

Deficiency Judgments and California Law

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CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.)

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Table of Contents

- I. [Introduction](#)
- II. [The General Rules](#)
- III. [Exceptions To The General Rules](#)
 - A. [Fraud](#)
 - B. [Bad Faith Waste](#)
 - C. [Non Standard Transactions](#)
 - D. [Sold Out Junior Lienholders](#)
 - E. [Environmentally Impaired Properties](#)
- IV. [Exception To The Exceptions](#)
- V. [Waiver Of Anti-deficiency Protection](#)
- VI. [Third Parties](#)
 - A. [Guarantors](#)
 - B. [Real Estate Brokers](#)
 - C. [Mortgage Brokers](#)
 - D. [Broker's Commission](#)
- VII. [Conclusion](#)

I. Introduction

Loan . . . 2. Something lent; esp. a sum of money lent, often for a specified period and repayable with interest. . . . (Webster's New World Dictionary, 2nd College Edition, 1976)

Loans are often evidenced by a written agreement called a promissory note. In a typical real estate transaction in California the note is secured by a trust deed on the real estate. Loans are made by a variety of sources such as institutional lenders (banks, savings and loans, and pension funds), private investors, mortgage bankers, and sellers. For some purposes (such as usury limitations), a seller who allows the buyer to make payments over time is not considered to have made a loan but rather to have given an extension of credit. For the remainder of this article, however, unless otherwise stated, seller carry-backs will be considered loans. Loans are made for a variety of purposes such as to purchase a property, refinance an existing loan, or pull equity out of a real estate asset in order to buy goods, pay off debts, or make investments.

The expectation of the lender at the time the loan is originated is that the borrower will make payments called for by the note and eventually pay off the loan in full. There are times, however, when a borrower is unable to meet its contractual obligation and defaults on the note. When a borrower defaults, California law generally requires a lender with a secured interest in real estate to foreclose on the real property securing the loan before proceeding against the borrower for collection of the debt. This procedure is known as the "One Action Rule" or the "One Form Of Action Rule" and is found in California Code of Civil Procedure section 726 which, in part, states:

- a. There can be but one form of action for the recovery of any debt or the enforcement of any right secured by a mortgage upon real property. . .

While this section appears to give a lender a choice of how to proceed to collect a debt, it has been interpreted to mean that a lender must pursue the security first. (*Walker v. Community Bank*, 10 Cal. 3d 729 (1974).) Only after the security (real estate) has been foreclosed upon can a lender pursue a borrower personally for collection on the debt.

Also, even though the statute makes reference to a mortgage, it applies to a deed of trust as well. (*Security Pacific Bank v. Wozab* (1990), 51 Cal. 3d 991, *Bank of California v. Leone*, 37 Cal. App. 3d 444 (1974).)

A lender can bring a judicial foreclosure, which involves the filing of a lawsuit for collection of the debt and obtaining a court order for the sale of the property. If the documentation is proper, the lender has the right to bring a nonjudicial foreclosure, or trustee sale, to acquire the security. In certain instances, California law prohibits the lender from pursuing the borrower at all. In those instances the "security first" rule of Code of Civil Procedure section 726 really becomes a "security only" rule.

This article will discuss circumstances under which a secured lender can pursue a borrower, or someone else, personally for a recovery of an unpaid debt as well as when a lender is prohibited from seeking any redress beyond the secured real property. The steps of the foreclosure process itself will not be addressed except when necessary to an understanding of how a particular step affects a lender's ability to seek compensation beyond the secured property. For purposes of this article, the difference between the amount of the unpaid balance on a loan and the amount recovered from the security is referred to as a deficiency judgment.

II. The General Rules

California has enacted anti-deficiency legislation which is found in Code of Civil Procedure sections 580b and 580d. Code of Civil Procedure section 580b prohibits deficiency judgments

based on the character of the loan at the time it is made. A lender whose loan is made for the purchase of residential property containing one-to-four units, one of which the borrower intends to occupy, and whose loan is secured by that same property, may only pursue the security and not the borrower. Additionally, section 580b prohibits a seller who has carried back a loan as part of the sales price of the property from obtaining a deficiency judgment against a defaulting borrower. This seller carry-back rule applies to any type of property, not just residential one to four. The statute reads as follows:

No deficiency judgment shall lie in any event after a sale of real property or an estate for years therein for failure of the purchaser to complete his or her 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 that real property or estate for years therein, or under a deed of trust or mortgage on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of that 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 any one thereof if no deficiency judgment would lie under the deed of trust or mortgage on the real property or estate for years therein.

Notice that section 580b does not refer to a seller but instead to a deed of trust given by the vendor to receive payment of the purchase price. The term vendor has been interpreted to include not just sellers but also previous lienholders who allow their liens to be assumed in order to effectuate a sale. (*Costanzo v. Ganguly*, 12 Cal. App. 4 1085 (1993).) Thus, even these prior lienholders/"vendors" are prevented from obtaining a deficiency judgment.

The prohibition on deficiency judgments found in Code of Civil Procedure section 580d, on the other hand, does not depend on the character of the loan, but rather on the process of the foreclosure action. Section 580d prohibits deficiency judgments when the property is sold through the exercise of a power of sale clause contained in the deed of trust. Thus, section 580d applies to nonjudicial, or trustee's sales, regardless of the type of property or the character of the loan.

As a result of section 580d, deficiency judgments, with limited exceptions, are only permitted following a judicial foreclosure. Even so, there are limitations on the amount of a deficiency following a judicial foreclosure. The amount of the deficiency judgment allowed is the lesser of:

- The amount by which the debt exceeds the fair value of the property at the time of the foreclosure sale or
- The amount by which the debt exceeds the sales price of the property at the foreclosure sale.

(Cal. Code Civ. Proc. § 726(b).)

For example, if a lender was owed \$300,000 at the time of the foreclosure sale and a successful bidder at that sale paid \$225,000, but the property's fair value was \$250,000, then the maximum deficiency judgment allowed would be only \$50,000. This is the case because the difference between the debt and the fair value ($\$300,000 - \$250,000 = \$50,000$) is smaller than the difference between the debt and the amount received ($\$300,000 - \$225,000 = \$75,000$).

In order to obtain a deficiency judgment, a lender must apply to the court for a deficiency judgment within three months of the judicial foreclosure sale (Cal. Code Civ. Proc. § 726(b)).

When reviewing the general rules regarding deficiency judgments, it is important to remember that any single rule which prohibits deficiency judgments will be effective regardless of the other

rules. For example, the seller who carries back a loan as part of the sale of an office building cannot obtain a deficiency judgment even following a judicial foreclosure. (Cal. Code Civ. Proc. § 580b.) Similarly, even if a judicial foreclosure action is pursued, a bank which has made a purchase money loan on an individual condominium which was to be owner occupied cannot obtain a deficiency judgment. (Cal. Code Civ. Proc. § 580b.)

III. Exceptions To The General Rules

Remember, the general rules governing deficiency judgments are:

- A lender must pursue the security before pursuing a borrower individually for a debt;
- No deficiency judgment is allowed following a trustee's sale;
- No deficiency judgment is allowed when the loan is a seller carry back; and
- No deficiency judgment is allowed when the loan is a purchase money loan for residential property containing one-to-four dwelling units.

Of course in law, as in life, there are always exceptions to the general rules and such is the case with the law of deficiency judgments.

A. Fraud

In spite of the anti-deficiency rules, a lender is permitted to sue a borrower for damages if the borrower fraudulently induced the lender into making the loan in the first place. This is true whether the foreclosure sale is judicial or non-judicial and whether or not the loan is purchase money. The Code of Civil Procedure even allows for the collection of punitive damages up to 50 percent of actual damages. However, if the loan is secured by a single family owner-occupied, residential property in an amount not exceeding \$150,000, annually adjusted, then the Code exemption does not apply. (Cal. Code Civ. Proc. §§ 726(f), (g) & (h).)

B. Bad Faith Waste

Waste can be defined as the failure of the borrower to maintain the property. While the general anti-deficiency rules apply if the borrower has allowed a waste to occur, California courts have allowed actions for a deficiency judgment in the event the borrower has committed "bad faith waste." (*Cornelison v. Kornbluth*, 15 Cal. 3d 590 (1975).) This is true whether the foreclosure sale is judicial or non-judicial and whether or not the loan is purchase money.

Bad faith waste is an injury to the property by the action or inaction of the person in possession which is reckless, intentional, or malicious. Only the damage resulting from bad faith waste, as opposed to decline due to market conditions or ordinary waste, is recoverable. (California Real Estate 2d, Miller & Starr, section 9:195, p. 620, section 9:50 pp. 136-137.)

C. Non-Standard Transactions

The Code of Civil Procedure section 580b's prohibition against deficiency judgments only applies to standard transactions. (*Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35 (1963).) For example, a seller who carries back a loan secured by a first deed of trust would be subject to section 580b. The same would be true of a seller who carries back a loan secured by a second deed of trust when the senior lien secures a conventional loan. However, the courts have held that a seller of vacant land who subordinates a seller carry-back loan to a commercial construction loan is not

barred from obtaining a deficiency judgment following a judicial foreclosure. (*Spangler v. Memel*, 7 Cal. 3d 603 (1972).)

It is interesting to note that one court has held that a construction lender supplying funds for construction of a borrower's personal residence (a situation we may think of as both non-standard and non-purchase money) was barred by section 580b from obtaining a deficiency judgment. (*Prunty v. Bank of America*, 37 Cal. App. 3d 430 (1974).)

Yet, a borrower who takes out a construction loan for improvements or repairs, but not to finance a personal residence, is subject to a deficiency judgment. (*Allstate Sav. & Loan Ass'n v. Murphy*, 98 Ca.; App. 3d 761 (1979).) It is not always easy to determine whether a loan is a standard transaction subject to the purchase money and seller carry-back restrictions on deficiency judgments or a non-standard transaction in which a deficiency may be obtained.

D. Sold Out Junior Lienholders

The security first rule does not prohibit a lender from suing directly on the debt when the security is legally worthless. Legally worthless is to be distinguished from economically worthless. For example, let's say a buyer borrows \$800,000 from a lender secured by a first trust deed in order to purchase a \$1,000,000 property. Subsequently, the same person borrows an additional \$200,000 secured by a second trust deed. The junior lienholder appraised the property at that time at \$1,250,000. If market conditions change and the property drops in value to \$800,000, and the borrower stops making payments on this second loan, the junior lienholder must foreclose rather than sue on the debt. While the junior security has no economic value, it is still legally valuable. On the other hand, if in our example, a senior lienholder foreclosed, resulting in the property being conveyed free and clear of the junior lien, then the junior security, in and of itself, has no value. In that situation, the junior lienholder can sue the borrower directly on the note. (*Roseleaf Corp. v. Chierighino, supra*.)

The sold out junior lienholder is unable to take advantage of this exception if the junior lien secures a standard purchase money loan. (*Brown v. Jensen*, 41 Cal. 2d 193 (1953).)

Additionally, the worthless security exception does not apply if the lender itself has taken some action to make the security worthless. A recent case has held that a lender which had both a first and a third deed of trust on a property could not pursue the borrower directly on the debt secured by the third trust deed if the lender had caused the third to be relinquished by foreclosing on its own first trust deed. (*Simon v. Superior Court (Bank of America)*, 4 Cal. App. 4th 63 (1992).) A creditor who loses its security through a culpable act does not come within the exception to the security first rule. (California Mortgage and Deed of Trust Practice, 2nd edition, Roger Bernhardt, section 4.7, p. 192.)

E. Environmentally Impaired Properties

For loans, extensions of credit, guaranties, or other obligations secured by real property made, renewed, or modified between January 1, 1992 and December 31, 1999, a lender may elect to waive its security and pursue its rights as an unsecured creditor, notwithstanding Code of Civil Procedure section 726, if the secured real property is environmentally impaired.

A lender does not have this option, however, if the security is a unit in a residential common interest development or residential property containing 15 or fewer units. A lender also does not have this right if the environmental hazard was not knowingly or negligently created, caused, or contributed to by the borrower or any related entity and, at the time of the secured obligation either the borrower was unaware of any environmental hazard or, if aware, disclosed such information to the lender. (Cal. Code Civ. Proc. § 726.5.)

IV. Exception To The Exceptions

As noted above, a lender is not barred by the one action rule, section 580b, or section 580d from pursuing a borrower for a deficiency judgment if the borrower had committed fraud in the inducement of the loan or bad faith waste upon the property prior to the foreclosure sale. However, even in those cases, a lender cannot pursue the borrower if there is no deficiency. Thus, a lender who submits a full credit bid for the property at a trustee's sale is deemed to have received property worth the amount of the bid. A full credit bid represents a satisfaction of the unpaid debt. Even if the property is actually worth less than the amount credit bid at the foreclosure sale, the full credit bid in and of itself cuts off a lender's right to a deficiency judgment against the borrower who has committed fraud or bad faith waste. (*Western Federal Savings v. Sawyer*, 10 Cal. App. 4th 1615 (1992); *Cornelisun v. Kornbluth*, *supra*.)

V. Waiver of Anti-deficiency Protection

The anti-deficiency protections cannot be waived by a borrower contemporaneous with or upon renewal of a secured loan. (Cal. Civ. Code § 2953; *Freedland v. Greco*, 45 Cal. 2d 462 (1995).) However, anti-deficiency protections can be waived subsequent to the loan being made if the waiver accompanies some event other than a renewal. For example, a waiver in connection with an extension of a loan or some other consideration or concession by the lender can be valid. (California Mortgage and Deed of Trust Practice, *supra*, section 4.49, p. 231, California Real Estate 2d, *supra*, section 9:174 p. 585.)

Each of the anti-deficiency protections must be waived separately. A waiver of the purchase money protection ((Cal. Code Civ. Proc. § 580b) will not have an effect on the protections afforded the borrower after a trustee sale has been conducted ((Cal. Code Civ. Proc. § 580d).

VI. Third Parties

A. Guarantors

In certain situations a lender can look to others for compensation for the loss suffered by the lender. One of these situations is where the note has been guaranteed by a third party. The following rules concerning guarantors only apply to true third party guarantors since a principal obligor under a note cannot guarantee his/her own performance. For example, a guarantor who is a partner of a general partnership is entitled to the same anti-deficiency protections as a partner who is not also a guarantor. The reason being that a general partner is personally liable for partnerships debts. This rule holds true even if the note is a non recourse note. (*Westinghouse Credit Corp. v. Barton*, 789 F. Supp. 1043 (1992).) Also, if individual shareholders guarantee a debt for a corporation which is nothing more than a "sham" or the alter - ego of guarantor/shareholder then the anti-deficiency rules protect the guarantor. (*Valinda Builders v. Bissner*, 230 Ca. App. 2d 106 (1964).)

A lender who forecloses non-judicially against a property is precluded from seeking a deficiency against a guarantor. (*Union Bank v. Gradsky*, 265 Cal. App. 2d 40 (1968).) However, although not yet clarified by the California Supreme Court, there remains a possibility that a lender can pursue a guarantor of a purchase money debt for a deficiency remaining after a trustee's sale. (Mortgage and Deed of Trust Practice, *supra*, section 8.15 and California Real Estate 2d, *supra*, section 9:198.)

A lender who judicially forecloses retains a cause of action against the guarantor for any deficiency. It is unclear however, whether the guarantor's liability is limited by the fair value rule of Code of Civil Procedure section 726.

A guarantor may waive the protections afforded by the one-action and anti-deficiency rules. Thus, the guarantor can give up the right to have the lienholder foreclose on the security before taking recourse against the guarantor. The guarantor can also give up the protections afforded by Code of Civil Procedure sections 580b and 580d. Once the guarantor pays, the guarantor is subrogated to the security, if any is left, held by the lender and may use it against the borrower subject to any defenses the borrower would have against the lender.

The guarantor's waiver is enforceable if it is clear and specific enough to adequately advise the guarantor what rights are being waived. (*Gradsky, supra; Cathay Bank v. Lee*, 18 Cal. Rptr. 2d 420 (1993).)

B. Real Estate Brokers

1. Mortgage Brokers

A lender who has used the services of a mortgage broker may have another source to look to when a loss cannot be recovered from the secured property or the borrower. The case of *Barry v. Raskov*, held that a mortgage loan broker is liable to a lender for the fraud or negligence of an independent appraiser it hired to appraise the security property. (*Barry v. Raskov*, 232 Cal. App.3d 447 (1991).)

Essentially, the court held that the lender had a valid action against the mortgage broker since the duty to obtain an appraisal is not delegable and a broker who relies on an appraiser is responsible for the fraudulent or negligent performance of that appraiser.

2. Broker's Commission

A broker who takes a commission in the form of a note secured by the property to be purchased is treated as a lender but not a vendor for purposes of section 580b. (*Kistler v. Vasi*, 71 Ca. 2d 261 (1969).) Thus, a broker who takes a commission in the form of a note secured by commercial property is not precluded from obtaining a deficiency judgment following a judicial foreclosure sale.

VII. Conclusion

So, did you follow all of that? If so, congratulations! The way I see it, the lesson to be learned is that, usually, deficiency judgments cannot be obtained, . . . but sometimes they can.

Lenders have an improved chance of receiving a deficiency if:

- The loan is secured by commercial, as opposed to residential, property;
- The loan is a refinance or other non-purchase money transaction;
- The lender pursues a judicial rather than a non-judicial foreclosure; or
- The borrower has signed a waiver of the various anti deficiency protections.

Borrowers, on the other hand, are least likely to suffer the consequences of a deficiency judgment if any of the following factors are present:

- The loan was used to purchase a residential property to be occupied by the borrower;

- The loan is made by the seller of the property; or
- The lender pursues a trustee's sale rather than a judicial foreclosure.

Beyond these general rules of thumb, the only way to know for sure if a deficiency judgment can be obtained is to examine the facts surrounding a particular loan and then to analyze those factors in light of the rules enumerated here and in the law.

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