that the majority rule inadequately protects the mortgagor and is also inconsistent with certain restrictions on independent damage actions brought after foreclosure. Part IV deals with circumstances in which the mortgagee cannot recover damages on a contract theory. The use of a tort theory is necessary, for example, when the defendant is a non-assuming grantee, who cannot be held liable on a contract theory. The issue here is whether the grantee's tort liability should be determined on the same basis as that of the mortgagor, or rather, according to rules applicable to third party tortfeasors. In addition, the Article discusses the problem created in California by the apparent inconsistency between an action for damages and section 580b of the Code of Civil Procedure, which bars personal liability on certain purchase money obligations.[7] It has been said of a purchase money trust deed that "the one taking such a trust deed knows the value of his security and assumes the risk that it may become inadequate."[8] Does this sentiment extend to the case of a trustor who so despoils the encumbered property that it is "vandalized and looted" and who is saved from a criminal charge only by his possessory right?[9] The last portion of Part IV explores the efforts of the California courts to allow recovery on a tort theory under rules compatible with the purposes of section 580b.

I

THE SOURCE AND THEORIES OF REMEDIES AGAINST WASTE

A. Background

In general, a mortgagee whose security suffers waste may sue for damages, enjoin future waste, or foreclose. The right of the mortgagee to recover damages from those responsible for waste was established under English law as early as the 12th century. In the United States, however, the availability of a right to recover was decisively influenced by the differing theories of a mortgage adopted in the various states. The common law mortgage in this country was initially conceptualized, in accordance with English tradition, as a conveyance of title to the mortgagee, defeasible on condition that the debt secured by the mortgage be paid. This concept survives in the so-called title theory jurisdictions, which comprise most of the states east

7. Personal liability is barred on any purchase money obligation given to a vendor and also on any purchase money obligation given to a third party, if the property financed by the third party is owner-occupied residential property of four units or less. CAL. CODE CIV. PRO. § 580b (West Supp. 1975).

8. Schumacher v. Gaines, 18 Cal. App. 3d 994, 999, 96 Cal. Rptr. 223, 226 (3d Dist. 1971), *quoting from* Brown v. Jensen, 41 Cal. 2d 193, 259 P.2d 425 (1953).

9. 18 Cal. App. 3d at 997 n.3, 96 Cal. Rptr. at 225 n.3.

of the Mississippi. Although the title theory has been criticized as a cumbersome legal fiction that must be constantly adjusted to satisfy the interests and needs of the parties,[10] it has posed few problems insofar as the mortgagee's action for waste is concerned. The mortagee in title theory jurisdictions is entitled to sue at any time after the waste has occurred, without the necessity of first foreclosing his mortgage.[11] He may recover actual damages, no matter how small.[12]

In the 19th century a number of American jurisdictions abandoned the title theory and developed instead the notion that the mortgagee's only interest in the encumbered property should be that of a lien holder having such rights, and only such rights, as were required to protect his security interest.[13] In marked contrast to judicial and legislative efforts in title theory jurisdictions, courts and legislatures in lien theory jurisdictions have found it difficult to decide what magnitude of damages is actionable, how damages should be measured, and whether an action may be maintained before foreclosure. These difficulties will be reviewed in detail later in this Article.

The mortgagee's right to enjoin waste was not generally recognized until the 18th century, but despite some early controversy over its availability,[14] this remedy poses today far fewer problems than the action for damages. The injunction, like equitable remedies generally, is available only when the mortgagee lacks an adequate remedy at law. In a rare show of harmony, both title and lien theory jurisdictions agree that an injunction can be decreed only when the waste complained of

10. *See, e.g.*, 1 G. GLENN, MORTGAGES § 28 (1943) [hereinafter cited as 1 GLENN]; W. WALSH, MORTGAGES § 23 (1934).

11. *E.g.*, Powell v. Williams, 14 Ala. 476 (1848); Barnes v. Upham, 93 Conn. 491, 107 A. 300 (1919).

12. Burrill Nat'l Bank v. Edminster, 119 Me. 367, 111 A. 423 (1920); Gooding v. Shea, 103 Mass. 360 (1869); Landon v. Paul, 22 Vt. 205 (1850).

13. Under the lien theory the mortgagor retains title until foreclosure, and the mortgagee's interest in the property is a security interest only. This system gives the mortgagee the right to force the sale of the property and apply the proceeds to payment of the debt in the event of default. In the absence of appropriate covenants in the mortgage, the mortgagee in a lien theory jurisdiction has no right to enter the property or interfere with the mortgagor's use of it prior to foreclosure. This theory is followed in most of the states west of the Mississippi.

California nominally follows the lien theory when the security device is a mortgage and the title theory when the security device is a deed of trust. This hybrid system originally caused much confusion. *See* Kidd, *Trust Deeds and Mortgages in California*, 3 CALIF. L. REV. 381 (1915). Over a period of years the deed of trust was gradually assimilated to the mortgage, so that with the exception of different rules for the application of the statute of limitations, *see* Grant v. Burr, 54 Cal. 298 (1880), the beneficiary under the deed of trust has no more rights by reason of the applicability of the title theory than does the mortgagee under the lien theory. *See* Bank of Italy v. Bentley, 217 Cal. 644, 20 P.2d 940 (1933).

14. 2 G. GLENN, MORTGAGES § 195 (1943) [hereinafter cited as 2 GLENN].

threatens substantial impairment of the mortgagee's security.[15] Some cases demand as a further requirement that the mortgagor be insolvent.[16] Once regarded as the remedy of choice,[17] the injunction has lost much of its practical importance, probably as the result of increased contemporary use of foreclosure as a remedy.

The equitable remedy of appointment of a receiver as a supplement to an injunction against waste[18] should also be mentioned for the sake of completeness, although this Article will not take up any problems associated with that remedy. Its principal importance is as a means of obtaining the rents and profits before and during foreclosure proceedings, where the security of the property itself is inadequate;[19] it also provides greater protection against tortious waste by a mortgagor than would an injunction standing alone.[20]

The final remedy in the mortgagee's arsenal against waste, and the one most recently to become prominent, is that of acceleration of the debt, leading to a foreclosure. Until well into the 19th century in England, foreclosure was so costly, protracted, and uncertain a process[21] that a mortgagee who might be compelled ultimately to foreclose would initially want to protect himself against waste by a speedily obtained injunction.[22] The foreclosure remedy has become more significant with the advent of the constant payment amortizing loan, which became the common form in this country after the depression of the

15. Title jurisdictions: Owings Lumber Co. v. Marlowe, 200 Ala. 568, 76 So. 926 (1917); Cooper v. Davis, 15 Conn. 556 (1843); Dudley v. Hurst, 67 Md. 44, 8 A. 901 (Ct. App. 1807); *cf.* Stewart v. Finklestone, 206 Mass. 28, 92 N.E. 37 (1910). Lien jurisdictions: Lavenson v. Standard Soap Co., 80 Cal. 245, 22 P. 184 (1889); Moriarty v. Ashworth, 43 Minn. 1, 44 N.W. 531 (1890); Jones v. Costigan, 12 Wis. 757 (1860).

16. Robinson v. Russell, 24 Cal. 467 (1864); Bank of Cheuango v. Cox, 26 N.J. Eq. 452 (1875). *Contra,* Williams v. Chicago Exhibition Co., 188 Ill. 19, 58 N.E. 611 (1900); Triplett v. Parmalee, 16 Neb. 649, 21 N.W. 403 (1884); Starks v. Redfield, 52 Wis. 349, 9 N.W. 168 (1881).

17. *See* 2 GLENN, *supra* note 14, § 198, at 1010-12.

18. G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 134 (2d ed. 1970) [hereinafter cited as OSBORNE].

19. *See generally* Regalia, *Receivers in California Litigation Involving Real Property,* 15 U.C.L.A.L. REV. 896, 904-10 (1968); Note, *Remedies Against "Milking" of Property by Mortgagor,* 46 HARV. L. REV. 491 (1933).

20. Some jurisdictions hold that inadequacy of security is not a sufficient ground for a receiver and that both insolvency of the mortgagor and actual or imminently threatened waste must be shown. *See, e.g.,* Grether v. Nick, 193 Wis. 503, 213 N.W. 304, *aff'd on rehearing,* 215 N.W. 571 (1927); Larson v. Orfield, 155 Minn. 282, 193 N.W. 453 (1923); Cortleyeu v. Hathaway, 11 N.J. Eq. 39 (1855). For a critique of this view, see OSBORNE, *supra* note 18, §§ 148-49.

21. OSBORNE, *supra* note 18, § 311; 1 G. GLENN, *supra* note 10, § 61, at 403-04.

22. The alternative means of protection was for the mortgagee to oust the mortgagor and take possession of the property. This course of action was regarded as a last resort remedy, because it exposed the mortgagee to strict rules of accounting for the income, expenses, and liabilities of the property. *See* Stinchfield v. Milliken, 71 Me. 567 (1880); 2 GLENN, *supra* note 14, § 211.

1930's. This right to pay in installments is typically granted subject to the debtor's compliance with a host of covenants in the note and mortgage. A number of these covenants are designed to prevent waste or reduce the harm it causes; the threat of acceleration (possibly leading to foreclosure) is a potent weapon against the commission of the types of waste defined in the mortgage.

Whether one or more of the above remedies will be available to the mortgagee depends on such variables as the theory of relief adopted by the court, the presence of covenants against waste in the mortgage, the type of waste committed, when relief is sought, and who (for example, the initial purchaser or subsequent grantee) is responsible for the waste. The balance of this Article will explore the significance of these variables, emphasizing how they may be manipulated to further the goal of debtor protection.

B. Theories Supporting an Action for Damages

1. Tort

In England, the mortgagee's remedies derived from those of the landlord. At early common law an action for damages caused by waste could be brought only against tenants of estates created by law,[23] and later those created by statute;[24] liability was imposed on life tenants and tenants for years. By the 16th century, an action on the case had become available against other tenants. Recognition of the mortgagor's status as equivalent to that of the tenant did not occur until near the end of the 17th century. Prior to that time, the mortgagee not only had title to the mortgaged property but also was usually in possession; hence the mortgagor simply was not in a position to commit waste. When it became customary for the mortgagor to remain in possession, he began to be regarded not only as equitable owner but also as a kind of tenant;[25] as such, he was liable in an action on the case for waste committed by him. The theory of such an action will be referred to here as the tort theory, since in modern times it is based on the notion that the mortgagor (or third party) has intentionally or negligently caused the value of the property to decrease. At common law, waste in the landlord-tenant context included both deliberate acts (voluntary waste) and negligently caused damage to the property (permissive

23. Attorney-General *ex rel.* Churchill v. Duke of Marlborough, 56 Eng. Rep. 588, 595 (Ch. 1818); Garth v. Colton, 26 Eng. Rep. 1231 (Ch. 1753); COKE ON LITTLETON 53b (18th ed. 1823).

24. Statute of Marlbridge, Marlborough, 52 Hen. 3, c. 23, § 2 (1267); Statute of Gloucester, 6 Edw. 1, c. 5 (1278).

25. *See* Powsely v. Blackman, 79 Eng. Rep. 569 (K.B. 1621); Partridge v. Bere, 106 Eng. Rep. 1311 (K.B. 1822); Hitchman v. Walton, 150 Eng. Rep. 1489 (Ex. 1838).

waste).[26] But destruction by the elements or by act of God did not constitute waste.[27] These distinctions were partly carried over into mortgage law and have created some confusion regarding the scope of liability under the tort theory.

The tort theory, based as it was on the landlord/title-holder's right to sue for damages, was easily assimilated into mortgage law in title theory jurisdictions.[28] In lien theory jurisdictions, however, the tort remedy was not so obviously applicable. The lien theory jurisdictions, led by New York, developed a new tort theory to justify the mortgagee's action for waste. In *Van Pelt v. McGraw*,[29] the court recognized the right of the mortgagee to sue for waste even though his only interest in the property was the lien (without title) of his mortgage. The court noted that the gravamen of an action for waste had generally been regarded as an injury to the land. Under the lien theory of mortgages, however, the mortgagee seems to have no right to recover for such an injury since he had neither title nor, in most instances, possession at the time the waste occurred. Recognizing that the mortgagee's concern was to maintain the value of his security, the court held that the mortgagee could bring the action provided that his security was impaired. The difference between damage to the land and impairment of the security is a matter of degree; under the title theory any damage to the land gives rise to a cause of action,[30] but under the lien theory the damage must be substantial enough to impair the security.[31]

The early cases in New York and other lien theory jurisdictions, though preserving a tort basis for the action, hedged the remedy with a number of qualifications. Thus, to sue a third party for waste, the mortgagee had to show that the mortgagor was insolvent[32] and that the

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26. Townshend v. Moore, 33 N.J.L. 284 (Sup. Ct. 1869).

27. Sticklethorne v. Hatchman, 74 Eng. Rep. 887 (K.B. 1586); 2 COKE, INSTITUTES 145. Apparently the tenant was liable for permissive waste only if substantial damage ensued as a result of the tenant's neglect. W. BEWES, THE LAW OF WASTE 213 (1894).

28. *See* Hastings v. Perry, 20 Vt. 272, 279 (1848), and cases discussed therein.

29. 4 N.Y. 110 (1850). Contractual recovery was unavailable in *Van Pelt v. McGraw*, since the defendant was a subsequent grantee who had taken title "subject to" the deed of trust but had not assumed the obligation. The great problem posed by the lien theory was how to recover against non-assuming grantees and third parties. The remedy of an action for waste was not necessary against the mortgagor, since he was personally liable for the debt, and if the waste reduced the value of the property, the mortgagee could foreclose and obtain a correspondingly greater deficiency judgment.

30. Searle v. Sawyer, 127 Mass. 491 (1879); Smith v. Moore, 11 N.H. 55 (1840); Langdon v. Paul, 22 Vt. 205 (1850).

31. Lavenson v. Standard Soap Co., 80 Cal. 245, 22 P. 184 (1889); Taylor v. McConnell, 53 Mich. 587, 19 N.W. 136 (1884); Turrell v. Jackson, 39 N.J.L. 329 (Sup. Ct. 1887); Van Pelt v. McGraw, 4 N.Y. 110 (1850).

32. Robinson v. Russell, 24 Cal. 467 (1864); Gardner v. Heartt, 3 Denio 232 (N.Y. 1846); Lane v. Hitchcock, 14 Johns. 213 (N.Y. Sup. Ct. 1817).

tortfeasor had either actual or constructive knowledge of the existence of the mortgage.[33] It was also held that no defendant was liable unless his acts were both tortious and intentional; no cause of action lay for negligent waste.[34] These limitations are not well rationalized in the cases and seem to have come about largely by accident.[35]

The case law in New York concerning tort theory liability for waste was codified in section 1622 of the Field Civil Code, adopted in 1865, which read as follows: "No person whose interest is subject to the lien of a mortgage may do any act which will substantially impair the mortgagee's security."[36] The California Civil Code[37] contains identical language. Both of these statutes make clear that a mortgagee does have a tort action provided that the value of his security is substantially impaired. They do not make clear, however, whether actionable waste can be permissive as well voluntary, or whether third parties or non-assuming grantees can be held liable in tort for waste. Neither of these issues—particularly the liability of the non-assuming grantee has been fully resolved.[38]

2. *Contractual Theory*

A contract basis for the mortgagee's remedies for waste committed by the mortgagor appeared about the same time as the mortgagor's tort liability.[39] The liability of the mortgagor for waste on a contract theory depends initially on the inclusion of appropriate covenants in the mortgage; ultimately, it depends on the willingness of courts to enforce those covenants. So long as the mortgagee was customarily in possession of the mortgaged property, there was no need for such covenants because the mortgagee could himself see to it that repairs were made, taxes paid, and the like. When mortgagees were no longer usually in possession, they began imposing contractual obligations upon the mortgagor to protect the property, using the threat of foreclosure or an action for damages to enforce the covenants.

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33. Johnson v. Bratton, 112 Mich. 319, 70 N.W. 1021 (1897); Van Pelt v. McGraw, 4 N.Y. 110 (1850); Hoskin v. Woodward, 45 Pa. 42 (1863).

34. Gardner v. Heartt, 3 Denio 232 (N.Y. 1846).

35. *See, e.g.*, Yates v. Joyce, 11 Johns. 136 (N.Y. Sup. Ct. 1814). A judgment creditor was given a cause of action for waste against a third party who removed improvements from property encumbered by the judgment lien pending execution. The complaint in *Yates* specified the defendant's knowledge of the lien, his insolvency, and the fraudulent intent. When the damage remedy was extended in *Van Pelt* and later cases to a mortgagee who also held only a lien on the property, it came encrusted with these requirements.

36. N.Y. CIV. CODE § 1622 (1865).

37. CAL. CIV. CODE § 2929 (West Supp. 1976).

38. See text accompanying notes 161-93 *infra*.

39. *E.g.*, Bank of Chenango v. Cox, 26 N.J. Eq. 452 (1875); Bunker v. Locke, 15 Wis. 702 (1862).

The relationship between the tort and contract theories has not been entirely congenial. The use of covenants gradually became sufficiently common that it was sometimes argued that liability should exist only for breach of a covenant and not on a tort theory.[40] This argument was not accepted and the tort theory remains important, especially with respect to defendants who have no contractual liability, like third parties and non-assuming grantees. The tort-contract relationship is further complicated by the tendency of some courts to apply tort principles, notably the substantial impairment rule, in cases dealing with the enforceability of covenants.[41]

3. Substitute Collateral Theory

The California Supreme Court once declared that whether mortgaged property is damaged by the mortgagor or by a third person and whether the damage is caused negligently, intentionally, or without fault, the proper explanation of the mortgagee's right to recover damages is the same: equitable conversion.[42] The cause of action or the fund arising from the damages is treated as substitute collateral, which takes the place pro tanto of the damaged real property, and the lien of the mortgage is permitted to attach in equity to this substitute property.

The court's suggestion that the substitute collateral notion is the basis for all the mortgagee's remedies is too broad, at least when the defendant is the mortgagor. As a rule, the mortgagee takes the risk that the value of his collateral may decline during the term of the mortgage. To the extent that such decline could be caused by the acts or omissions of the mortgagor, the mortgagee can to some extent protect himself by contractual provisions in the mortgage. Even without such provisions, he may be able to recover for some types of conduct under a tort theory. Thus either a tort or contract theory can support a cause of action against the mortgagor. To call such a cause of action "substitute collateral," however, obscures the real basis of the mortgagee's remedy, by failing to make clear that the substitute collateral will not exist at all unless the mortgagor is liable under a tort or contract theory.[43]

40. COKE ON LITTLETON, *supra* note 23, at 536; 2 W. BLACKSTONE, COMMENTARIES *282. The Statutes of Marlborough and Gloucester ameliorated the problem this doctrine created, by allowing recovery against tenants for life and tenants for years, without regard to any covenants against waste that might have been contained in the conveyance. There is some authority indicating that recovery against such tenants was possible absent a covenant even before enactment of the statutes. *See* F. POLLOCK & F. MAITLAND, 2 HISTORY OF ENGLISH LAW 9 & n.2 (1911).

41. See text accompanying notes 85-92 *infra.*

42. American Sav. & Loan Ass'n v. Leeds, 68 Cal. 2d 611, 614 n.2, 440 P.2d 933, 936 n.2; 68 Cal. Rptr. 453, 456 n.2 (1968).

43. In Cornelison v. Kornbluth, 15 Cal. 3d 590, 604 n.9, 125 Cal. Rptr. 557, 567

Where the contract obligation or tortious conduct of a third party has created a fund to which the mortgagor can resort as compensation for the damage done to his land, the substitute collateral notion adequately explains the mortgagee's right to participate in that fund. Having said this, however, it is only a slight extension of the concept to allow the mortgagee to create the fund in the first instance by giving him a direct cause of action against the third party, at least to the extent of the impairment of his security.[44] Thus it appears that a substitute collateral theory is unnecessary in an action by the mortgagee against the mortgagor and may not be required in an action against a third party.

There are two instances, however, where the theory of substitute collateral is appropriate: insurance cases and condemnation cases. In some instances solutions for the problems of waste may be aided by reference to the rules applied in those cases. Curiously, the idea that insurance proceeds are a substitute for the property has not generally been accepted.[45] Instead, the overwhelming number of jurisdictions follow the rule that the insurance contract is simply a contract of indemnity taken out by the mortgagor or mortgagee solely for his personal benefit.[46] Although it is recognized that the mortgagee has an insurable interest in the property to the extent of the mortgage debt, the proceeds of any insurance policy obtained by the mortgagor belong solely to him.[47] Theoretically, the insured property could be destroyed, and the mortgagor could collect on a policy for the full value of the property (not limited to the value of his own equity). If the mortgagor dissipated the funds, the mortgagee would be left with no remedy except the residual value of the property. The problem, though, is only theoretical, because mortgage and deed of trust forms in common use invariably provide for a policy to be taken out that covers at least the full amount of the debt and that is payable to the mortgagee in the first instance.[48] The mortgagee's right to the pro-

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n.9 (1975), the court asserts that the *Leeds* discussion of the substitute collateral theory was intended only to establish the basis for recovery against third party tortfeasors. Unfortunately, the court gives no indication of what theory governs the mortgagee's remedies against the mortgagor if the substitute collateral theory is not applicable.

44. Even though it denied recovery in the mortgagee's action against the mortgagor, the court in *Leeds* emphasized that the mortgagee was entitled to sue the third party tortfeasor.

45. OSBORNE, *supra* note 18, § 137.

46. *See, e.g.*, Suttles v. Vickery, 179 Ga. 751, 177 S.E. 714 (1934); Scott v. Judd, 255 Ill. App. 558 (1929); Chipman v. Carroll, 53 Kan. 163, 35 P. 1109 (1894).

47. *E.g.*, Columbia Ins. Co. v. Lawrence, 35 U.S. (10 Pet.) 507 (1836); Plimpton v. Farmers Mut. Fire Ins. Co., 43 Vt. 497 (1871).

48. OSBORNE, *supra* note 18, §§ 138-39. A typical provision in use in California reads "[t]o provide and maintain fire and other insurance as required by beneficiary

ceeds, absent such contractual stipulation, depends on the arrangements he makes for himself; he cannot rely on a substitute collateral theory.[49] The insurance proceeds rules are particularly significant in considering the mortgagee's right to a "double recovery," such as a payment that reduces the debt combined with the right to compel the mortgagor to restore damaged property to its original value.

In contrast to the treatment of insurance proceeds, the treatment of condemnation proceeds has always been governed by the substitute collateral theory. A partial condemnation causes the mortgagee to lose his lien on the part of the property taken; he also acquires an equitable lien on the proceeds of the award. Although the mortgagee's damages for waste in a lien theory jurisdiction are limited to the extent of damage to his security, this limitation does not typically apply in partial condemnation cases.[50]

C. *Substantial Impairment*

As indicated above, a mortgagee, particularly in a lien theory jurisdiction, cannot easily protect himself from insubstantial waste; courts often require him to wait until his security is substantially impaired before permitting him to take action against the mortgagor. This requirement is particularly onerous because in many jurisdictions the threshold of damage that qualifies as "substantial impairment" is set rather high.

Most of the lien theory jurisdictions hold that substantial impairment has not occurred until waste has reduced the value of the encumbered property to less than the unpaid balance of the debt.[51]

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satisfactory to and with loss payable solely to Beneficiary . . ." (form used by Security Pacific Bank).

49. *But see* Babow v. Home Ins. Co., 34 Cal. App. 3d 304, 109 Cal. Rptr. 858 (1st Dist. 1973). In *Babow* the holder of a second trust deed obtained his own insurance policy after the trustor failed to obtain a policy pursuant to the terms of the deed of trust. After a fire, the holder of the first trust deed foreclosed. When plaintiff sued his insurance company, the court used a substitute collateral approach instead of following the usual insurance rules and barred recovery because appraisals showed that the value of the property after the fire greatly exceeded the combined total of the first and second trust deeds.

50. For a comparison of waste damages with condemnation damages, see text accompanying notes 64-70 *infra.*

51. Taylor v. McConnell, 53 Mich. 587, 19 N.W. 196 (1884); Jackson v. Turrell, 39 N.J.L. 335 (1877); Leiberman v. Knight, 153 Tenn. 268, 283 S.W. 450 (1925); Carroll v. Edmundsen, 41 S.W.2d 64 (Tex. Civ. App. 1931); Jones v. Costigan, 12 Wis. 757 (1860). It has been said that California follows the same rule, on the authority of Lavenson v. Standard Soap Co., 80 Cal. 245, 22 P. 184 (1889). The complaint in *Lavenson* alleged that at the foreclosure the property was sold for less than the amount of the debt. The court observed that this circumstance was sufficient to state a cause of action, but the opinion does not hold that such an extreme degree of impairment of the security was a necessary element of the cause of action. Of course, if exhaustion

Commentators have suggested that this majority rule is unsatisfactory to the mortgagee, arguing that it deprives him of the margin of safety for which he has bargained.[52] Closer examination indicates, however, that the majority rule does not always harm the mortgagee. A distinction should first be drawn between the mortgagee who sues for damages without foreclosing and the mortgagee who intends to recover his damages as part of an action to foreclose. In the former situation the mortgagee will continue to have a loan at risk after recovering the damages; here the measure of his recovery ought to give him at least as secure a loan as he initially made. The majority rule fails to achieve this degree of protection, since it does not allow the mortgagee a cause of action unless his loan is jeopardized. Even then, the mortgagee may recover only enough to remain barely secured; hence he is largely dependent on the personal credit of the mortgagor. By contrast, the mortgagee who forecloses need not be concerned with whether the damages are substantial or how substantiality is to be measured. If the damages have reduced the value of the property to less than the amount of the debt, the mortgagee may recover the difference as a deficiency judgment.[53] If the value of the damaged property exceeds the debt, the mortgagee will in any event recover the debt out of the sale of the property.

The mortgagee, however, is not always protected by the remedy of foreclosure. If the defendant is a third party tortfeasor, the mortgagee will typically have no basis for foreclosing.[54] If the defendant is a non-assuming grantee, the mortgagee can recover only in an action for waste since the defendant would not be liable for a deficiency judgment. In these instances the mortgagee's interests are jeopardized by a rule that ties "substantial impairment" to the foreclosure sale value of the property. Some lien theory jurisdictions have dealt with these problems by enacting statutes authorizing the mortgagee to recover damages in an action against a third party equal to the damage to the

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of the security is a prerequisite to bringing an action against the mortgagor, as the *Lavenson* court hints, it would follow that no cause of action for damages would lie unless the security had been impaired to the extent that upon foreclosure it sold for less than the indebtedness. This analysis of *Lavenson* does not reveal what degree of damages is necessary to state a cause of action against third parties, against whom an action can be brought before foreclosure. *See* U.S. Financial v. Sullivan, 37 Cal. App. 3d 5, 112 Cal. Rptr. 18 (4th Dist. 1974).

52. OSBORNE, *supra* note 18, § 128, at 212.

53. Anti-deficiency legislation, like California Civil Code section 580b, may prohibit such a judgment. See text accompanying notes 200-16 *infra*.

54. Arguably, the mortgagor might still be liable under a repair covenant. *See* American Sav. & Loan Ass'n v. Leeds, 68 Cal. 2d 611, 617, 440 P.2d 933, 938, 68 Cal. Rptr. 453, 458 (1968) (dissenting opinion).

property, rather than the amount of impairment of the security.[55] Other jurisdictions, although initially requiring that damages reduce the value of the property to less than the debt, nonetheless allow the mortgagee to recover damages measured by the difference between value of the property before and after the waste was committed.[56] These latter jurisdictions give lip service to the lien theory, but they avoid some of its practical problems by giving the mortgagee a full recovery, instead of a recovery sufficient only to make the debt equal to the diminished value of the property.[57]

If the mortgagee seeks to obtain an injunction against future waste in addition to damages for waste already committed, the courts in all jurisdictions require a showing of substantial impairment of the security.[58] Substantial impairment is established in this case if the value of the collateral is so diminished that it no longer affords the mortgagee a reasonable margin above the amount of the debt. This rule protects the lender's bargain, since he still has a loan at risk after he obtains the injunction and damages. A rule tying substantial impairment to foreclosure value would give him inadequate protection.

The definition of "reasonable margin" is unclear. It has been suggested in some older cases that the property should be worth at least one-third more than the amount of the loan.[59] This is equivalent to a loan equal to 75 percent of the value of the property, a surprisingly liberal standard considering that loans in those days were typically made at much lower ratios of loan to value than the 80-90 percent ratio that prevails today. Thus the "one-third more" rule appears to conflict with language suggesting that the margin of collateral should be that which a conservative, prudent lender would expect to receive.[60] It is also not clear how this rule could be applied to a junior mortgagee.

The injunction cases that developed the rule that the lender was entitled to a reasonable margin of security usually involved loans that did not amortize. Since the typical real property secured loan today

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55. Several such statutes are cited and discussed in Note, 53 HARV. L. REV. 503 (1940).

56. *E.g.*, U.S. Financial v. Sullivan, 37 Cal. App. 3d 5, 112 Cal. Rptr. 18 (4th Dist. 1974) (dictum); Atlantic Coast Line R.R. v. Rutledge, 122 Fla. 154, 165 So. 563 (1935); Heller v. Gerry, 47 App. Div. 2d 697, 339 N.Y.S. 2d 18 (1975).

57. For discussion of the slight difference between the full recovery under the lien theory discussed in the text and full recovery under the title theory, see OSBORNE, *supra* note 18, § 128, at 212 & n.67.

58. Title jurisdictions: *e.g.*, Coker v. Whitlock, 54 Ala. 180 (1875); Pettengill v. Evans, 5 N.H. 54 (1829). Lien jurisdictions: *e.g.*, Miller v. Waddingham, 91 Cal. 377, 27 P. 750 (1891); Moriarty v. Ashworth, 43 Minn. 1, 44 N.W. 531 (1890); Eienberg v. Javas, 100 N.J. Eq. 326, 134 A. 769 (Ct. Err. & App. 1926).

59. King v. Smith, 67 Eng. Rep. 99 (Ch. 1843).

60. *Id.*; Moriarty v. Ashworth, 43 Minn. 1, 44 N.W. 531 (1890).

amortizes in even installments over the life of the loan, the contemporary lender expects the comfort of an increased margin of safety in the later years of the loan when principal amortization will have reduced the loan-to-value ratio.[61] This gradual reduction in the unpaid principal balance has been cited as one of the factors that has persuaded lenders in the post World War II period to increase both the loan-to-value ratio and the term of the loan[62]—steps that increase the risk, especially in the early years of the loan. Given this background, it might be argued that when waste occurs in the later years of the loan, the nonforeclosing lender should receive those damages that will restore the low loan-to-value ratio that existed when the waste occurred, rather than the lesser amount needed to restore the much higher ratio dictated by the traditional formula.[63]

In evaluating this argument, it is helpful to consider the rules developed under analogous circumstances to determine the respective rights of mortgagor and mortgagee to share in a partial condemnation award. The majority rule gives the entire condemnation award (up to the amount of the debt) to the mortgagee.[64] The so-called "two-fund" theory justifies this result: the award is treated as additional collateral, so that the mortgagee may resort to the award or the mortgaged property in any order and to any extent, even if the property remaining after the condemnation is entirely adequate security for the debt.[65] This rule is inconsistent with the theory of waste in lien jurisdictions, which allows the mortgagee to recover only if his security was substantially impaired. Yet even some of the lien theory jurisdictions follow the two-fund notion in condemnation cases.[66]

The two-fund notion does no harm where foreclosure is imminent. It permits a mortgagee to proceed first against the property and then

61. A. AXELROD, C. BERGER & Q. JOHNSTONE, LAND TRANSFER & FINANCE 136-37 (1971).

62. *Id.* at 106-07. Undoubtedly, the inflationary trend in real estate prices also contributed to lenders' liberality.

63. It has been suggested that damages should restore the ratio of debt to value of property that prevailed at the time the loan was made. Note, 10 TEX. L. REV. 475, 482 (1932). Although this formula would be an improvement over the general rule in noninjunction cases, the example given by the author of the note shows that he contemplated a nonamortizing loan. This formula does not seem fair when the loan amortizes.

64. Teague, *Condemnation of Mortgaged Property*, 44 TEX. L. REV. 1535, 1540 (1966) [hereinafter cited as Teague].

65. City of Chicago v. Salinger, 384 Ill. 515, 52 N.E.2d 184 (1943); *In re* Dillman, 276 Mich. 252, 267 N.W. 623 (1936).

66. *See, e.g.*, Boutelle v. City of Minneapolis, 59 Minn. 493, 61 N.W. 554 (1894); Cyllene Corp. v. Eisen, 272 N.Y. 526, 4 N.E.2d 431 (1936); *In re* New York (East River Park), 184 App. Div. 509, 172 N.Y.S. 50 (1918).

recover any deficiency out of the condemnation award.[67] Such a procedure is consistent with the lien theory because the failure of the property to sell for the amount of the debt indicates that the partial condemnation did impair the security. A partial condemnation, however, will often occur at a time when foreclosure is not imminent. In such instances, the condemnation award should be viewed not as additional collateral but as substitute collateral.[68] Under a substitute collateral theory, a court should determine how much of the fund the mortgagee needs to have applied to the debt in order to put him in the same position after condemnation as that which he enjoyed before. The preferable solution is to give the mortgagee that portion of the award that will maintain the ratio of debt to value of the property that existed at the time of the taking.[69]

Such a rule seems equally desirable in waste cases. The waste rule that comes the closest to adopting the desired standard is the rule discussed above in injunction cases. Those cases apply enough of the award to the debt to restore the same debt-to-value ratio that existed at the time the loan was originally made. The injunction rule contemplates the continued existence of the mortgage; hence the need for a formula that maintains the margin of safety created by excess collateral, since the lender will remain exposed to risk of further deterioration of the property. The injunction rule could be improved, however, by also applying it to any action for damages for waste brought by a nonforeclosing mortgagee and by recognizing that the interests of the parties should be measured by the debt-to-value ratio at the time the waste occurs.

67. *In re* Dillman, 276 Mich. 252, 267 N.W. 623 (1936). The converse may not be true. *See, e.g.*, Rose v. Conlin, 52 Cal. App. 225, 231, 198 P. 653, 655-56 (1st Dist. 1921) (suggesting that the mortgagee can only reach condemnation proceeds after the foreclosure sale leaves a deficiency).

68. Los Angeles Trust & Sav. Bank v. Bortenstein, 47 Cal. App. 421, 190 P. 850 (2d Dist. 1920).

69. Teague, *supra* note 64, at 1547-48. This rule was followed in Trustees v. Harshman, 262 Ill. 72, 104 N.E. 235 (1914). *Cf.* Investors' Syndicate of America v. Dade County, 98 So. 2d 889 (Fla. Dist. Ct. App. 1957) (condemnation took approximately 10 percent of land; court allotted 10 percent of award to mortgagee, but no showing was made of ratio of mortgage debt to value of property either at time loan was made or at time of taking.) Teague, *supra* note 64, at 1543 n.53, opines that the *Harshman* case has been superseded in Illinois by City of Chicago v. Salinger, 384 Ill. 515, 52 N.E.2d 184 (1943). Although *Salinger* did follow the majority rule, under which the entire award is given to the mortgagee, whether the *Salinger* court meant to abandon the *Harshman* rule is not clear. *Salinger* neither cites nor discusses *Harshman*. Moreover, *Salinger* was a foreclosure case; thus under any theory the mortgagee was entitled to the entire award, at least to the extent that there was a deficiency at the foreclosure sale. *Harshman* was not a foreclosure case. It is when the mortgage continues in effect that it is most important to prorate the award; such proration protects the mortgagee's expectations, without creating financing difficulties for the mortgagor seeking to repair the damage caused by the partial taking.

The substantial impairment doctrine imposes a real barrier to recovery by the mortgagee. Although the doctrine does not always harm the mortgagee, he can be expected to attempt to finesse the rule by contractual provisions. The next part of this Article examines that attempt and the associated problems with the use of covenants.

II

PROBLEMS IN ENFORCING COVENANTS AGAINST WASTE

Since the substantial impairment rule limits the mortgagee's right to recover damages in tort in a lien theory jurisdiction,[70] the mortgagee typically seeks to protect his security interest through covenants in the mortgage. Through such covenants the mortgagee in a lien theory jurisdiction[71] attempts to gain the same protection that mortgagees in title theory jurisdictions enjoy as a matter of law.[72] At the same time, the covenants may also provide a basis for foreclosure when waste occurs.

Mortgage provisions aimed at expanding the mortgagee's protection fall into one of two categories. The first category comprises attempts to expand the concept of waste to include not only physical injury to the property, but also other acts or omissions of the mortgagor that might jeopardize the mortgagee's security. The other category consists of attempts to give the lien theory mortgagee remedies for physical damage under circumstances in which the tort theory would not permit a remedy; such circumstances commonly include instances where the damage is less than substantial or does not result from the mortgagor's deliberate act. As will be seen, courts have often rebuffed mortgagees' attempts of the latter kind.

A. Financial Covenants

From the mortgagee's point of view, there is little difference between an act that results in physical damage to the property and any other act of neglect that threatens the value of the collateral or the priority of the mortgage. The law of waste, however, often treats the latter differently. Two of the more common and significant instances of such threats are the mortgagor's failure to pay taxes and his failure

70. See text accompanying notes 29-38 *supra*.

71. Covenants against waste are also used in title theory jurisdictions, to define waste more precisely.

72. In title theory jurisdictions the mortgagee has a cause of action for any injury to the property, whether or not the extent of the injury substantially impairs his security. *See, e.g.*, First Nat'l Bank v. Sproull, 105 Ala. 275, 16 So. 879 (1894); W & R Inv. Co. v. Edwards Supply Co., 304 Mass. 650, 24 N.E.2d 518 (1939); Delano v. Smith, 206 Mass. 365, 92 N.E. 500 (1910); Sanders v. Reed, 12 N.H. 558 (1842) (waste by third party under license from mortgagor).

to service senior encumbrances—"financial waste." Failure to make such payments has an immediate harmful effect on the mortgagee's security, at least as harmful as the mortgagor's cutting timber or allowing improvements to deteriorate.

Despite the importance of financial waste to the mortgagee, it is difficult for the mortgagee in lien theory jurisdictions to recover a judgment for financial waste unless the mortgage contains covenants against such waste. The difficulty stems largely from the well settled rule that in the absence of appropriate covenants in the mortgage, the mortgagee does not have a cause of action to recover damages caused by permissive waste.[73] Since financial waste is usually permissive waste, the mortgagor's insolvency or lack of care, not his malice or cupidity, endangers the mortgagee's security in these situations.[74] In addition, even if the courts should extend the mortgagee's tort cause of action to include financial waste or if a particular mortgage does contain appropriate covenants, the substantial impairment rule would likely bar the mortgagee in lien theory jurisdictions from recovery for waste. The amount of money required to pay such items as taxes, premiums, and installments due on senior encumbrances is often only a small fraction

73. The leading case is Camden Trust Co. v. Handle, 132 N.J. Eq. 97, 26 A.2d 865 (Ct. Err. & App. 1942) (failure of defendant to pay taxes is not waste unless there is tax covenant in mortgage and defendant is mortgagor or assuming grantee). *See* Merchants' Union Trust Co. v. New Philadelphia Graphite Co., 10 Del. Ch. 18, 83 A. 520 (1912) (mortgagee could not enforce lease covenant against lessee from mortgagor's assignee, because there was no privity of contract between them; and lessee not liable for nonpayment of taxes absent enforceable covenant); Wiggin v. Lowell Five Cent Sav. Bank, 299 Mass. 518, 13 N.E.2d 433 (1938) (dicta re taxes); Union Mortgage Co. v. Nelson, 82 N.Y.S.2d 268 (Sup. Ct. 1948) (junior mortgagee cannot hold mortgagor liable for failure to pay taxes and service senior encumbrance). The case of Nielsen v. Heald, 151 Minn. 181, 186 N.W. 299 (1922), is sometimes cited for the proposition that a mortgagor's failure to pay taxes or other encumbrances that become senior after the execution of the mortgage is waste. But the court's statements to that effect must be understood in the context of the Minnesota statute that prohibits the mortgagee from appoining a receiver to collect the rents prior to both foreclosure and the expiration of the statutory redemption period, unless the mortgagor has committed waste. Such a rule induces a court to be more liberal in defining waste, to avoid the inequity of the mortgagor continuing to profit from the property even afer foreclosure, while the mortgagee's security is threatened with extinction. *See* Nusbaum v. Shapero, 249 Mich. 252, 228 N.W. 785 (1930). Dicta have appeared in other cases suggesting that the mortgagor has a duty to pay taxes even when no covenant imposes such a duty. But the statements are made in the context of allowing the mortgagee to add taxes paid by him to the debt secured by the mortgage. These cases do not contain any reasoning from which one could imply a cause of action for waste to recover unpaid taxes. *See, e.g.*, Donkin v. Killefer, 32 Cal. App. 2d 729, 732, 90 P.2d 810, 812 (4th Dist. 1939); Waterson v. Devoe, 18 Kan. 223, 233 (1877); South Amboy Trust Co. v. McMichael Holdings, Inc., 141 N.J. Eq. 12, 56 A.2d 437 (Ch. 1947).

74. This proposition may not always apply to the owner of commercial property, who sometimes deliberately fails to pay taxes when he has decided to attempt to sell the property or let it go to foreclosure because he regards his equity as not worth saving.

of the amount of the debt;[75] and in most instances the mortgagee has a sufficient margin of property value over debt so that his making such payments would not substantially impair the mortgagee's collateral.[76] The fortunate mortgagee in a title theory jurisdiction does not face either the permissive waste or substantial impairment problem;[77] the lien theory mortgagee merely seeks equal status by including appropriate covenants against financial waste in his mortgage.[78]

The lien theory mortgagee's effort to protect himself against financial waste by covenant has produced mixed results. The enforceability of such covenants is generally accepted[79] and their use is widespread. As a result, no practical difference exists between the mortgagee's rights in title and lien theory jurisdictions. Methods of enforcement, however, are limited in both title and lien theory jurisdictions. There is only scant authority that the mortgagee can recover damages from a mortgagor who does not pay taxes.[80] Even after paying delinquent taxes, the mortgagee cannot sue to recover the sums advanced.[81] The mortgagee's only reliable remedy for financial waste is to advance the funds needed to pay taxes, senior encumbrances, and other charges needed to protect the security of the collateral, and then to recover the

75. This observation will usually be true with respect to a first mortgage, but the security of a junior mortgagee might be impaired even by relatively small future advances.

76. See text accompanying notes 51-70 *supra* for discussion of how substantial impairment of the security may be measured.

77. *E.g.* Delano v. Smith, 206 Mass. 365, 92 N.E. 500 (1910) (recovery allowable for permissive waste); Byrom v. Chapin, 113 Mass. 308 (1873) (mortgagee entitled to recover for damage to property even if he still has adequate security).

78. A typical example is the form deed of trust prepared by Security Title Insurance Co., which provides in relevant part:

> To protect the security hereof, Trustor agrees. . . . To pay: at least ten days before delinquency all taxes and assessments affecting said property, including assessments on appurtenant water stock; when due, all encumbrances, charges and liens, with interest, on said property or any part thereof, which appear to be prior and superior hereto. . . . Should Trustor fail to make any payment or to do any act as herein provided, then Beneficiary or Trustee, but without obligation so to do and without notice to or demand upon Trustor and without releasing Trustor from any obligation hereof, may: make or do the same in such manner and to such extent as either may deem necessary to protect the security hereof. . . .

79. Security-First Nat'l Bank v. Lamb, 212 Cal. 64, 297 P. 550 (1931).

80. Wiggin v. Lowell Five Cent. Sav. Bank, 299 Mass. 518, 13 N.E.2d 433 (1938) (by implication); Camden Trust Co. v. Handle, 132 N.J. Eq. 97, 26 A.2d 865 (Ct. Err. & App. 1942) (dictum).

81. 1 GLENN, *supra* note 10, § 91.1, at 553. Although Glenn states that an independent action may not be brought either before or after foreclosure, only one case has been found prohibiting an action before foreclosure. Horrigan v. Wellmouth, 77 Mo. 542 (1883). For cases barring an independent action after foreclosure, see, *e.g.*, San Mateo County Bank v. Dupret, 124 Cal. App. 395, 12 P.2d 669 (1st Dist. 1932); Vincent v. Moore, 51 Mich. 618, 17 N.W. 81 (1883); Criswell v. McKnight, 120 Neb. 317, 232 N.W. 586 (1930); Stone v. Tilley, 100 Tex. 487, 101 S.W. 201 (1907).

advances either by suing on the entire debt or by foreclosing. Moreover, since the foreclosure remedy is available in all jurisdictions regardless of whether they follow the title theory or the lien theory[82] and regardless of whether the advances are made pursuant to a covenant in the mortgage,[83] the utility of the covenants is dubious.[84]

B. Repair Covenants

Analysis of the problems encountered in lien theory jurisdictions by mortgagees who seek a contractual remedy against physical waste that is permissive or that does not substantially impair their security must begin with classifying the types of contractual provisions in common use. Typically such provisions, hereinafter "repair covenants," include one or more of the following: (a) a covenant not to demolish any structure on the property; (b) a covenant to keep all structures on the property in good condition and repair or in the same condition as existed upon the execution of the mortgage; (c) a covenant to undertake specific acts of maintenance, such as irrigation, pruning, or periodic painting; (d) an express covenant not to commit or permit "waste" on the property. The following discussion first reviews some representative cases involving the various repair covenants and concludes by contrasting judicial treatment of repair covenants with the different rules applied to financial covenants.

The courts have been strongly inclined to hold a repair covenant unenforceable against a mortgagor who demolishes part or all of existing improvements in preparation for installation of new improvements. If the net value of the property after completion of the new improvements is equal to or greater than the value prior to demolition, the court will likely conclude that the mortgagee has suffered no damages and that equity will not permit strict enforcement of the covenant against demolition under such circumstances.[85] Typically, courts in such cases

82. See cases cited in note 79 *supra.*

83. *See, e.g.*, DeMoville v. Merchants & Farmers Bank, 237 Ala. 347, 186 So. 704 (1939); Federal Land Bank v. Treece, 199 Ark. 1168, 138 S.W.2d 90 (1940); Bie v. Hulet, 149 Fla. 227, 5 So. 2d 457 (1942). In some states there is a statutory basis for the mortgagor's right to make the payments and add them to the debt. *E.g.*, CAL. CIV. CODE § 2876 (West 1974).

84. *But see* Gilmour v. First Nat'l Bank, 21 Colo. App. 301, 121 P. 767 (1912), in which the court held that a probate claim could be brought on a tax covenant. *Cf.* First Nat'l Bank v. Standard Accident Ins. Co., 38 Ariz. 77, 297 P. 864 (1931).

85. Bart v. Streuli, 5 Cal. 2d 67, 52 P.2d 922 (1935); Planters' Mfg. Co. v. Greenwood Agency Co., 168 Miss. 892, 152 So. 476 (1934); Heller v. Gerry, 47 A.D.2d 697, 364 N.Y.S.2d 615 (1975). Although the improvements removed may be valneless, the conrt will enforce the repair covenant unless the mortgagor is replacing them with improvements of greater value. The mortgagor cannot allow the improvements to deteriorate and then claim he is free to demolish them as valueless. *See* Braswell v. Morris, 275 So. 2d 189 (La. App. 1973).

do not distinguish between a mortgagee who seeks damages and one who asserts the breach of the covenant as a basis for foreclosure.

The reasoning of these cases, though superficially attractive, is both shallow and unfair to the mortgagee insofar as it serves to bar the mortgagee from foreclosing his mortgage because he has apparently suffered no damages. The absence of damage to the property would indeed be fatal to a suit alleging waste and seeking to collect damages, but the mortgagee should have the right to accelerate the debt whenever any condition expressed in the note or the mortgage has failed. For it is reasonable to assume that the parties intended that the prohibition on demolition would give control over development of the property to the mortgagee. Under the terms of the covenant, the mortgagor must obtain the mortgagee's consent before he proceeds with development in order to avoid breach of the covenant and consequent acceleration of the debt. If the covenant is not enforced, the mortgagee faces a real risk that the construction that was supposed to follow the demolition will never be completed or that, even if completed, the building will be uneconomic and provide less security than the original structure.[86] The most efficient method of controlling these risks is to enforce the covenant. In that way, the mortgagee has an opportunity to protect himself by approving proposed plans and specifications, and by requiring a completion bond. It is inefficient for the courts to deny this contractual remedy to the mortgagee, thereby necessitating an after-the-fact determination of whether the mortgagee's security was impaired by the demolition and subsequent construction. If the court does find such impairment, the remedy of foreclosure is less satisfactory after the collateral has depreciated; the remedy of an action for damages is satisfactory only so long as the mortgagor is financially sound. Any legal theory that forces the mortgagee to rely primarily on the mortgagor's solvency fails to give effect to the chief purpose of the mortgage: to give the lender effective recourse against the collateral regardless of the personal strength of the borrower.

Another type of physical damage case occurs when the mortgagee has recourse to some fund as compensation for the damage. In cases of this type, the courts have sometimes forced the lender to look only

86. For an example of an improvement that decreased the value of the land, see Schumacher v. Gaines, 18 Cal. App. 3d 994, 96 Cal. Rptr. 223 (3d Dist. 1971). In landlord-tenant law the risk of such conduct is controlled by the doctrine of ameliorative waste, which makes the tenant liable for any improvements placed on the property without the permission of the landlord. *E.g.*, McDonald v. O'Hara, 117 Misc. 517, 192 N.Y.S. 545 (Sup. Ct. 1917); Agate v. Lowenbein, 57 N.Y. 604 (1874). This doctrine has not been extended to mortgage law, probably because it would be regarded as unwarranted interference with the mortgagor right to use his property. See text accompanying notes 100-02 *infra*.

to the fund. For example, if the damage has been substantial and the mortgagee will receive the insurance proceeds, courts have interpreted repair covenants as not imposing an obligation to rebuild.[87] Such an interpretation may do violence to the language of the typical repair covenant[88] and proceeds on the theory that the parties did not intend to give the mortgagee a double recovery in the form of a money payment plus re-establishment at the mortgagor's expense of the precatastrophe value of the property.

A particularly striking case of this kind is *Erickson v. Rocco*,[89] in which the court refused to allow the mortgagee to foreclose even though the property had been substantially damaged by fire some 8 months previously. Not only had the property not been rebuilt, but it also had suffered further deterioration from vandalism, despite sporadic attempts by the mortgagor to protect it. The court weakened the covenant to keep the property in good condition by construing it to require only normal maintenance and not rebuilding. The mortgagee emphasized that the mortgagor had also covenanted neither to commit nor to permit waste, but the court held over a sharp dissent that waste had not been "permitted" since the mortgagor had attempted, albeit unsuccessfully, both to protect the remains and to obtain new insurance coverage for them. The court emphasized that insurance naming the mortgagee was in force at the time of the fire, even though the insurer had refused to settle with the mortgagor and there was no indication of when such settlement would be reached or in what amount.

Some of the repair covenant cases suggest the principle of marshalling of assets: the mortgagee has a dual remedy and can be forced to use that remedy which does the least injury to the mortgagor.[90] The cases discussed above apply this principle by barring the mortgagee from foreclosing so long as there is a reasonable probability that he can recover from a fund. Conversely, the same principle has been applied to bar the mortgagee from reaching the fund, where the mortgagee is deemed adequately protected by a covenant obligating the mortgagor

87. Breed v. Glasgow, 92 F. 760 (C.C.W.D. Va. 1899), *aff'd sub. nom.* Withrow Lumber Co. v. Glasgow, 101 F. 863 (4th Cir. 1900); Woody v. Lytton Sav. & Loan Ass'n, 229 Cal. App. 2d 641, 40 Cal. Rptr. 560 (2d Dist. 1964) (by implication).

88. Typical repair covenants in California form deeds of trust purveyed by Title Insurance & Trust Co., Security Title Insurance Co., and Chicago Title Insurance Co. all require that the trustor not only keep the property in good repair but also restore any improvements that become damaged or destroyed.

89. 433 S.W.2d 746 (Tex. Civ. App. 1968).

90. *See* OSBORNE, *supra* note 18, § 291, discussing mortgagor's right to compel mortgagee to proceed first against nonexempt property in order to protect homestead, and to proceed first against part of mortgaged property sold to assuming grantee. But see notes 135-37, *infra* and accompanying text for discussion of cases suggesting that mortgagee must foreclose before reaching proceeds of partial condemnation.

to rebuild. The developing rule in the two-fund cases appears to be that the mortgagee can expand his remedies by contract; however, his right to choose among remedies will depend not on his own wishes but on the court's perception of the mortgagor's needs. The rule will be applied even if the mortgage expressly gives the mortgagee discretion either to retain the fund or to make it available to the mortgagor to pay for the cost of rebuilding.[91]

Another way in which the mortgagor can be shielded from the the effect of a repair covenant is to construe it as being inapplicable to damage that occurred prior to the mortgage, on the theory that the mortgagor undertakes to protect the mortgagee's security interest only against conditions developing after the mortgage. Conditions that preceded the mortgage, under this theory, are a risk to be borne by the lender even if he was unaware of the nature and extent of such risks at the time he took the mortgage.[92]

The above cases merely limit mortgagees' attempts to obtain by contract more protection against physical deterioration than is available

91. Milstein v. Security Pacific Nat'l Bank, 27 Cal. App. 3d 482, 103 Cal. Rptr. 16 (2d Dist. 1972). *Milstein* is a partial condemnation case. Whether the same principles apply when the fund consists of insurance proceeds is less certain. Of course, if the mortgage requires insurance to be obtained (usually in the form of a policy paid for by the mortgagor, with a loss payable clause in favor of the mortgagee) and does not specify how the proceeds of the policy are to be applied, the mortgagor may specify that the proceeds be applied to cost of repairs, next installment payments due, or such other manner of distribution that gives him the maximum benefit. Madjis v. Anderson, 260 Md. 30, 271 A.2d 350 (1970). In the usual case, the mortgage will give the mortgagee the option of applying the proceeds to reduce the debt or of making them available to the mortgagor to pay for repairs. The cases are in conflict whether the mortgagor can defeat this right and force application of the funds to cost of repairs by repairing at his own expense and then asserting that the mortgagee has suffed no damages and should not therefore be entitled to a windfall. The following indicate that the mortgagee may apply the proceeds to reduce the debt: Pink v. Smith, 281 Mich. 107, 274 N.W. 727 (1937); Board of Trustees v. Cream City Mut. Ins. Co., 255 Minn. 347, 96 N.W.2d 697 (1959); Saverese v. Ohio Farmers' Ins. Co., 260 N.Y. 45, 182 N.E. 665 (1932). Cases indicating denial of recovery to the mortgagee include: Citizens Ins. Co. v. Foxbilt, Inc., 226 F.2d 641 (8th Cir. 1955) (applying Iowa law); Babow v. Home Ins. Co., 34 Cal. App. 3d 304, 109 Cal. Rptr. 858 (1st Dist. 1973); Huey v. Ewell, 22 Tex. Civ. App. 638, 55 S.W. 606 (5th Dist. 1900). The rule of the *Savarese* case was changed by statute in 1965 to give the mortgagor the option to use the proceeds for rebuilding. N.Y. REAL PROP. LAW § 254 (McKinney 1965).

It has also been suggested that the mortgagor should not recover because in repairing the damage he acts as a volunteer. *See* Note, 81 U. PA. L. REV. 481 (1932); this argument seems dubious, and in any case it would be inapplicable to the mortgagor confronted with a repair covenant as in *Milstein*.

92. *See* American Sav. & Loan Ass'n v. Leeds, 68 Cal. 2d 611, 440 P.2d 943, 68 Cal. Rptr. 453 (1968) (holding that section 580b of the Code of Civil Procedure places on mortgagee the risk that the security was inadequate at the time the loan was made and that the risk cannot be shifted by a repair covenant); Nielsen v. Heald, 151 Minn. 181, 186 N.W. 299 (1922) (mortgagor's failure to pay senior encumbrances existing at time junior encumbrance was created is not waste).

under traditional lien theory notions. Two recent cases, however, apparently hold that repair covenants are inherently unenforceable if they purport to expand that protection. In *United States v. Angel*,[93] the federal government held a mortgage encumbering a large public housing project, on which more than 1,000 health, fire, building, and sanitation code violations had been reported. The mortgage contained specific covenants to comply with such laws, in addition to covenants to make all repairs and replacements necessary to preserve and maintain the value of the property. Relying on evidence that the estimated value of the property was about seven times the unpaid balance of the mortgage, the court ruled that the mortgagee could not foreclose since his security had not been substantially impaired. Although the possibility of an action for damages was not directly raised in the case, the thrust of the court's opinion apparently makes that remedy equally unavailable. No attempt will be made here to support the reasoning of the case; evidently the court's ire was raised by the plaintiff's "Orwellian" suggestion that the government as mortgagee of a property affected by a public interest should be subject to a different standard than a private mortgagee.[94] Whatever the merits of this suggestion,[95] it should not have prevented the court from considering whether the government was entitled to at least the same remedy that a private party would have enjoyed. Neither precedent nor policy supports disregarding the government's attempt to protect itself by covenant and instead limiting it to the remedy it would have had in the absence of any provision in the mortgage.

An equal unwillingness to enforce repair covenants appears in *Krone v. Goff*.[96] The mortgagee sought recovery for waste after the property had been substantially damaged by earthquake. Although the mortgagor was obviously not responsible for the damage on a tort theory, the mortgagee relied on a covenant requiring the mortgagor to repair or replace any damaged improvements on the property. In a muddled opinion the court apparently held, among other things, that liability for waste must be grounded on an intentional tort or negligence and that breach of a repair covenant can never create a cause of action for waste.

Angel and *Krone* are undoubtedly extreme cases, yet they do exemplify the typical attitude of courts regarding repair covenants. The tendency of courts in repair covenant cases is to construe the covenants narrowly and to hold them inapplicable to a large number of fac-

93. 362 F. Supp. 445 (E.D. Pa. 1973).

94. *Id.* at 447.

95. If anything, the trend of the law is in the other direction. For example, landlords of property benefitting from publicly assisted financing are far more restricted in the remedies available to them if the tenant defaults than are landlords generally.

96. 53 Cal. App. 3d 191, 127 Cal. Rptr. 390 (2d Dist. 1975).

tual circumstances. Courts thereby substantially defeat the attempt of the mortgagee to improve by contract the remedy that precedent or statute provides him in the absence of a stipulation in the mortgage.

C. *An Analysis of the Judicial Response to Covenants*

The above discussion indicates that covenants against financial waste are generally enforced, at least by foreclosure, though apparent breaches of repair covenants are often not punished. One possible reason for this difference in judicial attitude is that financial covenants operate against a favorable background of law, in the sense that even in the absence of a covenant, the mortgagee has a foreclosure remedy if the mortgagor fails to pay taxes and service senior liens. The purpose of financial covenants is not to create a remedy but rather also to define more precisely the manner in which that remedy may operate.[97] By contrast, the repair covenants, at least in lien theory jurisdictions, depart from the common law by creating a duty to repair where none existed.[98] This explanation has an attractive simplicity, but nothing in the decisions suggests that the courts are strictly construing the repair covenants simply because they are in derogation of the common law. Moreover, this explanation is refuted by the statements in early cases—which denied recovery for permissive waste on a tort theory—that the mortgagee could have recovered if the defendant had been liable on an appropriate covenant.[99]

97. *See* So. Amboy Trust Co. v. McMichael Holdings, Inc., 141 N.J. Eq. 12, 56 A.2d 437 (1947). For example, a tax covenant might make it clear that the mortgagee can recover for taxes paid before they become due or those paid while the mortgagor is protesting the tax assessment. *See* Annot., 74 A.L.R. 506 (1931).

98. For cases following the rule that the mortgagor may not recover for permissive waste consisting of failure to repair, in the absence of a covenant, see, *e.g.*, Campbell v. McComb, 4 Johns. Ch. 534 (N.Y. 1820); Onondago v. Syracuse Sav. Bank, 26 N.Y.S.2d 448 (Sup. Ct. 1940); Reid v. Bank of Tennessee, 1 Sneed 262 (Tenn. Sup. Ct. 1853); Breed v. Glasgow, 92 F. 760 (C.C.W.D. Va. 1899), *aff'd sub. nom.* Withrow Lumber Co. v. Glasgow, 101 F. 863 (4th Cir. 1900).

Glenn argues that the mortgagor is liable for permissive waste consisting of failure to repair, where the damage accrues slowly and not as the result of a sudden catastrophe. But the two cases he cites for this proposition do not support it. 2 GLENN, *supra* note 14, § 198, at 1009-10, *citing* Damiano v. Bergen City Land Co., 118 N.J. Eq. 535, 180 A. 489 (1935), and Cottle v. Wright, 140 Misc. 373, 251 N.Y.S. 699 (Sup. Ct. 1931). In *Damiano* the waste was permitted by a non-assuming grantee; the court held that the mortgagor was liable on a deficiency judgment. But since he had such liability in any event and no attempt was made to recover from the grantee, it cannot be said that this case approves liability for permissive waste. In *Cottle* the non-assuming grantee, who was also the defendant, was responsible for permitting the property to fall into disrepair. The court held him liable for waste, but emphasized that he had substantially impaired the value of the security by cutting timber; the damages awarded equaled the value of the timber. There is neither a holding nor even dicta that defendant might have been liable merely for the disrepair.

99. *See, e.g.*, Campbell v. McComb, 4 Johns. Ch. 534 (N.Y. 1820); Reid v. Bank of Tennessee, 1 Sneed 262 (Tenn. Sup. Ct. 1853).

A more adequate explanation for the differential enforcement of financial and repair covenants may be derived from considering the calculation the mortgagor must make in deciding whether to incur the expenses of repairs. It has long been recognized that the mortgagor has dominion over the mortgaged property and may deal with it as if he were the owner. Even in title theory jurisdictions, where the law of waste derives from landlord-tenant law, the mortgagor may use the property in such manner as is usual and proper "in the exercise of good husbandry."[100] This license includes the right to do some injury to the property, like cutting timber or severing fixtures. Thus the mortgagor has considerable discretion in deciding how to manage the property, including the right to decide, within reasonable limits, whether it is economically sound to incur the cost of repairs. Furthermore, his decision is not likely to have an immediate effect on the mortgagee's rights.

The decision whether to pay taxes or service senior encumbrances, on the other hand, is not similarly dependent on the mortgagor's discretion; rather, compliance with financial covenants is mandatory. The rule benefits both parties, since if the mortgagor fails to pay, both mortgagee and mortgagor will lose their interests.[101]

Since compliance with repair covenants, unlike financial covenants, rests heavily on the mortgagor's discretion, judicial enforcement of the repair covenant is inherently difficult. Courts are unavoidably called upon to assess not only the wisdom of the mortgagor's judgment in deciding whether to undertake repairs, but also the quality of any repairs made.[102] Reluctance to engage in this dual assessment has

100. *See, e.g.*, Searle v. Sawyer, 127 Mass. 491 (1879).

101. The distinction between tax cases and repair cases appears early. The mortgagee has been allowed recovery for taxes advanced upon the mortgagor's failure to pay where such expenses were absolutely necessary to preserve the mortgagee's estate, Mix v. Hotchkiss, 14 Conn. 31 (1840), and also where they benefited the mortgagor, Kortwright v. Cady, 23 Barb. 490, 497 (N.Y. Sup. Ct. 1857). Expenditures for repairs were rarely essential from the standpoint of the mortgagee. There was some concern that to allow the mortgagee to recover them would force the mortgagor not only to pay a larger debt than he had bargained for, but also perhaps to lose his equity as a result. Silver Lake Bank v. North, 4 Johns. Ch. 370 (N.Y. 1820). This distinction is consistent with the notion that the mortgagor ought to be left free, within very broad limits, to choose to let his property deteriorate if he is short of funds or has made the determination that it is uneconomic to invest further in upkeep of the property.

102. The necessity for this compound assessment may explain the willingness of the court in Erickson v. Rocco, 433 S.W.2d 746 (Tex. Civ. App. 1966), to treat the mortgagor as having complied with the covenant when he made a half-hearted and largely unsuccessful effort to protect the property from vandalism. *Cf.* Savarese v. Ohio Farmers' Ins. Co., 260 N.Y. 45, 182 N.E. 665 (1932), rejecting the idea that the mortgagor can repair damage and thereby deprive the mortgagee of his right to insurance proceeds: "Must the mortgagee litigate the extent and sufficiency of the repairs, or, if partially repaired, is his insurance to be reduced in proportion?" *Id.* at 55, 182 N.E. at 668.

resulted in both reliance on the principle that the mortgagee can recover only if his security has been substantially impaired and denial to the mortgagee of the greater protection that he sought through mortgage covenants.

Judicial reluctance to enforce repair covenants is understandable; it is not necessarily justifiable. Since damages incurred by a purported breach of a repair covenant are difficult to measure, the courts could require the mortgagee to establish his loss by foreclosing before they grant him recovery.[103] The courts could effect an even more significant change by permitting acceleration and foreclosure based on breach of repair covenants regardless of whether damages are available. If this policy seems too harsh, particularly in consumer cases, courts should face that issue squarely and refuse to enforce the repair covenant only when it would produce an unconscionable result.[104]

D. "Due-on" Clauses: An Indirect Means of Protection Against Insubstantial Waste?

Two decisions of the California Supreme Court dealing with the enforceability of "due-on" clauses[105] contain dicta that diverge from the principles followed in other lien theory jurisdictions (and heretofore in California as well) with respect to the mortgagee's remedies for waste, especially physical waste. In *La Sala v. American Savings & Loan Association*[106] the court held that a due-on encumbrance clause, which permitted a mortgagee to accelerate the note when the mortgagor placed a junior encumbrance on the property, was unenforceable as an "unreasonable" restraint on alienation. The court did, however, concede that if in a particular case a junior encumbrance jeopardized the security of the senior, acceleration would be permitted. Ordinarily, the priority of a senior encumbrance would not be threatened by the creation of a junior encumbrance,[107] but the court suggested several

103. See text accompanying notes 121-31 *infra*.

104. It is possible that the courts are disinclined to respect such bargains because mortgages are often furnished to the borrower on standard printed forms that he must essentially accept or reject without negotiation of terms. *Cf.* Tahoe Nat'l Bank v. Phillips, 4 Cal. 3d 11, 480 P.2d 320, 92 Cal. Rptr. 704 (1971).

105. A due-on clause gives the lender the right to accelerate the indebtedness when the property securing it is either subjected to a further encumbrance or is conveyed. Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629 n.1, 526 P.2d 1169 n.1, 116 Cal. Rptr. 633 n.1 (1974).

106. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

107. An exception to this rule is the effect of a junior encumbrance upon the priority of future advances by the senior encumbrancer. Optional advances by the senior become subordinate to any junior lienholder who gave actual notice to the senior before the advance was made, Dockrey v. Gray, 172 Cal. App. 2d 388, 341 P.2d 746 (3d Dist. 1959), unless the advances were used to improve the encumbered property,

situations in which it thought the junior encumbrance might increase the likelihood of waste that could jeopardize the senior.[108] These themes were further developed in *Tucker v. Lassen Savings & Loan Association*,[109] in which the court extended its *La Sala* reasoning to bar automatic enforcement of a due-on sale clause. A traditional justification for the due-on sale clause has been that if a lender relied in part on the financial strength and reputation of the borrower at the time the loan was made, he should not be compelled to continue extending credit to a subsequent purchaser who might not be equally reliable.[110] Although automatic enforcement was barred in *Tucker*, the court recognized that a sale could sometimes jeopardize the lender's security; the court, however, was unwilling to allow a lender to accelerate unless he could show that the sale posed a specific threat to the collateral, such as increased likelihood of waste. The emphasis in *La Sala* and *Tucker* on the importance of protecting the lender against waste reveals a curious inconsistency: both decisions would apparently encompass physical waste,[111] yet the courts have been reluctant to enforce covenants that are intended to deal directly with the risk of physical waste.

After *La Sala* and *Tucker* one would expect a lender desirous of protecting his collateral to be more aware of physical waste, since they allow him to use the possibility of waste resulting from a junior encumbrance or a transfer of title to justify accelerating a loan in order to reinvest at a higher rate of interest. Furthermore, the *Tucker* opinion indicates that the lender need not show any evidence of actual waste;

Turner v. Lytton Sav. & Loan Ass'n, 242 Cal. App. 2d 457, 51 Cal. Rptr. 552 (1st Dist. 1966).

108. The court noted that a sale of the property would transfer "possession, with the responsibility for maintenance and upkeep, to the vendee." 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859. The court then suggested that acceleration upon placing a junior mortgagee in possession would be proper because such conduct "would pose the same dangers of waste and depreciation as would an outright sale." 5 Cal. 3d at 881, 489 P.2d at 1124, 97 Cal. Rptr. at 860. This reasoning is unfortunately incomplete; the court does not indicate why transfer of the responsibility for maintenance to either a vendee or a mortgagee in possession would increase the risk of waste. The court also suggested that if a junior encumbrance left the owner with little or no equity in the property, acceleration would be proper. Although the reasoning is not spelled out, one might surmise that such an owner would no longer have an economic incentive to maintain the property in good condition, except to the extent that he was concerned about the possibility of a deficiency judgment after foreclosure.

109. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

110. *See, e.g.*, Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (2d Dist. 1969). Even before *Tucker* this justification had been criticized as unrealistic.

111. *La Sala* specifically refers to the danger of the property becoming rundown because the new owner neglects its maintenance. 5 Cal. 3d at 879-80, 489 P.2d at 1123, 97 Cal. Rptr. at 859. *Tucker* is in accord. 12 Cal. 3d at 638-39, 526 P.2d at 1175, 116 Cal. Rptr. at 639.

it is enough to show an increased possibility of waste.[112] Of course, these greater remedies against waste, particularly physical waste, are available to the mortgagee only when the property has been sold. When the mortgagee must deal with the original borrower, *La Sala* and *Tucker* are inapplicable, leaving him no adequate remedy against incipient waste except to seek an injunction, which is available only if a risk of substantial impairment of the security is shown. As shown above, attempts by the mortgagee to protect himself against permissive or insubstantial physical waste by including repair covenants that if breached would allow him to foreclose or sue for damages have not been very successful. Nonetheless, the notion in *La Sala* and *Tucker* that the mortgagee can protect himself by a due-on clause not only against slight actual impairment to the security but also against merely prospective impairment is a sharp departure from the general trend of the law.

The court's unusual treatment of waste in *La Sala* and *Tucker* may reflect a belief that the lender is entitled to some relief when a covenant against alienation or further encumbrance is breached, even though the court has decided that direct enforcement of such covenants in all situations infringes too severely upon the rights of the borrower. Put another way, although the court has imposed on the lender a burden of proving in each case that his decision to accelerate the debt is reasonable, the burden can be met by showing very little impairment. For example, where a lender bargains for the psychological security of knowing who owns his collateral and who has primary responsibility for paying the debt, *La Sala* and *Tucker* recognize that the lender should be permitted to accelerate upon showing that a conveyance or encumbrance even slightly threatens waste to his security. Otherwise, the lender who bargains for such a high degree of assurance against the risk of default on the loan or damage to the collateral has no remedy at all.[113] An injunction against waste is probably a less effective enforcement device—and in any case is available only in the event substantial

112. 12 Cal. 3d at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639.

113. *Cf.* Coast Bank v. Minderhout, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964). In *Coast Bank* the court held a due-on sale clause to be enforceable as a lien, though it was perhaps otherwise unenforceable as a restraint on alienation. See Hetland, *Real Property and Real Property Security: The Well-Being of the Law*, 53 CALIF. L. REV. 151, 168-69 (1965). In Tahoe Nat'l Bank v. Phillips, 4 Cal. 3d 11, 480 P.2d 320, 92 Cal. Rptr. 704 (1971), the court defended the result in *Coast Bank* as affording the only way in which the right bargained for by the lender could be enforced. A similar argument may be made in favor of enforcing a due-on sale clause as, instead, a "due upon increased likelihood of waste clause." This approach permits the lender to keep the property out of the hands of an unreliable borrower, but denies him the right to use the due-on clause for the purpose the *Tucker* court found illegitimate—increasing the rate of interest on the loan.

impairment of the security is threatened[114]—while an action for damages would be unavailing where no damages have yet occurred.

Future cases may show that the *La Sala-Tucker* exception for incipient waste could swallow up its rule forbidding automatic enforcement of due-on clauses. The court's reference to the lender being entitled to protection against the likelihood of waste and the "moral risks" of foreclosure[115] suggests that a lender's "feeling of insecurity" may be a legitimate ground for acceleration. Personal property security agreements often specify the lender's insecurity as one of the bases for declaring a default, but in real property transactions where the value of the collateral tends to be more stable, such provisions are not customary. If adopted as a ground for default in realty transactions, lender insecurity may subject a substantial number of loans to acceleration. For example, whenever the buyer of the mortgaged property is late in making his loan payments, the lender could claim to feel insecure and accelerate, even if the value of the property in relation to the amount of the outstanding loan balance provides an ample margin of safety.[116] Such feelings of insecurity might be heightened because many buyers, uncertain whether *Tucker* protects them from acceleration,[117] may believe it prudent to use unrecorded documents, require the seller to continue servicing the debt, and otherwise make it difficult for the lender to discover that the property has been conveyed.

Tucker has not yet spawned any reported decisions indicating how much weight should be given to the lender's fear of possible future waste, but a recent superior court decision illustrates the problems that may be encountered.[118] The seller of a motel took back a purchase money first

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114. King v. Smith, 2 Hare 239 (1843); Robinson v. Russell, 24 Cal. 467 (1864); Moriarty v. Ashworth, 43 Minn. 1, 44 N.W. 531 (1890); Van Wyck v. Alliger, 6 Barb. 507 (N.Y. Sup. Ct. 1849). *Contra,* Williams v. Chicago Exhibition Co., 188 Ill. 19, 58 N.E. 611 (1900).

115. Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 639, 526 P.2d 1169, 1175, 116 Cal. Rptr. 633, 639 (1974).

116. The lender's right to accelerate might be limited by the doctrine found in personal property secured transactions: that the grounds for insecurity must be commercially reasonable. *See* UNIFORM COMMERCIAL CODE § 1-208 (1962 version) and Comment thereto; G. GILMORE, 2 SECURITY INTERESTS IN PERSONAL PROPERTY § 43.4 (1965).

117. The *Tucker* rule may not bar acceleration after the installment payments to the seller have reduced his interest in the property to less than "significant." 12 Cal. 3d at 639 n.9, 526 P.2d at 1175 n.9, 116 Cal. Rptr. at 639 n.9. The court did not state how much equity (either in absolute or relative terms) the seller had to retain in order to have a "significant" interest; also, there is some uncertainty whether even full payment to the seller deprives him of a significant interest if he remains personally liable. *See* Praw & Duffy, *Enforceability of Due-On-Sale Clauses after Tucker,* BEV. HILLS B.A.J., Jan.-Feb. 1975, at 11, 19-20.

118. Mona Kai Associates v. Danna, Civil No. 362216 (San Diego County Super. Ct. Oct. 21, 1975).

deed of trust, reserving the right to accelerate the note upon sale of the property unless he approved the credit of a transferee. The property was subsequently resold several times and subjected to several junior encumbrances, without the original seller's knowledge. When the original seller discovered the last sale, he demanded and received credit information from the principals of the limited partnership that had most recently acquired the property. The original seller later testified that he remained uneasy because he had not received credit information on the limited partnership itself nor did he understand precisely who owned the property,[119] so he recorded a notice of default.

The limited partnership then brought a *Tucker*-theory action to enjoin the threatened acceleration and foreclosure. The superior court gave judgment for the defendant, on the ground that the exchanges of interests in the property between the limited partnership and its principals had confused the chain of title and raised legitimate fears that they might somehow impair the security. The court thus permitted the nervous state of mind of the original seller to outweigh the following uncontested facts: plaintiff had fully paid two junior encumbrances on the property, spent some $11,000 in remodeling the property, made all payments due to original seller, and furnished original seller with a financial statement (albeit unaudited, as the court was at pains to point out) showing a net worth of nearly $400,000 at a time when the balance owed to original seller was $125,000. Moreover, the original seller testified that he would have been willing to let the partnership assume the loan if it had agreed to an increased rate of interest on the note. The trial court's judgment under these circumstances illustrates precisely the use of a due-on clause that the supreme court condemned in *Tucker*.

On the whole, the trial court appears to have reached the wrong result. Possibly, the personal character of the transaction influenced the decision; the original seller was not an institutional lender but a retired individual, whose subjective concerns might be entitled to

119. The trustors had conveyed to D, taking back a purchase money second deed of trust. D conveyed to B, who subsequently encumbered the property with a third deed of trust. B then conveyed to B, Inc. B, Inc., conveyed to plaintiff. Plaintiff was controlled by Belanich who, as general partner, held a 1 percent interest; the limited partners were Belanich and his wife (62 percent) and Belanich's mother-in-law (37 percent). At this time defendant first became aware of the transfers of title and plaintiff's ownership of the property, although there was some question whether plaintiff's organization as a limited partnership had then been completed. Shortly thereafter, plaintiff conveyed an undivided 37 percent interest to Belanich's mother-in-law, who on the same day conveyed that interest to the Belanichs in exchange for other property. As a result, at the time defendant, the beneficiary under the first deed of trust, recorded a notice of default and election to accelerate, plaintiff owned an undivided 63 percent interest and the Belanichs owned the remaining undivided 37 percent interest.

greater weight. The decision indicates the difficulty that courts will face in applying the *La Sala-Tucker* dicta that acceleration is proper when there is a so-called moral risk of foreclosure.

The *La Sala-Tucker* view of waste, if interpreted liberally in future decisions, is inconsistent with the reluctance of the courts to enforce repair covenants. The importance of strict adherence to such covenants as a means of protecting the mortgagee's security against incipient waste should be apparent. Periodic maintenance of apartment house property and proper irrigation and cultivation of agricultural property, for example, tend to maintain the income produced by such properties at a higher level than if such maintenance were neglected. Loans on such properties are frequently based more on income potential than on the liquidation value of the property at foreclosure. If maintenance is neglected and rents and profits decline, the mortgagee should be able to protect himself immediately by enforcing the maintenance and repair covenants in the mortgage, without waiting until the lack of maintenance has become so pronounced that the security value of the property has been substantially impaired. Why this reasoning should not permit the same enforcement against the original mortgagor that *Tucker* allows against the mortgagor's transferee is not apparent. It was suggested earlier that the reluctance of courts strictly to enforce repair covenants might be occasioned by the difficulties of evaluating on a case-by-case basis the wisdom of the mortgagor's judgment in deciding whether and how maintenance and repairs should be made. The *Tucker* rule, however, mandates a case-by-case consideration of the reasonableness of the mortgagee's acceleration, and such consideration necessarily embraces some second-guessing of the mortgagor's decisions. Once the California courts have embarked on this course, any distinction between enforcement of repair covenants after property has been sold and their enforcement against the original mortgagor appears artificial and unsound.

Although the reluctance of courts to enforce repair covenants is superficially consistent with the trend toward debtor protection mentioned at the outset of this Article, the *La Sala-Tucker* approach to waste is more sound. "Debtor protection" should not be translated to mean that the debtor always wins. In the long run, such an attitude is harmful to debtors, because it leaves lenders so unprotected that they must respond by charging higher interest or by greatly restricting access to credit. The appropriate policy is to give the lender enough protection to permit him to collect his loan and, where the loan is uncollectible, to enforce his rights with respect to his collateral. The rights that the lender bargained for should be restricted only to the extent that their

exercise imposes an unconscionable burden on debtors. The repair covenant cases often ignore this policy. For example, the debtor is often not a borrower giving a mortgage on his home as a security, but is an investor or developer engaging in a commercial venture. There may be circumstances requiring protection of these more sophisticated and financially stronger borrowers, but nothing in the repair covenant cases so indicates. Moreover, the problems with enforcing repair covenants do not even arise in many title theory jurisdictions. Since the distinction between title theory and lien theory is formalistic and not grounded in any need to protect debtors, it is unwise for courts in lien theory jurisdictions to perpetuate this distinction. Debtors in lien theory jurisdictions are afforded protections that they probably do not need, and mortgagees in the same jurisdictions are deprived of the benefit of their bargain. *La Sala* and *Tucker* are unique in attempting to resolve the problem on the basis of the actual needs of the parties; it is hoped that this approach will be extended to permit enforceability of repair covenants against the original borrower as well as against his successor in interest.

III

Timing the Action for Damages

The case law includes no significant discussion of what policies should dictate the procedural steps required of a mortgagee who has a right to foreclose in response to waste. Depending on the jurisdiction, he may either (1) first foreclose and then, if the foreclosure sale results in a deficiency, pursue a claim for damages caused by waste, or (2) bring an action prior to foreclosure.[120] In the title jurisdictions it is assumed that the mortgagee may bring such an action at any time as an incident to his title and right of possession, or at least that he may bring the action any time after default.[121] The lien jurisdictions, on the other hand, have not developed a coherent theory of when the action may be brought. In addition, the substantive right to recover damages in lien theory jurisdictions is limited by the substantial impairment of security rule. However, cases that allow a pre-foreclosure action[122] do not premise its availability on a showing of substantial

120. Often the mortgagee will have at the same time both a claim for damages for waste and the possibility of foreclosing his mortgage. In such a situation the waste consists of an act or omission of the mortgagor that not only damages the value of the security, but also constitutes a breach of his covenants in the mortgage.

121. *See, e.g.*, Sloss-Sheffield Steel & Iron Co. v. Wilkes, 231 Ala. 511, 165 So. 764 (1936); Krikorian v. Grafton Coop. Bank, 312 Mass. 272, 44 N.E.2d 665 (1942); Federal Land Bank v. Jones, 211 N.C. 317 (1937).

122. The following cases hold or suggest that the action may be brought before

impairment. Most jurisdictions allow the mortgagee to bring an action on the debt before exhausting the security,[123] so a similar action to recover for waste before foreclosure might be justified by analogy. The pre-foreclosure waste action, however, is likely to give the mortgagee an inequitable double recovery. The rule regarding proper timing of the action in California is affected by statutory language that may require the mortgagee to foreclose before seeking recovery for waste.[124]

A. Foreclosure as a Condition to Recovery

1. Policy and Priorities

A sound policy governing the timing of the mortgagee's action for damages should be based on a consideration of the advantages and disadvantages to both parties of requiring foreclosure before recovery. Beginning with the mortgagee, he will not always prefer to recover damages prior to his foreclosing. The threat of foreclosure itself is probably his most effective weapon against potential waste. Imminent foreclosure may deter the commission of waste far more effectively than the threat of possible liability for damages. If the mortgagor has already committed waste, the mortgagee who forecloses first can sometimes buy the property at his own sale for no more than the balance owed, recoup his loan, and repair and resell the property at a profit. The mortgagee who sues first for damages, on the other hand, may recover only part of his loan in the action; unless he follows up with a foreclosure proceeding, the balance of the loan will remain outstanding to the presumably unreliable borrower who caused the waste.

The mortgagee may also prefer to foreclose first if his jurisdiction applies the substantial impairment rule. In such a jurisdiction the court in an independent damage action must determine not only the damage to the property but also whether the value of the property in its damaged state exceeds the amount of the debt. If the mortgagee forecloses first, however, he can rely on the marketplace to determine the damages by the amount bid at the foreclosure sale. The "foreclose first" rule therefore yields more efficient trials, since neither the parties nor the courts must make difficult determinations of value.[125]

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foreclosure. *See, e.g.*, Arnold v. Broad, 15 Colo. App. 389, 62 P. 577 (1900); Taylor v. McConnell, 53 Mich. 587, 19 N.W. 196 (1884) (*semble*); Garleiner v. Glicken, 23 Misc. 2d 170, 196 N.Y.S.2d 784 (Sup. Ct. 1960); Manhattan Co. v. Mosler Safe Co., 246 App. Div. 785, 284 N.Y.S. 145 (1935).

123. *See, e.g.*, Powell v. Williams, 14 Ala. 476 (1848); Barnes v. Upham, 93 Conn. 491, 107 A. 300 (1919); Stephens v. Sherrod, 6 Tex. 294 (1851).

124. See text accompanying notes 132-42 *infra*.

125. *Cf.* J. HETLAND, SECURED REAL ESTATE TRANSACTIONS § 2.11, at 53 (1974) [hereinafter cited as SECURED REAL ESTATE TRANSACTIONS], arguing that the judicially

On the other hand, the mortgagee will have less trouble with his bidding strategy if he does not foreclose first, because he himself must estimate the amount of his damages and deduct that amount from the amount of the debt when he makes his credit bid. If his estimate of the damages is too low, then his credit bid will exceed the amount realized upon reselling the property. He will not be able to make up the difference in a judgment against the mortgagor because the amount of his credit bid will be deducted from the total debt, thereby reducing the sum that he can recover in the damage action.[126]

By contrast, if the waste action precedes foreclosure, the risk of uncertain valuation falls on the mortgagor. For example, if the property appraisal in the waste action overestimates the amount of damage, the mortgagee who recovers a judgment for such inflated damages and thereafter forecloses knows precisely how high he should bid. He can later recover part of the debt by reselling the property—which by hypothesis is worth more than the amount of the bid—and recover the balance by collecting the inflated judgment.

From the viewpoint of the mortgagor, "foreclosure first" saves him the expense and harassment of having to defend a separate action for waste. In one jurisdiction the mortgagor is protected by the doctrine that an action on the debt bars a subsequent action to foreclose the

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created system of determining damage in land sale contract cases, which was designed to save the vendee from the rigors of strict foreclosure, is far less efficient than a foreclosure sale would be. The difficulty of appraising the damages is even greater in a waste action, because of the general rule that the security has not been impaired unless its value has been reduced below the amount of the debt. Thus Glenn argues that the mortgagee's claim against even a third party "is not ripe for damages until his remaining security proves insufficient upon foreclosure." 1 GLENN, *supra* note 10, § 34.2, at 228-29.

126. In Cornelison v. Kornbluth, 15 Cal. 3d 590, 608, 542 P.2d 981, 993, 125 Cal. Rptr. 557, 569 (1975), the court rejected the contention that it was difficult for a mortgagee who must foreclose first to make an estimate of damages recoverable for waste reliable enough to support an accurate credit bid. The court recommended that the mortgagee adopt the following strategy:

> [E]nter a credit bid in an amount equal to what he assesses the fair market value of the property to be in its condition at the time of the foreclosure sale. If that amount is below the full amount of the outstanding indebtedness and he is successful in acquiring the property at the foreclosure sale, he may then recover any provable damages for waste.

The court's recommendation disregarded the risk that a mortgagee making a low credit bid may overestimate the fair market value of the property, and thereby lose part of his damages for the reasons pointed out in the text. If the mortgagee seeks to avoid this risk by making a nominal bid, he runs the risk that a third party may buy the property for a slightly greater amount. The mortgagee would then be in the same position as an unsecured creditor, entirely dependent on the solvency of the mortgagor to recover the greater part of the debt. Moreover, as the *Cornelison* opinion itself holds, in California the mortgagee's claim for the difference between the amount of the debt and the small sum paid at the foreclosure sale may be barred by the anti-deficiency laws, even when the mortgagor has wasted the property. See text accompanying notes 213-16 *infra*.

mortgage.[127] A similar application of the principle of res judicata should be employed with respect to an action to recover damages for waste.

The mortgagor would also prefer a "foreclosure first" rule whenever he is personally liable for a deficiency. Foreclosure eliminates the need to determine whether the deficiency was created or aggravated by waste, since the foreclosure will automatically establish the amount of the mortgagee's damages. At the same time, it will give the mortgagor the benefit of a market test of the value of the property, to the extent the foreclosure process affords such a benefit.

The advantages to the mortgagor of requiring foreclosure first are less apparent when the mortgagor is not personally liable on the note. The liability of such a mortgagor cannot be determined solely by a low bid at the foreclosure sale, since the value of the property might have been depressed by general economic conditions in addition to waste. Consequently, the mortgagor who is not personally liable on the debt will have to face trial to determine his liability for waste. Nonetheless, the foreclosure bid will set the maximum amount of the damages[128] and will transfer to the mortgagee the risk resulting from the difficulty of making an accurate judicial determination of damages. The mortgagor, then, will generally prefer a rule requiring foreclosure as a condition to bringing of the action.

Whether the mortgagor will actually realize the potential benefits of a rule requiring foreclosure as a condition to recovering damages for waste depends on how well the foreclosure process emulates an open market. Unfortunately, the great majority of foreclosed properties are bid in by the foreclosing mortgagee for no more than the amount of the debt. Quite often his is the only bid made. The scarcity of buyers is not surprising, since the mode of disposition of real property at a foreclosure differs so greatly from the mode in which real estate is normally sold. In contrast to the typical consensual real estate sale, foreclosure properties carry no sales commission to attract brokers, are advertised

127. *In re* Wilson, 390 F. Supp. 1121 (D. Kan. 1975); Kearny v. Nunn, 156 Kan. 563, 134 P.2d 635 (1943). California achieves the same result by statutory interpretation. See note 138 *infra*.

128. In California and other jurisdictions having fair value statutes, the maximum damages may be less than the difference between the debt and the bid. CAL. CODE CIV. PRO. § 726 (West 1967). The actual damages might be less than the maximum damages because the defendant's liability for waste when he is not personally liable on the debt (*e.g.*, a non-assuming grantee) would be determined as of the date he committed or permitted the acts of waste; if this event occurred prior to foreclosure, the value of the property might have been further reduced by market conditions for which the mortgagor could not be held responsible. *See* Cottle v. Wright, 140 Misc. 373, 251 N.Y.S. 699 (Sup. Ct. 1931); *cf.* Cornelison v. Kornbluth, 15 Cal. 3d 590, 542 P.2d 981, 125 Cal. Rptr. 557 (1975).

only in the rudimentary fashion prescribed by statute,[129] generally have no financing available,[130] and are sold without warranty of title.[131] Obviously, this manner of sale is unlikely to produce bids as high as the amount that the property would bring if sold in the usual marketing process.

Despite the inadequacies of foreclosure sales, however, the above discussion indicates that the mortgagee should, in general, be required to foreclose prior to bringing an action for damages. Such a procedure is considerably more favorable to the mortgagor and does not, on balance, harm the mortgagee. The proposed rule would thus be consistent with the goal of increasing protection for debtors when that goal can be achieved without unduly impeding the rights of mortgagees to protect their collateral and recover damages for its waste.

2. *California Statutory Requirements*

In California, the rule requiring foreclosure first may be mandated by section 726 of the Code of Civil Procedure.[132] That statute provides that the enforcement of any right secured by a mortgage must be by an action to foreclose the mortgage.[133] So long as a mortgage remains in existence (for example, where it has not been extinguished by foreclosure of a senior encumbrance), section 726 bars an action on the debt prior to foreclosure[134] and arguably bars any personal recovery for waste as well.

The California courts have never squarely determined the applicability of section 726 to an action against the mortgagor for waste. The issue was first discussed in *Lavenson v. Standard Soap Co.*,[135] which con-

129. In California an advertisement (no minimum size or type specified) must be published three times during a period at least 20 days before the sale, in a "newspaper of general circulation." CAL. GOV'T CODE § 6000 (West 1966). Frequently, the newspaper selected will be a legal journal not likely to attract the attention of the general public, although complying with the statutory definition of "general circulation."

130. In California all title company forms of trust deeds specify that the sale shall be for cash. The applicable statute also contemplates a sale of "cash or the equivalent of cash." CAL. CIV. CODE § 2924(h) (West Supp. 1975). Since the beneficiary's own bid is usually a credit bid up to the amount of the debt, he may elect to extend credit to particular bidders. But such unusual arrangements (which incidentally are considered as cash equivalents) are not available to the general public. *See* Nomellini Constr. Co. v. Modesto Sav. & Loan Ass'n, 275 Cal. App. 2d 114, 79 Cal. Rptr. 717 (3d Dist. 1969).

131. *See* Brown v. Busch, 152 Cal. App. 2d 200, 313 P.2d 19 (3d Dist. 1957).

132. CAL. CODE CIV. PRO. § 726 (West Supp. 1976).

133. A deed of trust or a mortgage with power of sale can be foreclosed by private sale pursuant to the power, in which case section 726 is inapplicable. For discussion of the limitations on recovery of damages for waste after such private sale, see text accompanying notes 194-99 *infra*.

134. Barbieri v. Ramelli, 84 Cal. 154, 23 P. 1086 (1890). *See also* Schwerin v. Shostak, 213 Cal. App. 2d 37, 28 Cal. Rptr. 332 (1st Dist. 1963).

135. 80 Cal. 245, 22 P. 184 (1889).

tains some vague dicta suggesting that foreclosure might be a prerequisite to the action. Nearly 80 years later, the California Supreme Court indicated that the issue was still unresolved. The court recognized the possibility that "the one-form-of-action provision of section 726, Code of Civil Procedure or an analogous common law rule [may] preclude enforcing either of these provisions [*i.e.*, the repair covenants] except as incident to a foreclosure . . . ."[136] The only other case law bearing on the subject consists of two appellate decisions that suggest, again in dicta, that in partial condemnation cases the mortgagee may not reach the condemnation proceeds (notwithstanding that such proceeds constitute substitute collateral) unless he first forecloses and establishes that the sale of the remaining property did not satisfy the debt.[137] The above cases furnish virtually no guidelines for determining whether section 726 was intended to bar an action for waste prior to foreclosure or whether such an action, if allowed by the mortgagor, would result in the "sanction effect" of section 726 and the consequent loss to the mortgagee of his security.[138]

136. American Sav. & Loan Ass'n v. Leeds, 68 Cal. 2d 611, 614, 440 P.2d 933, 935, 68 Cal. Rptr. 453, 455 (1968); *see* Krone v. Goff, 53 Cal. App. 3d 191, 193 n.2, 127 Cal. Rptr. 390, 392 n.2 (2d Dist. 1975) (interpreting *Leeds* as stating that section 726 bars an action against the mortgagor before foreclosure).

137. Rose v. Conlin, 52 Cal. App. 225, 231, 198 P. 653, 655 (1st Dist. 1921); Reed Orchid Co. v. Superior Court, 19 Cal. App. 648, 665, 128 P. 9, 18 (3d Dist. 1912). *Cf.* Woody v. Lytton Sav. & Loan Ass'n, 229 Cal. App. 2d 641, 40 Cal. Rptr. 560 (2d Dist. 1964) (holding that because fire insurance policy procured by mortgagor and payable to mortgagee is not substitute collateral, but a contract of indemnity for sole benefit of mortgagee up to amount of debt, mortgagee may collect insurance proceeds and apply them against the debt without first having to foreclose).

138. If a mortgagee obtains a judgment by suing on the debt without having first foreclosed on the security, the judgment is valid but the sanction effect will bar the mortgagee from enforcing his mortgage in a subsequent proceeding, whether judicial or nonjudicial. Walker v. Community Bank, 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974); Ould v. Stoddard, 54 Cal. 613 (1880). Similarly, the mortgagee who obtains a judicial foreclosure in an action in which he neglects to include all his collateral loses the right thereafter to resort to the unincluded security by reason of the sanction effect. Stockton Sav. & Loan Soc'y v. Harrold, 127 Cal. 612, 60 P. 165 (1900). *See* J. HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS § 6.7 (1970) [hereinafter cited as HETLAND]; D. AUGUSTINE & S. ZARROW, 5 CALIFORNIA REAL ESTATE LAW & PRACTICE § 120.42 (1974). Hetland cites Weaver v. Bay, 216 Cal. App. 2d 559, 31 Cal. Rptr. 211 (1st Dist. 1963), as standing for the proposition that section 726 of the Code of Civil Procedure does not require judicial foreclosure before bringing an action against the mortgagor for waste. This issue is nowhere discussed in *Weaver*; in fact, before appealing that part of the judgment denying her claim of waste, the plaintiff had foreclosed *nonjudicially* on the property pursuant to the trial court's declaratory judgment. Some slight support for the Hetland position may be garnered from the court's suggestion that plaintiff's appeal on the waste issue should have been rejected, even had the evidence established waste, because she had already taken advantage of the decree below to hold the nonjudicial sale. By negative implication, this observation may indicate that if the evidence for waste had been established, plaintiff might have recovered in an action brought before any foreclosure. As for Augustine and Zarrow,

The policies that should govern the application of section 726 to the mortgagee's action to recover damages against the mortgagor for waste are discussed somewhat obliquely in *U.S. Financial v. Sullivan.*[139] The defendants in that case were third party tortfeasors who contended that section 726 prevented the beneficiary of a trust deed from suing them except in conjunction with foreclosure of the trust deed. In concluding that section 726 does not protect such third parties, the court was apparently aware that the most important purpose of section 726 is to serve as a procedural aid to the anti-deficiency laws by forcing the mortgagee to treat the collateral as the principal obligor. The mortgagee can proceed against the mortgagor personally, if at all, only after that principal asset has been exhausted. In addition, section 726 forces the mortgagee to assert all his remedies in a single action, thereby protecting the mortgagor from the burden of defending first an action on the debt, and later an action to foreclose the mortgage.

These purposes of section 726, as set forth in *U.S. Financial*, are applicable to an action against the mortgagor for waste, if the action is viewed as analogous to an action on the note secured by the mortgage. It has long been established in California that if the value of the mortgaged premises declines, the mortgagee cannot simply sue on the debt, claiming that he is economically, if not legally, unsecured. He must hold a foreclosure sale to test the value of the property before obtaining a personal recovery.[140] This rule is appropriate regardless of whether the decline in value stems from market forces or from the mortgagor's conduct. The rule is consistent with the policies previously discussed, which favor requiring foreclosure prior to or concurrently with the recovery of damages for waste, even without a statutory basis for such a course of action.

An action for waste may not always be perfectly analogous to an action on the debt. For example, if the mortgagor commits waste by exploiting minerals, the mortgagee who brings an action for damages is not seeking primarily to hold the mortgagor personally liable on the debt. He wishes to prevent the mortgagor from profiting by the destruction of the security value of the property. One authority has therefore suggested that an action to recover damages for waste is not an action to enforce a right secured by the mortgage, which would be subject to section 726.[141] Moreover, it might be argued that the action

they simply note that section 2929 of the Civil Code creates liability for waste whether or not the security is being foreclosed. This remark is made, however, with regard to availability of injunctive relief and does not weaken the contention that section 726 requires an action for damages to be brought after or concurrently with foreclosure.

139. 37 Cal. App. 3d 5, 112 Cal. Rptr. 18 (4th Dist. 1974).

140. *See* Barbieri v. Ramelli, 84 Cal. 154, 23 P. 1086 (1890).

141. HETLAND, *supra* note 138, § 6.7.

for waste is an enforcement of the mortgage security itself, like an action to recover rents and profits. Nevertheless, the similarities between the action on the debt and the action for waste outweigh the differences.

The argument for applying section 726 to an action seeking damages for waste has been buttressed by a recent decision of the California Supreme Court, holding that the mortgagee's right to recover for waste is limited by the anti-deficiency laws.[142] Although the case did not involve section 726, the court did indicate that there is no difference in principle or economic substance between personal recovery against a mortgagor for waste and personal recovery based simply on the mortgagor's liability on the note.[143]

In California, therefore, it appears likely that section 726 prohibits the mortgagee from recovering damages for waste unless he previously or simultaneously foreclosed. Such a rule would be desirable in other lien theory jurisdictions in which there is no similar statutory authority. It is at least arguable that the rule gives greater protection to the mortgagor. In addition, it would make the procedural rule governing when the action may be brought consistent with the substantive rule that allows recovery of damages only when waste has so greatly reduced the value of the property that upon foreclosure it would not produce enough to pay the debt.

B. Special Circumstances Justifying Pre-Foreclosure Recovery

If, as a general rule, the mortgagee must foreclose before obtaining a recovery for waste, that rule should not be applied when it is not necessary to protect the mortgagor or when it would create undue hardship for the mortgagee. The courts, recognizing these exceptions, have refused to apply the rule in two situations.

First, the mortgagee clearly ought to be able to recover damages without having to foreclose when third parties commit waste without the mortgagor's participation. When waste is committed solely by third parties, the mortgagee usually cannot foreclose the mortgage. This result especially follows if the only recovery would be in tort, since the mortgagor could not be liable if he neither intentionally nor negligently participated in causing the waste.[144] Thus, since the commission of the

142. Cornelison v. Kornbluth, 15 Cal. 3d 590, 542 P.2d 981, 125 Cal. Rptr. 557 (1975).

143. *Id.* at 603, 542 P.2d at 990, 125 Cal. Rptr. at 566.

144. The mortgagor may be liable under a contract theory of waste if, for example, the mortgage contained a repair covenant and the mortgagor failed to repair the third parties' waste. At least one court, however, has refused to hold the mortgagor liable under such circumstances, and its decision is in accord with the strict interpretation of

waste of itself would not justify foreclosure against the mortgagor, no reason exists to require the mortgagee to foreclose before suing the third parties for damages. To impose such a requirement might deprive the mortgagee of any remedy at all.[145]

The matter becomes more complicated if the mortgagor has joined the third parties in the commission of the waste. In such circumstances, a conflict presents itself between the proposed mortgagor-defendant rule, which would require foreclosure first, and the third party-defendant rule, which would allow immediate suit for damages. The conflict can be resolved, however, by following both rules at the same time: allowing the mortgagee to sue the third parties for waste while foreclosing upon the mortgagor.[146] This solution saves the mortgagee the burden of proving waste against the mortgagor, since the equivalent of the waste damages will be obtained automatically in the form of a deficiency judgment.[147]

A second possible exception to the proposed "foreclose first" rule is that of the mortgagee seeking to enjoin waste. He has traditionally been entitled to obtain damages in the same proceeding for whatever waste has already occurred, provided that the waste has substantially impaired the security.[148] This practice is designed to protect both parties from the unnecessary delay and expense that would result if the plaintiff had to bring a second action to obtain those remedies traditionally awarded only in an action at law. Also, the practice achieves one of the purposes of a "foreclose first" rule: to resolve the entire controversy—realization of the security and imposition of personal liability —in a single proceeding. Consequently, allowing the mortgagee to recover damages as part of the injunction action might be an appropriate exception to a rule requiring a mortgagee to foreclose first. The

repair covenants followed by most courts. Garleiner v. Glicken, 23 Misc. 2d 170, 196 N.Y.S.2d 784 (Sup. Ct. 1960).

145. *See* OSBORNE, *supra* note 18, § 129; 1 GLENN, *supra* note 10, § 34 (1943). The best discussion of the reasons in favor of allowing an action by the mortgagee against the third party without regard to whether foreclosure has occurred are found in U.S. Financial v. Sullivan, 37 Cal. App. 3d 5, 112 Cal. Rptr. 18 (4th Dist. 1974). Osborne cites Taylor v. McConnell, 53 Mich. 587, 19 N.W. 196 (1884), as standing for the contrary rule. OSBORNE, *supra* note 18, § 128, at 213 n.74. Although *Taylor* did not allow the mortgagee to recover against a third party after a defective foreclosure, the opinion makes clear that recovery was barred only because the complaint failed to allege substantial impairment of security. The mortgagee instead relied on the defective sale to establish that the waste reduced the property's value to less than the debt.

146. Federal Land Bank v. Jones, 211 N.C. 317, 190 S.E. 479 (1937); *see* 1 GLENN, *supra* note 10, § 34.1 (1943).

147. For discussion whether section 580b of the Code of Civil Procedure precludes recovery for waste against a purchase money mortgagor in California, see text accompanying notes 201-36 *infra*.

148. *See* 2 GLENN, *supra* note 14, § 198, at 1011-12 (1943).

foreclose first rule, however, also gives the mortgagor the benefit of a market determination of the damages, to the extent that a market actually operates at foreclosure sales. Since reliance on the market furthers equity's historic goal of enabling the mortgagor to realize upon his equity of redemption, some reason at least remains for not awarding damages in the injunction proceeding. If foreclosure is imminent when the injunction is sought, there is even greater reason for not awarding damages. Such an award will not save the mortgagor from defending the additional foreclosure proceeding, but at the same time will deprive him of the benefits of a market. Consequently, a court of equity should exercise its discretion either to defer awarding damages incident to an injunction if a foreclosure proceeding is pending or to vacate any award of damages if a foreclosure proceeding is thereafter commenced based upon defaults existing at the time of the injunction action.

A more serious conflict between injunctive proceedings and the proposed general rule requiring foreclosure as a condition to an award of damages arises under California law. If, as argued above,[149] section 726 of the Code of Civil Procedure requires the mortgagee always to exhaust his security before obtaining any personal recovery against the mortgagor, then a mortgagor defending the injunction action is entitled to block the award of damages by pleading section 726 as an affirmative defense. Moreover, the mortgagor could refrain from pleading section 726 until after the injunction and award of damages had become final, and then argue that the sanction effect of section 726 had destroyed the security of the mortgage.[150]

C. *Limitations on Independent Action to Recover Damages After Foreclosure*

The policy and statutory bases[151] for requiring a mortgagee to foreclose before recovering damages for waste should not prevent recovery in an independent action brought after foreclosure is complete. The principle object of a foreclosure first rule—to give the mortgagor an opportunity to realize on his equity at the foreclosure

149. See text accompanying notes 132-42 *supra.*

150. *See* Salter v. Ulrich, 22 Cal. 2d 263, 138 P.2d 7 (1943); Ould v. Stoddard, 54 Cal. 613 (1880). *See generally* Leipziger, *Deficiency Judgments in California: The Supreme Court Tries Again,* 22 U.C.L.A.L. REV. 753, 787-93 (1975) [hereinafter cited as Leipziger]. No reported case granting an injunction and damages has discussed this problem. Professor Hetland, however, presents a persuasive analogous argument: a mortgagee who obtains the appointment of a receiver in an action for specific performance of a rents and profits clause and allows the action to go to judgment before holding a trustee's sale should be barred by the sanction effect of section 726 from foreclosing his deed of trust. HETLAND, *supra* note 138, § 6.8.

151. *E.g.,* CAL. CODE CIV. PRO. § 726 (West 1975).

sale—is achieved whether the damages for waste are determined by the amount of the bid or in a subsequent lawsuit. Nevertheless, when waste consists of failure to pay taxes, the courts have generally refused to permit the mortgagee to recover in a separate action brought after foreclosure.[152]

Various judicial explanations for the rule denying recovery of taxes in an independent action after foreclosure are hardly satisfying. It is frequently said that since all advances by the mortgagee (that is, the original loan plus the amount of taxes paid) become part of a single debt secured by the mortgage, a separate action cannot be brought to recover only a part of that debt.[153] Sometimes this assertion rests on the argument that the mortgagee's right to recover taxes paid is only an incident of the mortgage, so that the right ceases to exist after the mortgage has been extinguished by foreclosure.[154] Other cases deny recovery because the mortgagee has improperly split the cause of action by bringing a separate lawsuit after foreclosure.[155] All of these explanations are verbal formulas that mystify more than they explain.

Curiously, courts and other authorities who argue in favor of the single debt theory in the tax cases inconsistently support the view that the mortgagee should recover in a physical damage case, whether or not he has first foreclosed.[156] The tax cases carry out a desirable policy, mandated by statute in several states,[157] of not harassing a mortgagor with two actions when the entire matter could be resolved in one.[158] The argument in favor of such a rule is even stronger in physi-

152. *E.g.*, Stafford v. Russell, 117 Cal. App. 2d 326, 255 P.2d 814 (2d Dist. 1953); Hillsborough Inv. Co. v. City of Tampa, 149 Fla. 7, 13, 5 So. 2d 256, 258 (1941); Homeowners' Loan Corp. v. Joseph, 306 Ill. App. 244, 252, 28 N.E.2d 330, 334 (2d Dist. 1940); Businesswomen's Holding Co. v. Farmers' & Merchants Bank, 194 Minn. 171, 177, 259 N.W. 812, 814-15 (1935); Stoue v. Tilley, 100 Tex. 487, 489, 101 S.W. 201, 203 (1907). The mortgagee who brings an action to recover taxes before foreclosure also cannot recover. Horrigan v. Wellmuth, 77 Mo. 542, 545 (1883) (dictum).

153. Vincent v. Moore, 51 Mich. 618, 619, 17 N.W. 81 (1883).

154. *E.g.*, Horrigan v. Wellmuth, 77 Mo. 542, 545 (1883).

155. *E.g.*, Day v. Brenton, 102 Iowa 482, 491, 71 N.W. 538, 541 (1897).

156. OSBORNE, *supra* note 18, § 128, at 213. The author asserts that forcing the mortgagee to postpone foreclosure until he recovers for waste is unnecessary and unfair. Yet he commends the policy of the tax cases that require that all debts growing out of the mortgage relation be settled in a single action. *Id.* § 173, at 300. *Compare* Taylor v. McConnell, 53 Mich. 587, 19 N.W. 196 (1884), *with* Vincent v. Moore, 51 Mich. 618, 17 N.W. 81 (1883).

157. *E.g.*, CAL. CODE CIV. PRO. § 726 (West Supp. 1976).

158. An exception must be made when recovery of waste damages is sought after a nonjudicial foreclosure. Although properly speaking the foreclosure in such instances is not an "action," the mortgagor who believes he has a defense to the foreclosure is obliged first to resist the foreclosure and thereafter, if he loses, to make whatever defense he has to the charge of waste in a separate proceeding. This unfortunate result might be prevented by statute in California. See text accompanying notes 194-99 *infra*.

cal damage cases, since the independent action to recover for physical waste, when brought before foreclosure, not only tends to deprive the mortgagor of the benefits of a market test of the extent of the damages, but also increases the risk that the mortgagee may receive a windfall recovery.[159]

The rule of the tax cases that generally requires the mortgagee to pay delinquent taxes and then recover as part of the foreclosure is fair provided, of course, that foreclosure is an available remedy. The courts have correctly refused to follow the general rule if its reason no longer applied. Thus a separate action to recover the taxes is allowed if, for instance, foreclosure is unavailable because the statute of limitations has run on the mortgage.[160]

IV

LIMITATIONS ON LIABILITY FOR DAMAGES

A. Liability of the Subsequent Grantee and Third Parties

Courts have failed to develop coherent theories of liability concerning whether the mortgagor's grantee who does not assume the mortgage can be held personally liable for waste damages. Some decisions have held that such a grantee is not liable for waste, apparently on the assumption that the only basis for waste liability is contractual.[161] Most courts have recognized that even if the mortgage does not contain a covenant prohibiting the conduct complained of—typically either excessive cutting of timber[162] or removal of improvements[163]—liability may properly be imposed on a tort theory. Whether a subsequent grantee or a third party may be liable in tort for permissive waste remains unsettled, however.

The distinction between voluntary and permissive waste originated in English landlord-tenant law. Although some early authority indicates that tenants were liable for permissive waste despite the absence of appropriate contractual provisions in the lease,[164] this theory was gradually abandoned with respect to leases[165] and never became rooted

159. See text accompanying 125-26 *supra.*

160. Federal Land Bank v. Brooks, 139 Fla. 506, 190 So. 737 (1939); Catlin v. Mills, 140 Wash. 1, 247 P. 1013 (1926).

161. Hughes v. Edwards, 22 U.S. (9 Wheat.) 489, 500 (1824); Camden Trust Co. v. Handle, 132 N.J. Eq. 97, 26 A.2d 865 (1942).

162. *See, e.g.,* Easton v. Ash, 18 Cal. 2d 530, 116 P.2d 433 (1941); Van Pelt v. McGraw, 4 N.Y. 110 (1850); Cottle v. Wright, 140 Misc. 373, 251 N.Y.S. 699 (Sup. Ct. 1931); Fairbank v. Cudworth, 33 Wis. 358 (1873).

163. *See, e.g.,* Buckout v. Swift, 27 Cal. 433 (1860); Yates v. Joyce, 11 Johns. 136 (N.Y. Sup. Ct. 1814).

164. *See* note 40 *supra.*

165. *Compare* Yellowly v. Glover, 11 Ex. 274, 293, 156 E.R. 833, 843 (1855), *with In re* Cartwright, 41 Ch. D. 532 (1889).

in mortgage law.[166] The mortgagee's only remedy for permissive waste not barred by a covenant was to retake possession of the property, which he could do at any time subject to the onerous rules of accounting applicable to a mortgagee in possession.

Since the only widely accepted basis of liability for permissive waste was in contract, the subsequent grantee was not liable for permissive waste unless the mortgage contained covenants defining and prohibiting it, and unless the grantee assumed the mortgage and thereby became liable on the covenants.

The predominant view, reflected in the preceding discussion, is that a subsequent grantee's liability for waste rests on the same basis as does that of the mortgagor: He is liable on a tort theory to the extent that his conduct resembles the deliberate acts out of which the tort theory of waste grew, but he is not liable for permissive waste consisting of oversight and neglect. The original mortgagor, of course, is contractually liable on all the covenants in the mortgage because he was a party to it. His grantee becomes similarly liable if, but only if, he assumes the mortgage.[167]

Third parties whose negligent acts damaged the property and thereby impaired the mortgagee's security have been held not liable for waste under a doctrine originating in New York.[168] This point of view was apparently followed by the trial court in *U.S. Financial v. Sullivan*,[169] which sustained defendants' demurrers to a complaint alleging that they negligently planned and supervised the development of a housing subdivision. The court of appeals reversed, relying on the statutory mandate that every person must exercise due care to avoid injuring the personal property of another.[170] This principle had previously been applied to hold negligent developers, designers, and contractors liable to purchasers of the injured property.[171] The court in *U.S. Financial* cast the mortgagee-plaintiff in the same role that the purchaser-plaintiff had assumed in the prior cases. The court asserted

166. There is slight authority in title theory jurisdictions that the mortgagor might be liable for permissive waste. *See* Wiggin v. Lowell Five Cent Sav. Bank, 299 Mass. 518, 13 N.E.2d 433 (1938) (dicta re failure to pay taxes).

167. For example, failure of the mortgagor or his successor to maintain improvements in good repair or to pay taxes has been treated as not actionable where no covenant in the mortgage required such conduct or where a successor had not assumed the mortgage. *See, e.g.*, Camden Trust Co. v. Handle, 132 N.J. Eq. 97, 26 A.2d 856 (1942); Campbell v. McComb, 4 Johns Ch. 534 (Ct. of Chancery N.Y. 1820); Reid v. Bank of Tenn., 1 Sneed 262 (Tenn. Sup. Ct. 1853).

168. Gardner v. Heartt, 3 Denio 232 (N.Y. Ct. App. 1846); *see* Denton, *supra* note 3, at 161, 165-66.

169. 37 Cal. App. 3d 5, 112 Cal. Rptr. 18 (4th Dist. 1974).

170. CAL. CIV. CODE § 1714 (West 1970).

171. 37 Cal. App. 3d at 13, 112 Cal. Rptr. at 24.

that this characterization was justified by the foreseeability of substantial damage to the security, the lack of any additional burden on parties who were already under a duty of due care with respect to purchasers of the property, and the availability of insurance to cushion the burden of liability.[172] Such factors, of course, might not be present in every case in which a third party negligently impairs a mortgagee's security. If they are not, the third party may not be found liable. This result, however, should occur only because of the peculiar equities of the case and not, as under the New York rule, because of an unrationalized exemption for third parties allegedly guilty of negligence.

All the respondents in *U.S. Financial* were third party tortfeasors who did not own an interest in the property.[173] It is unclear whether the reasoning in that case is equally applicable when the defendant is a non-assuming grantee. Courts are unwilling to hold a mortgagor liable for negligence if he does not keep the property in good repair, absent a contractual obligation to repair.[174] At the same time, however, courts have usually construed repair covenants strictly against the mortgagee. The tendency suggests that *U.S. Financial* will not be extended to impose liability for negligence on either the mortgagor or his successor in interest.

The mortgagee in California might seek to overcome the judicial hostility toward negligence liability of the mortgagor and his successors by relying on Civil Code section 2929.[175] That statute prohibits any person whose interest is subject to a mortgage from doing "any act" that would substantially impair the security of the mortgage. The phrase "any act" is certainly broad enough to include negligent conduct. Section 2929, however, is derived from New York case law that imposes waste liability on the mortgagor and his successors only for intentional torts.[176] Also, it is uncertain whether section 2929 prohibits passive as well as active negligence. Some of the most common and economically significant types of waste are acts of omission, such as failure to repair or pay taxes. It is not clear that either section 2929 or the negligence liability rule of *U.S. Financial* imposes liability on both the mortgagor and his successors for even active negligence.

The California Supreme Court recently addressed, but did not resolve, the question of a non-assuming grantee's liability for waste. In *Cornelison v. Kornbluth*,[177] the court held that the liability of a non-

172. 37 Cal. App. 3d at 12-15, 112 Cal. Rptr. at 22-24.

173. One defendant was a former owner of the property but had sold it before it was mortgaged, so that this defendant's interest had never been subject to the mortgage.

174. See cases cited at note 98 *supra*.

175. CAL. CIV. CODE § 2929 (West 1974).

176. Gardner v. Heartt, 3 Denio 232 (N.Y. Ct. App. 1846).

177. 15 Cal. 3d 590, 125 Cal. Rptr. 557 (1975).

assuming grantee should not be determined by rules applicable to a third party tortfeasor, so long as the original mortgagor was protected against a deficiency judgment by Code of Civil Procedure section 580b. The court pointed out that a grantee assuming a purchase money loan has long been entitled to the same section 580b protection against a deficiency judgment as the original mortgagor.[178] In order to avoid placing the non-assuming grantee in a worse position than that of the assuming grantee, the court extended section 580b's protection to the non-assuming grantee. The *Cornelison* opinion, however, does not solve the immediate problem: it holds that a non-assuming grantee, like the original mortgagor, is liable for waste arising from his intentional or reckless conduct, but it does not indicate whether he may be liable on a negligence theory.[179] The implication of *Cornelison*, though, is that the non-assuming grantee could not be held liable for negligent waste if the original mortgagor could not be liable on a negligence theory.

On balance, considerable doubt remains whether either the mortgagor or his successors may be held liable on a tort theory for permissive waste that impairs the mortgagee's security. The mortgagee may be able to recover for negligent waste from the mortgagor or a grantee who assumes the mortgage, because the negligent acts or omissions might also be specifically prohibited by covenants in the mortgage.[180] The mortgagee cannot hold the non-assuming grantee liable, however, on a contract theory, and there is little authority for holding him liable on a negligence theory.

This conclusion, incidentally, lends further support to the doctrine of *Tucker v. Lassen Savings & Loan Association*.[181] If the non-assuming grantee cannot be held liable for his neglect of the property, the mortgagee should be given the right to enforce his due-on sale clause and foreclose the mortgage because he fears the possibility of waste.

The preceding discussion suggests that a non-assuming grantee, unlike the assuming grantee, may never be liable for waste on a contract theory. Two rather exotic theories have occasionally been employed to establish such contractual liability. First, some jurisdictions espouse the doctrine that a non-assuming grantee who agrees both

178. *E.g.*, Stockton Sav. Bank v. Massanet, 180 Cal. 2d 200, 114 P.2d 592 (1941). For the text of section 580b see note 201 *infra*.

179. In considering the circumstances under which section 580b should bar recovery for waste damages, this Article concludes that for some kinds of negligent conduct such recovery should be allowed as not inconsistent with the purpose of section 580b. See text accompanying notes 218-29 *infra*.

180. But see text accompanying notes 83-96 *supra*, for a discussion of judicial unwillingness to enforce some of those covenants.

181. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

to take title subject to the mortgage and to pay the agreed purchase price should be treated as having become personally liable to pay the debt.[182] The theory is that the grantee has received the value of the entire property from his grantor, yet has paid only the amount of his down payment. There is therefore an implied obligation on the grantee's part to pay the balance of the consideration by discharging the mortgage.[183] The theory itself may have some merit, but in practice too many of the cases make an unsound distinction between two types of transactions. The first is a purchase agreement in which the vendee agrees to pay a stipulated price for the equity (that is, the down payment) and take title subject to the mortgage; the second is an agreement in which the stipulated price is the entire value of the property without deduction for the encumbrance, with the vendee again agreeing to take title subject to the mortgage. Although some cases treat the second type of agreement as an assumption, the burden should be on the vendor to show the assumption agreement by more convincing evidence.[184] Nevertheless, where this doctrine of implied assumption of the mortgage is honored, the non-assuming grantee could be held liable under all the waste covenants in the mortgage.[185]

A second manner in which waste covenants might be imposed on a non-assuming grantee is to hold that the covenants run with the land. At first glance, this seems obviously true. The typical waste covenants to make repairs or to pay real estate taxes are covenants that in landlord-tenant law clearly run with the land. These are covenants that "touch and concern" the land, since they can only be performed on the encumbered land or are of value only to someone having an interest in the encumbered land. The problem in mortgage law is to find the necessary privity of estate to permit the burden of the covenant

182. *See* cases cited in OSBORNE, *supra* note 18, § 258, at 514 n.10.

183. Heid v. Vreeland, 30 N.J. Eq. 591 (1879). The case speaks of the balance of the purchase price (*i.e.*, the amount of the mortgage indebtedness) as being the vendor's money, implying that it is almost fraudulent for the vendee to receive title to and use of the property without paying the full purchase price stated in the agreement.

184. Parole evidence is admissible both to establish that a deed absolute on its face actually constitutes a mortgage and to establish the amount of the debt secured by such a mortgage. Anglo-California Bank v. Cerf, 147 Cal. 384, 81 P. 1077 (1905). It is only a slight extension of this doctrine to admit parole evidence to establish that the grantee agreed to assume and pay the amount of the debt. *See* White v. Schader, 185 Cal. 606, 198 P. 19 (1921). Such parole evidence is sufficient, however, only if it is "clear and convincing." *See* Beeler v. American Trust Co., 24 Cal. 2d 1, 147 P.2d 583 (1944). The slight variations in the wording of the agreement that are the basis of the doctrine discussed in the text do not meet this standard.

185. *See* White v. Schader, 185 Cal. 606, 198 P. 19 (1921), holding that the grantee who impliedly assumed the debt is also liable for payment of attorneys' fees pursuant to covenant in the mortgage. See text accompanying notes 230-36 *infra*, for discussion of recovery of attorneys' fees as waste.

to run against the non-assuming grantee. In a title theory jurisdiction, privity exists because both mortgagee and mortgagor share the estate and the mortgagor's right to use the property derives from the notion that he is a tenant of the mortgagee.[186]

Despite the attraction of the analogy between landlord-tenant covenants and mortgagee-mortgagor covenants, only one title theory jurisdiction, Maryland, has regularly held that the waste covenants in a mortgage run with the land, thereby imposing personal liability on a non-assuming grantee.[187] This theory gives the mortgagee protection against the non-assuming grantee's breach of financial covenants, his failure to maintain the property in good condition, and other forms of permissive waste for which recovery is not available on a tort theory.

In a lien theory jurisdiction the attempt to enforce waste covenants against a non-assuming grantee fails because neither privity of contract (as a result of the grantee's failure to assume the contract contained in the mortgage) nor privity of estate is present. There can be no privity of estate because the mortgagee in a lien theory jurisdiction has no estate. The mortgagor is the absolute owner; the mortgagee has only a lienholder's right to reach the property, force it to be sold, and have the proceeds applied against his debt.[188]

The situation in lien theory states is well illustrated by *Merchants' Union Trust Co. v. New Philadelphia Graphite Co.*[189] The mortgagee in that case sought to recover damages for waste from a lessee of the mortgagor, based on the lessee's failure to pay certain royalties due pursuant to the lease. The court pointed out that the lease had been made after the execution of the mortgage and was, as a matter of law, subject to it. Therefore the mortgagee upon foreclosure could have terminated the lease; its enforcement, however, was a different matter. The mortgagee in a lien theory state acquires an estate in the property only upon foreclosure and purchase of the property.[190] Since the mortgagee's foreclosure and entry occurred after the mortgagor had executed the lease, no privity of estate existed between mortgagee and lessee when the lease was created. Consequently, the mortgagee could not enforce the lease as a covenant running with the land.

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186. W. WALSH, MORTGAGES, § 22, at 111 (1934).

187. Union Trust Co. v. Rosenburg, 189 A. 421 (Md. Ct. App. 1937); Waring v. National Sav. & Trust Co., 138 Md. 367, 114 A. 57 (Ct. App. 1921).

188. Gavit, *Under Lien Theory is Mortgage Only a Power of Sale?* 15 MINN. L. REV. 147 (1931).

189. 10 Del. Ch. 18, 27, 83 A. 520, 527-28 (1912) (applying Pennsylvania law).

190. *Id.* at 27, 83 A. at 527. Entry before foreclosure in a lien theory jurisdiction will suffice to perfect the mortgagee's claim to rents and profits but still does not give him title. 1 GLENN, *supra* note 10, § 33.3 (1943).

Recognizing the difficulties created by the lack of privity of estate in a lien theory jurisdiction, the mortgagee in *Merchants' Union Trust* suggested as an alternate theory the possibility that the covenant might run in equity under the rule of *Tulk v. Moxhay*.[191] This rule allows the covenant to be enforced as an equitable servitude even if covenantor and covenantee were not in privity. The court rejected the suggestion because it was inapplicable to the covenant in question, which was not a restriction on how the property was to be used; however, the rule that affirmative covenants, like the royalty payments provision in *Merchants Union Trust*, cannot be treated as equitable servitudes has since been abandoned.[192] Consequently, it would be possible today to extend *Tulk v. Moxhay* to impose liability for waste upon a non-assuming grantee, provided, of course, that the grantee takes with at least constructive knowledge of the terms of the mortgage.[193] Since violation of an equitable servitude against waste would produce a calculable monetary loss, the servitude could be enforced by treating it as a lien for the amount of damage and by allowing the mortgagee to foreclose. As equitable servitudes, however, the waste covenants would not expose the non-assuming grantee to personal liability for damages. If the courts should adopt the proposed doctrine, the mortgagee would get a right to foreclose. Such judicial action would be unnecessary if the courts recognize the validity of the waste covenants that are breached. At least in lien theory jurisdictions, one must conclude that the mortgagee can obtain damages from the grantee only when the grantee assumes (either expressly or by implication) or when the waste is caused by the grantee's intentional tort.

B. Damages for Waste and the California Anti-Deficiency Statutes

1. Section 580d

In California, section 580d of the Code of Civil Procedure bars any personal liability on a note secured by a mortgage or deed of trust after a nonjudicial foreclosure.[194] This statute places the efficient non-

191. 2 Ph. 774, 41 E.R. 1143 (Ch. 1848).

192. *See* Hunt v. DelCollo, 317 A.2d 549 (Del. Ch. 1974); R. POWELL, 5 REAL PROPERTY ¶ 671, at 146-47 & n.11 (1974).

193. One case required that the mortgagee show that the defendant acted with actual malice, in the sense that he knowingly intended to destroy the mortgagee's security. Gardner v. Heartt, 3 Denio 232 (N.Y. 1846). Later cases made clear that the defendant's actual knowledge was sufficient. Wilson v. Maltbie, 59 N.Y. 126 (1874); Van Pelt v. McGraw, 4 N.Y. 110 (1850). Finally, it was held that constructive knowledge derived from the recording statutes was sufficient. Turrell v. Jackson, 39 N.J.L. 329 (1877). If mortgage covenants were to be enforced as equitable servitudes, the non-assuming grantee would be required to have constructive knowledge of them to comply with the doctrine of *Tulk v. Moxhay*.

194. CAL. CODE CIV. PRO. § 580d (West 1970).

judicial remedy on a parity with the more expensive and time-consuming remedy of judicial foreclosure. Section 580d protects the debtor by forcing the mortgagee who wants a deficiency judgment to foreclose judicially and to honor the mortgagor's right to retain possession of the property and redeem it within 1 year after the foreclosure.[195] If permitting the mortgagee to recover damages would frustrate this statutory scheme, section 580d should be read to bar an action for waste after foreclosure.

Although some opinions imply that section 580d does not bar a post-foreclosure action,[196] the California Supreme Court in *Cornelison v. Kornbluth*[197] held that it does. The application, however, is limited. The court declared that the recovery of damages for waste is akin to a partial deficiency judgment. This analogy is appropriate since California follows the general rule in lien theory states that recoverable damages have not been sustained unless the waste has reduced the value of the property to less than the amount of the debt—precisely the situation in which a deficiency would be created.[198] The court, however, did not reach the logical conclusion that no recovery should be allowed in an action for waste brought after a nonjudicial foreclosure. Under the rule promulgated by the court, waste damages caused by general economic decline are recoverable on a nonpurchase money debt only after a judicial foreclosure. Damages caused by the trustor's "bad faith" (that is, malicious or reckless conduct), though, are recoverable after either a judicial or nonjudicial foreclosure. The resolution of the section 580d issue in *Cornelison* tends to defeat the policy of the statute. For example, the mortgagee will have no incentive to use judicial foreclosure in cases involving bad faith waste. The mortgagee would likewise have no reason to resort to judicial foreclosure if the waste is permissive—caused by the mortgagor's negligence or bad judgment. Moreover, if the court's references to general economic decline are taken literally, section 580d also would not bar recovery in an independent action for waste after a particular building's value (but not that of real estate generally) decreases. In short, only when an economic depression alone causes waste would the mortgagee

195. Roseleaf Corp. v. Chierighino, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

196. In Willys of Marin County v. Pierce, 140 Cal. App. 2d 826, 296 P.2d 25 (1st Dist. 1956), the court held that section 580d did not bar personal liability upon a lease after the deed of trust securing the lease had been foreclosed at a trustee's sale, because the statute explicitly referred to deficiency on a "note." *See* Loretz v. Cal-Coast Dev. Corp., 249 Cal. App. 2d 176, 57 Cal. Rptr. 188 (1st Dist. 1967) (dictum that "note" as used in section 580d and "obligation" as used in section 726 may not be synonymous).

197. 15 Cal. 3d 590, 125 Cal. Rptr. 557 (1975).

198. For further discussion of the analogy between recovery of waste damages and recovery of a deficiency judgment, see text accompanying notes 141-42 *supra*.

be forced to resort to judicial foreclosure to recover his deficiency judgment. The court reached this peculiar result by mechanically applying to a section 580d problem the policies it created to deal with the very different problem arising under section 580b.[199]

2. *Section 580b*

After many years of controversy, it is now settled in California that the mortgagee's usual right to recover damages for waste is subject to the limitations of the anti-deficiency laws. This Article has already indicated that sections 726 and 580d of the Code of Civil Procedure impose certain procedural limitations on the timing of recovery for waste.[200] The mortgagee's recovery may be barred entirely, however, by Code of Civil Procedure section 580b, which generally prohibits any deficiency judgment on a purchase money obligation.[201] The mortgagor might well claim that an award of damages for waste is an indirect means of collecting part of the purchase price, and that the policy of section 580b dictates that the mortgagee use nonmonetary remedies.[202] In *Cornelison v. Kornbluth*[203] the California Supreme Court accepted this argument in principle. But that decision is flawed because, like earlier cases, it is not grounded upon any general theory of waste, nor does it adequately analyze the relationship between waste and section 580b.

a. *Analysis of the Cases*

The case law that preceded *Cornelison* contained inconsistent and

199. *See* 15 Cal. 3d at 604-05, 125 Cal. Rptr. at 567.

200. See text accompanying notes 132-44 and 194-99 *supra.*

201. The statute reads as follows:

> No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale, or under a deed of trust, or mortgage, given *to the vendor* to secure payment of the balance of the purchase price of real property, *or under a deed of trust, or mortgage, on a dwelling for not more than four families given to a lendor to secure repayment of a loan which was in fact used to pay all or part of the purchase price of such dwelling occupied, entirely or in part, by the purchaser.*
>
> Where both a chattel mortgage and a deed of trust or mortgage have been given to secure payment of the balance of the combined purchase price of both real and personal property, no deficiency judgment shall lie at any time under one thercof if no deficiency judgment would lie under the deed of trust or mortgage on real property.

CAL. CODE CIV. PRO. § 580b (West 1967) (italics show 1963 amendment). For discussion of purposes of this statute and the effect of the 1963 amendment, which made deficiency judgments available to third party lenders on "commercial" property, see text accompanying notes 218-21 *infra.*

202. The mortgagee has various ways of locking the barn door while most of the horse is still inside, such as enjoining threatened waste, appointing a receiver to onst the wasting mortgagor from possession, and accelerating the debt and foreclosing while the waste is still incipient.

203. 15 Cal. 3d 590, 125 Cal. Rptr. 557 (1975).

inadequately rationalized results. In *Weaver v. Bay*,[204] the first case to consider the application of section 580b to waste,[205] the court implied that a cause of action for waste might lie. The issue was never discussed, however, because the court upheld the trial court's determination that plaintiff had failed to present sufficient evidence of impairment of the security. The decision in *American Savings & Loan Association v. Leeds*[206] is somewhat more illuminating. American Savings, holder of a purchase money trust deed on defendant's home, sought to recover the full amount of its loan after the improperly filled lot settled and the property allegedly became worthless. American Savings relied primarily on a repair covenant. Emphasizing that the improper filling and resultant settling had occurred before defendants bought the property,[207] the court held that a purchase money trustor could not be held personally liable because of a physical condition that had existed at the time of sale. The effect of the decision is to place on the lender the burden of investigating all conditions that might reduce the value of the property before he makes his loan.

The question implicit in *Leeds* is whether section 580b similarly bars recovery for conditions arising after the loan is made, even if the mortgage contains a covenant obligating the borrower to repair such conditions. The *Leeds* court alluded to this issue in provocative dicta, stating that section 580b

> does not prohibit mortgagees from preventing mortgagors or third parties from physically harming the security or from recovering damages for such harm. Such a recovery is not a deficiency judgment. Since the purchase money lender is confined to his security, it is all the more important that he be allowed effectively to protect it.[208]

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204. 216 Cal. App. 2d 559, 31 Cal. Rptr. 211 (1st Dist. 1963).

205. Easton v. Ash, 18 Cal. 2d 530, 116 P.2d 433 (1941), has been cited as holding that section 580b does not bar an action for waste. Although the mortgage in *Easton* was a purchase money mortgage, it was executed prior to the enactment of section 580b, and that statute has been held unconstitutional as applied to mortgages executed before the effective date of the statute. Hales v. Snowden, 19 Cal. App. 2d 366, 65 P.2d 847 (2d Dist. 1936). Consequently the section 580b issue was not discussed in *Easton*.

206. 68 Cal. 2d 611, 440 P.2d 933, 68 Cal. Rptr. 453 (1968).

207. *Id.* at 616, 440 P.2d at 937, 68 Cal. Rptr. at 457. It is not at all clear that American Savings would have been allowed to recover even if the damage had occurred after the loan was made. *See* Prunty v. Bank of America, 37 Cal. App. 3d 430, 112 Cal. Rptr. 370 (1st Dist. 1974) (third party lender barred from holding purchase money borrower personally liable after property destroyed in landslide; issue of recovery on waste theory based on the repair covenants was not raised by defendant); Krone v. Goff, 53 Cal. App. 3d 191, 127 Cal. Rptr. 390 (2d Dist. 1975) (held that *Leeds* barred recovery after property damaged by earthquake; court did not discuss fact that damage occurred after plaintiff had sold property to defendant).

208. 68 Cal. 2d at 614-15 n.2, 440 P.2d at 936 n.2, 68 Cal. Rptr. at 456 n.2 (citation omitted).

Unfortunately, the court's reason—the necessity for the mortgagee to protect his collateral because he cannot look to the mortgagor personally to satisfy the debt—does not support the court's conclusion that recovery of damages for waste must be allowed.

It might well be possible adequately to protect the mortgagee's interests by allowing him to enjoin threatened waste or by interpreting some of the repair covenants less stringently than they have been interpreted. If waste has already commenced, the mortgagee could accelerate the debt and foreclose before serious damage was done to the property. Such an approach would protect the mortgagee adequately and at the same time would avoid exposing the mortgagor to personal liability.

Another unsatisfactory aspect of the court's dicta in *Leeds* is the lack of an adequate theoretical basis for the action. The court indicated that all waste cases are based on the substitute collateral notion.[209] This doctrine is useful when the gravamen of an action is to recover a fund in the hands of a third party, but it cannot be used as the sole basis for imposing liability on the mortgagor. Even if a cause of action against the mortgagor could logically be regarded as a substitute for the property, the cause of action must first have some basis either in contract or tort.[210]

Although *Weaver* and *Leeds* offered suggestive dicta that would permit recovery on a waste theory, the first court to rule squarely on the issue did not mention either case. In *Schumacher v. Gaines*[211] the trustors, after purchasing ranch property in northern California, partially completed construction of a multi-use commercial building. During construction, defendants damaged the property by causing erosion, cutting trees, and accumulating debris. After plaintiffs filed a notice of default, defendants gutted the building and removed or sold such items as insulation, wiring, and plumbing fixtures. The jury awarded damages in plaintiff's action for waste, but the court of appeal reversed. The court based its decision on the notion that "section 580b deprives the holder of a purchase money note and deed of trust of *any* remedy other than the right to look solely to the security and no personal judgment may be recovered."[212] No direct authority was cited for this proposition,[213] nor

209. *Id.*

210. See text accompanying notes 42-44 *supra.*

211. 18 Cal. App. 3d 994, 96 Cal. Rptr. 223 (3d Dist. 1971).

212. *Id.* at 999, 96 Cal. Rptr. at 226.

213. The authority cited by the court was Brown v. Jensen, 41 Cal. 2d 193, 259 P.2d 425 (1953). *Brown* held that a sold out purchase money junior mortgagee was barred by section 580b from suing on the now unsecured note; in the course of reaching that decision, the court did say that a deficiency judgment "is nothing more than the difference between the security and the debt." *Id.* at 198, 259 P.2d at 427. Taken

did the court discuss whether the obvious equities in favor of the seller could be accommodated without defeating the policies of section 580b.

Faced with these conflicting and badly rationalized precedents, the California Supreme Court attempted to resolve the issue in *Cornelison v. Kornbluth.*[214] The purchase money trustor in this case had conveyed the property to defendant, who had taken title subject to the deed of trust without assuming it. Plaintiff mortgagee alleged in her first cause of action that defendant was liable for breach of contract. Plaintiff alleged that defendant had assumed the purchase money deed of trust and had violated its terms by failing to pay taxes, by allowing the physical condition of the property to deteriorate so badly that it was condemned as unfit for habitation, and by selling the property to another buyer in violation of a due-on sale clause. Plaintiff sought damages in a second cause of action on a negligence theory. The trial court granted defendant's motion for summary judgment because defendant's uncontroverted declarations established that he had not assumed the obligations of the original trustor. The court saw no other basis on which liability could be predicated.

On appeal, the supreme court properly decided first whether there was a basis for the waste action before considering whether the action would be barred by section 580b. In affirming on the first cause of action, the court accepted the reasoning of the trial court that defendant could not be liable on a contract theory because he had not assumed the contractual obligation. The court proceeded to reject, without discussion, plaintiff's contention that the covenants in the deed of trust ran with the land. In discussing the second cause of action, the court pointed out that Civil Code section 2929 imposes a duty not to commit waste on all persons whose interests in real property are subject to a mortgage. Since defendant, as a non-assuming grantee, took subject to the mortgage, he could be liable for waste even though he had not assumed any contractual liability. The court denied recovery, however, holding that by purchasing the property pursuant to a credit bid in the amount of the entire indebtedness, plaintiff had fully satisfied the obligation and could show no damages. Nevertheless, in extensive and carefully considered dicta, the court declared that under some circumstances recovery of damages for waste is possible notwithstanding section 580b.

The court declared that the "primary purpose" of section 580b was to prevent sellers and lenders from aggravating a general economic down-

literally, this observation would preclude an action to recover damages for waste. But waste was not involved in *Brown*, and taking the court's statement so far out of context is not helpful in reaching a proper result. *Cf.* HETLAND, *supra* note 127, § 6.26, at 275.

214. 15 Cal. 3d 590, 125 Cal. Rptr. 557 (1975).

turn by not only taking the property from defaulting purchasers but also burdening them with personal liability.[215] The court's narrow interpretation of section 580b's purpose led naturally to its erroneous conclusion that the statute should bar recovery for waste only when the value of the property has dropped due to a general economic decline. Of course, if economic decline did cause a drop in value of the encumbered property, recovery of damages should not be permitted under the guise of a claim that the mortgagor committed or allowed waste. This result is especially clear when, as the court noted, conduct denominated as waste may only be a symptom of the economic decline. The mortgagor who has insufficient funds, for instance, not only may fail to make payments on the note but also may default on tax payments or defer essential maintenance. Despite the court's reasoning, the language of section 580b does not permit personal recovery when forces other than general economic decline cause the loss. The courts have consistently applied 580b to protect buyers when it was abundantly clear that the buyer's default had nothing to do with any economic decline, and, indeed, when there was no evidence that a general economic decline was in fact occurring.[216]

When the court turned to a consideration of the circumstances under which a recovery for waste is allowed notwithstanding section 580b, its analysis was incomplete. The court pointed out, correctly, that the purposes of section 580b could not have included protecting the mortgagor from liability for his "bad faith"—defined as "reckless, intentional, and at times even malicious"[217] conduct. Unfortunately, the court failed to discuss the significance of negligent conduct by the mortgagor, even though the complaint had alleged that it was defendant's negligent maintenance of the property that caused it to be condemned.

The court's resolution in *Cornelison* of the conflict between the mortgagee's right to recover damages for waste and the policies of section 580b allows the mortgagee to recover damages caused by the mortgagor's "bad faith" conduct and denies recovery for damages caused

215. *Id.* at 603, 125 Cal. Rptr. at 566. It is unfortunate that the court continues to describe the purpose of section 580b by using outworn verbal formulas that did not make much sense even under the original version of section 580b and that have become entirely obsolete since the 1963 amendment to section 580b. *See* Leipziger, *supra* note 50, at 756-66.

216. *See, e.g.*, Brown v. Jensen, 41 Cal. 2d 193, 259 P.2d 425 (1953); Prunty v. Bank of America, 37 Cal. App. 3d 430, 112 Cal. Rptr. 370 (1st Dist. 1974) (trustor's dwelling destroyed by landslide); Lucky Investments Inc. v. Adams, 183 Cal. App. 2d 462, 7 Cal. Rptr. 57 (3d Dist. 1960) (speculative subdivision, developer unable to sell houses).

217. 15 Cal. 3d at 604, 125 Cal. Rptr. at 567.

by general economic decline. It leaves unresolved, however, the extent to which anti-deficiency laws prevent recovery for other forms of waste, such as decline in value peculiar to a particular property or waste caused by negligence. Like its predecessors, *Cornelison* illustrates the compound failure of the courts to develop any comprehensive theory of waste applicable to a mortgagor or his successor in interest, and then to apply that theory so that the policies of section 580b will also be given effect.

b. A Proposed Theory

To reach an accommodation between the mortgagee's right to recover damages and section 580b, it is necessary to determine what goals the statute serves. The purpose of section 580b has eluded the courts from the outset. Attempts to justify the statute by assigning to it some special function not dealt with by other provisions of the anti-deficiency legislation have not been very successful.[218] In 1963 the legislature amended section 580b to allow third party lenders to recover deficiency judgments on purchase money loans used to buy commercial property, but not on those used to buy residential property.[219] This amendment fortifies the argument, recently reiterated by the court of appeal in *Nevin v. Salk*,[220] that the section is primarily designed to protect the residential buyer. The evolution of section 580b will be complete when the converse of the *Nevin* court's position is recognized: if the purchased property is being used for commercial purposes, a deficiency judgment should be available to the lender, regardless of whether he is the vendor or a third party lender. This transformation of the statute is not yet complete, but evidence suggests that it is well under way.[221] The discussion that follows will therefore emphasize the problem of protecting the residential buyer.

Given the tenor of section 580b, the lender's right to recover damages in an action for waste against a residential buyer should be severely limited. To begin with, assume that the lender's action is based on a covenant in the deed of trust, such as a repair covenant or a covenant to pay taxes. The likely reason for the buyer-borrower's

218. *See* Leipziger, *supra* note 150, at 758-66.

219. "Residential property," as used in the text, means owner-occupied residential property of four units or less. "Commercial property" is used to refer to all other types of real property. This distinction is drawn from the language of the 1963 amendment to section 580b. See note 201 *supra*.

220. 45 Cal. App. 3d 331, 119 Cal. Rptr. 370 (4th Dist. 1975): "Stated in simple terms, the main goal of the Legislature in enacting and amending section 580b was to protect the ordinary buyer from personal liability when purchasing a home." 45 Cal. App. 3d at 341, 119 Cal. Rptr. at 375.

221. *See* Leipziger, *supra* note 150, at 771-87.

breach will be straitened financial circumstances. The investment in a home represents the major asset for most consumers; because of its financial and emotional importance to the buyer, it is unlikely that he will fail to perform his obligations under the deed of trust unless he is simply unable to invest additional money in the house. For the same reasons, it is quite likely that the buyer who is in default under the waste covenants in the mortgage will at the same time be in default on his installment payments. Essentially, these are risks that the lender can calculate when he makes the loan. The risk of waste is no greater than the risk of the buyer defaulting on his payments; it is, in a sense, a condition existing at the time the loan is made.

When section 580b applies, the lender should bear the risk of default, since his only protection against default is the value of the property, not the personal liability of the financially embarrassed owner. The lender should also be limited to the property, where the waste consists of the buyer's breach of the covenants in the mortgage, because the lender has other means of protecting himself. Undoubtedly, the most common forms of waste that consist of breach of contract are the mortgagor's failure to maintain or rebuild the improvements and his failure to pay taxes. Typically, failure to rebuild occurs after catastrophic loss; the lender can usually protect himself against this risk by insurance. Standard forms of trust deeds invariably give the lender the right to specify the amounts of insurance coverages and the types of risks to be insured against. The lender can minimize the risk that the buyer will not obtain or pay for the policy by retaining the right to collect and impound insurance permiums and to advance the amount of such premiums if the borrower fails to do so. Thus if physical loss occurs through fire, earthquake, or other disaster, the lender should not be allowed to recover against a buyer protected under section 580b.[222]

It might be argued that the lender's ability to protect himself against catastrophic loss does not cover the risk of slow deterioration. Few lenders will incur the expense of regularly inspecting residential property to make sure that such deterioration is not occurring. Even if they took such precautions, the jaundiced attitude of most courts toward repair covenants makes it unlikely that the lender would be permitted to foreclose once deterioration is evident. The drawback is not

222. Such is the implication of the discussion of insurance in Prunty v. Bank of America, 37 Cal. App. 3d 430, 112 Cal. Rptr. 370 (1st Dist. 1974), although the possibility of the bank's recovering on a waste theory was not discussed in the opinion. In Krone v. Goff, 53 Cal. App. 3d 191, 127 Cal. Rptr. 390 (2d Dist. 1975), the court noted that under the deed of trust the beneficiary could have required the trustor to maintain earthquake insurance; the court held that section 580b defeated the beneficiary's attempt to recover earthquake damages on a waste theory.

as serious as it might seem, for several reasons. First, the typical borrower who allows the property to deteriorate is often in default on his financial covenants, so that the lender could foreclose. Secondly, the lender is not without recourse even if the borrower keeps up his payments, but fails to repair because of divorce, alcoholism, or other personal problems. If the lender is aware that repairs are not being performed, he may obtain an injunction when the deterioration has substantially impaired the security in the equity sense—that is, has reduced the value below the level satisfactory to a prudent lender. Moreover, the borrower who allows the property to deteriorate will often be a borrower whose financial difficulties, even if they have not yet forced him to default on his regular payments, will force him to sell property he can no longer afford to maintain. The lender can protect himself against this contingency by inserting due-on sale clauses in its deeds of trust. The borrower who is selling under such circumstances will probably have to cash out his equity, so that even under the *Tucker* rule the due-on sale clause would be enforceable.[223]

It was suggested at the outset of this discussion that the mortgagee's right to recover damages for waste committed by the mortgagor should be severely limited when section 580b protects him against personal liability on the purchase money obligation. From this premise it follows that the mortgagee should not recover damages for physical injury to the property, whether caused by catastrophe or by slow deterioration resulting from faulty maintenance by a strapped-for-cash mortgagor. A fortiori, the mortgagee ought not to recover for any breach of financial covenants, such as waste caused by failure to pay taxes or to service prior encumbrances. The mortgagor's contractual obligation to make these regular payments is analytically similar to his contractual obligation to pay the balance of the purchase money note; indeed, funds to pay taxes, insurance premiums, and prior debts are often collected by the mortgagee as part of the payments on his note. If recovery upon such obligations were allowed, the policy of section 580b would be frustrated.

Through Civil Code section 2929 it is possible to preserve the policies underlying section 580b when the action is based not on contract provisions in the mortgage—as is the case in both the repair and the financial covenants—but on a tort theory. Section 2929 provides a basis for the damages action that is not dependent on the agreement of the parties and is conceptually dissimilar to the contract-based obli-

223. Any extension of *Tucker* to bar enforcement of all due-on sale clauses would certainly protect the mortgagee by allowing him to require the purchaser to be financially strong and of good character. *See* Austin v. Calamars, Civil No. 360321 (San Diego City Super. Ct., Sept. 16, 1975).

gation dealt with by section 580b. The typical cases in which the courts allow recovery for waste on a tort theory are timber cutting, removal of improvements, or other activities in which the mortgagor decreases the value of the land for his own profit. It is unlikely that these activities are often caused by the mortgagor's strained finances or any other circumstance that the lender could investigate at the time the loan is made; thus, the rationale of *Leeds*—that the lender bears the burden of a pre-loan inspection—is inapplicable. Nor is it likely that the California legislature, in enacting section 580b, was attempting to protect from personal liability a buyer who created that liability by conduct designed to create a profit for himself.

It is also relevant that the mortgagee is much less able to protect himself against deliberate waste, whether done for profit or for spite, than against negligent waste. The mortgagee cannot obtain insurance against the risk of intentional damage.[224] The possibility of the mortgagee's protecting himself by other means, such as an injunction or a foreclosure, that do not impose personal liability on the mortgagor, is also unlikely when the waste is intentional. There is some risk that by the time the lender discovers spiteful or profitable waste, the damage will have progressed too far for an injunction to be very helpful. Although the lender could undoubtedly accelerate the debt and foreclose in such circumstances, the foreclosure sale may well create a large deficiency because of the severity of the waste. Such a deficiency could be recovered only if section 580b is interpreted to be inapplicable to the mortgagee's action for damages. A policy allowing recovery for intentional waste would make the treatment of waste consistent with that accorded to other intentional torts, such as fraud, to which section 580b has been held inapplicable, at least by implication.[225] In short, the legitimate needs of the mortgagee can best be accommodated and the statutory policy underlying Civil Code section 2929 best be given effect if section 580b is interpreted as inapplicable to waste resulting from an intentional tort.

Since the liability of third parties for negligent waste is now established in California,[226] it is necessary to consider the possible liability

224. The so-called standard mortgage clause in an insurance policy will protect the mortgagee even if the property is destroyed by the mortgagor's willful act. J. B. Kramer Grocery Co. v. Glen Falls Ins. Co., 497 F.2d 709 (8th Cir. 1974) (arson). The type of damage done by the malicious mortgagor, such as removal of improvements, is not, however, a risk covered by the usual casualty policy.

225. *See* Pastor v. Younis, 238 Cal. App. 2d 259, 47 Cal. Rptr. 684 (2d Dist. 1965); *cf.* Paap v. Von Helmholt, 185 Cal. App. 2d 283, 8 Cal. Rptr. 568 (4th Dist. 1960) (damages in unlawful detainer action allowed against land contract vendee who wrongfully continued to occupy property after termination of contract).

226. U.S. Financial v. Sullivan, 37 Cal. App. 3d 5, 112 Cal. Rptr. 18 (4th Dist. 1974).

of the negligent purchase money mortgagor. The problem might require different answers, depending on the type of negligence involved. Negligence might consist of simple forgetfulness, as when the mortgagor neglects to pay fire insurance premiums or a senior lienholder. The mortgagee in such circumstances could make the payment himself and threaten the defaulting mortgagor with foreclosure unless he was timely reimbursed. In the event, however, that the mortgagee is unaware of the default until after the house burns down or the senior lienholder forecloses, his remedy is not so apparent. Since economic pressure upon the mortgagor did not cause the waste, it seems consistent with section 580b to impose personal liability on the mortgagor; however, if the mortgagee is an institutional lender and the mortgagor a homeowner, a court might conclude that his right and ability to supervise the loan and to ensure that the mortgagor makes all required payments give him sufficient protection. His failure to use it, a court might decide, constitutes contributory negligence, barring or at least limiting the right to recover.[227]

If the mortgagor's negligence consists of bad judgment, a more difficult problem arises. Assume that the mortgagor, being foolish or niggardly, overloads his electrical wiring system or repaints too seldom. As a result, the house is seriously damaged by a fire of electrical origin, or by dry rot and termites. If the *Cornelison* court was correct in suggesting that section 580b should protect the buyer only from personal liability caused by a general decline in the value of property, there would be no obstacle to holding such a mortgagor liable. But such a narrow interpretation of section 580b's scope is inconsistent with the host of cases that have applied section 580b without any consideration at all of the condition of the economy. Moreover, the recent conversion of section 580b into a statute primarily designed to protect the residential buyer[228] suggests that when such a buyer is placed under economic stress for reasons personal to him (for example, divorce, alcoholism, illness), he suffers enough from foreclosure and should not be further penalized with personal liability. If this view of the statute's purpose is accepted, it follows that the mortgagor should be personally liable for "bad judgment" negligence only if the mortgagee establishes that such bad judgment was not related to the mortgagor's straitened finances. Unfortunately, such a rule would require awkward case-by-case determinations. Rarely will funds for home maintenance be absolutely unavailable; courts will therefore have to determine whether the

227. See cases discussed at note 222 *supra.*

228. Nevin v. Salk, 45 Cal. App. 3d 331, 341, 119 Cal. Rptr. 370, 375 (4th Dist. 1975); *see* Leipziger, *supra* note 150, at 756-66.

mortgagor erred in buying a car or in paying for his children's education instead of investing more funds in his house.

It was earlier argued that the problem of making case-by-case determinations should not deter courts from enforcing repair covenants. In the present context, however, the courts are presented with a more difficult problem, because the standard against which they must measure the mortgagor's conduct is not provided by a specific covenant but by the more amorphous notion of how a reasonable mortgagor should care for property which he owns but in which the mortgagee also has a major interest. In addition, the precedents for holding a mortgagor liable for negligence are uncertain. For both of these reasons courts should defer to the policy of debtor protection embodied in section 580b and should only allow recovery for waste in those cases in which the negligence is gross and the extent of harm to the mortgagee is substantial.

Perhaps the most difficult type of waste to analyze in relation to section 580b is the right of the purchase money mortgagee to recover attorney's fees. The mortgagee cannot recover a deficiency judgment including attorney's fees where the fees are incurred in an ordinary foreclosure; in such a case, section 580b's ban of a deficiency on the note would include any attorney's fees payable pursuant to the note. A different rule may be appropriate if the mortgagee prevails in an action brought by the mortgagor challenging either the validity of the mortgage or some aspect of the debt. Although one does not ordinarily think of a mortgagee who incurs attorney's fees as having been subjected to waste, the defense of the security against legal attack is as necessary to the mortgagee as protection of the property against physical deterioration.

Even the purchase money mortgagee is entitled to add his attorney's fees to the debt secured by the mortgage.[229] If the value of the property is great enough, section 580b is irrelevant; the mortgagee can recover his fees from the sale of his collateral without seeking a personal judgment against the mortgagor.[230] The problem arises when the mortgagee seeks a money judgment for such fees. The right of the purchase money mortgagee to recover attorney's fees has been

229. CAL. CODE CIV. PROC. §§ 580c, 726 (West 1976); Johns v. Moore, 168 Cal. App. 2d 709, 336 P.2d 579 (1st Dist. 1959); Bisno v. Sax, 175 Cal. App. 2d 714, 346 P.2d 814 (2d Dist. 1959). *But see* SECURED REAL ESTATE TRANSACTIONS *supra* note 125, at 156-57 (1974).

230. *But see* SECURED REAL ESTATE TRANSACTIONS *supra* note 125, §§ 4.13, at 95, 8.8 at 157 (1974). Professor Hetland argues that under applicable statutes attorneys' fees may not be recoverable at all (except during the 3-month reinstatement period) unless the mortgagee judicially forecloses. His argument, however, is not directed against the possibility of recovery on a waste theory.

discussed in one case and dealt with by implication in a couple of others. In *Hunt v. Smyth*[231] the court rejected the trustor's contention that section 580b barred recovery of attorney's fees, reasoning that they were a kind of future advance and that the beneficiary making or incurring them could be treated as a lender rather than as the seller. The court then permitted recovery against the trustor of the commercial property involved in the case, since section 580b allows third party lenders to recover deficiencies on commercial property loans. This reasoning is unsound. The purchase price and all future advances—including the attorney's fees—were secured by a deed of trust on the property; all expenses and loans thus became part of a single debt.[232] The court's reasoning in *Hunt* does not recognize that the property is security for the entire debt; it cannot be split into a purchase money secured debt plus a nonpurchase money advance for the attorney's fees in order to evade the impact of section 580b.[233]

A better resolution of the attorney's fees problem could be obtained by analogy to the intentional tort type of waste for which recovery ought to be allowed notwithstanding section 580b. Like the trustor's tortious physical destruction of the property, the borrower's lawsuit cannot be foreseen by the lender at the time the loan is made. Like intentional waste, the lawsuit is neither an insurable risk nor one that can be minimized by careful supervision of the loan. Furthermore, its impact cannot be alleviated by the mortgagee's obtaining an injunction or proceeding to foreclosure. The absence of these factors —predictability, insurability, and availability of other remedies—indicates the desirability of equivalent treatment of tortious waste and the mortgagee's right to attorney's fees. This parallel treatment is no less desirable even though the mortgagor's bringing of a lawsuit is not ordinarily considered tortious conduct. Despite the mortgagor's right to take such action, he nonetheless jeopardizes the mortgagee's security by doing so. To give the mortgagor the protection of the statute in such cases would go far beyond the legislative purpose of protecting buyers who have been subjected to economic strain, and would also give the mortgagor an unfair advantage in litigation because only he could recover his attorney's fees if he prevailed.[234]

231. 25 Cal. App. 3d 807, 101 Cal. Rptr. 4 (1st Dist. 1972). Attorneys' fees were also awarded to the purchase money mortgagee in Nevin v. Salk, 45 Cal. App. 3d 331, 119 Cal. Rptr. 370 (4th Dist. 1975), without discussion of whether they were barred by section 580b; by implication they were allowed as a form of waste, since the court emphasized that the attorneys' fees were necessarily incurred in protecting the security of the deed of trust from the buyer's legal attack.

232. *Cf.* Freedland v. Greco, 45 Cal. 2d 462, 289 P.2d 463 (1955).

233. *See* Loretz v. Cal-Coast Dev. Corp., 249 Cal. App. 2d 176, 57 Cal. Rptr. 188 (1st Dist. 1967).

234. The beneficiary's claim for attorneys' fees must be based upon some provision

If the basic principle of allowing the purchase money mortgagee to recover attorney's fees is accepted, it is still both possible and desirable to limit that principle to avoid conflict with the goals of section 580b. One obvious limitation is to allow recovery only where the mortgagor brings an action (including a cross complaint) that attacks the validity of the security or the entire loan transaction—for instance, a claim of usury. But attorney's fees incurred by the mortgagee in routinely processing a default and foreclosure should not be personally recoverable from the mortgagor. In this situation the risk of default is predictable, and the mortgagee should take his costs into account when making the loan and setting the rate of interest. If this limitation were not adopted, the mortgagee could recover attorney's fees whenever the mortgagor failed to pay the debt. Such a recovery would be inconsistent with the principle of allowing the mortgagee to recover ouly those attorney's fees incurred because of a threat to the security. In addition, courts should deny recovery of attorney's fees whenever the value of the encumbered property reasonably appears to the court to be sufficient security for both the debt and the attorney's fees.[235]

Finally, the courts generally have considerable discretion in determining the reasonableness of a claim for attorney's fees. They can reduce them if it appears that imposition of the fees would be unduly harsh to the mortgagor. Thus, if the mortgagee prevails in the litigation but the mortgagor then makes his payments and retains the property, an award of full attorney's fees is appropriate. Such an award is obviously less appropriate when the litigation in which the mortgagor challenges the security interest results in a foreclosure and subsequent loss by the mortgagor of his entire investment in the property.[236]

CONCLUSION

Some of the difficulties encountered in rationalizing the law applicable to the mortgagee's remedies for waste result from a blind application of doctrines that fail to recognize the legitimate and bargained for requirements of mortgagees. The first set of problems this Article discussed —the attempts of mortgagees to improve their remedies by use of appro-

in the note or deed of trust. Even if such a provision allows only the beneficiary to recover attorneys' fees, where the trustor is the prevailing party, he will be permitted to recovery attorneys' fees pursuant to statute. CAL. CIV. CODE § 1717 (West 1970).

235. This approach would make the rule comparable to that which would apply when attorneys' fees are sought as part of the debt in a judicial foreclosure. The mortgagee would not be allowed to recover the attorneys' fees in the form of a deficiency judgment if an appraisal of the property indicated that its fair market value exceeded the total debt, including the attorneys' fees. CAL. CODE CIV. PRO. § 726 (West 1967).

236. This point of view was adopted by the court in Nevin v. Salk, 45 Cal. App. 3d 331, 119 Cal. Rptr. 370 (4th Dist. 1975).

priate covenants—shows the unfortunate reluctance of the courts to enforce those covenants and their concomitant tendency to rely on rules that would be applicable in the absence of such covenants. Similarly, the task of measuring substantial impairment of the security becomes complicated when the rule designed to measure such impairment for the foreclosing mortgagee (that is, a decrease in the value of the collateral below the amount of the debt) is mistakenly applied to the nonforeclosing mortgagee who anticipates the continued existence of the debt and his exposure to fresh risks in the future. The doctrines criticized above could be justified if they provided important protection for debtors, but neither the decisions themselves nor independent analysis of the problems involved indicates that this is the case.

Conversely, the courts have overlooked the needs of the debtor in failing to articulate any policies to govern when an action may be brought; the results of the decisions are consequently inconsistent. This problem can be solved if courts will consider the effects of the procedural decision upon the parties, emphasizing the importance of giving maximum protection to the mortgagor.

Placing proper limits upon the substantive right to recover damages against the non-assuming grantee and, in California, the purchase money mortgagor requires the courts to reach a difficult accommodation between the needs of debtors and mortgagees. The decisions indicate that such defendants are entitled to special protection against personal liability, but the courts have failed to construct coherent bases for imposing waste liability or for extending protection to such debtors. No simple answer is possible in this area. The outcome should vary depending primarily upon the type of waste involved and the extent to which the mortgagee can protect himself by means other than imposing personal liability on the mortgagor.