New Anti-Deficiency Protection for Residential Real Property Loans

Short sales and foreclosures have unfortunately become all too common in these times. Residential real estate borrowers who lose their properties to short sales or foreclosure sometimes also face a monetary liability if the short sale or foreclosure proceeds do not cover the outstanding balance of the loan. California Governor Arnold Schwarzenegger took action yesterday on two legislative bills dealing with the recovery of such shortfalls (or "deficiencies") on obligations secured by residential real property. He signed one bill into law and vetoed the other.

Deficiency Liability

When a loan is secured by real property, the term "deficiency" refers to an amount that remains due after disposition of the property, usually by foreclosure. For example, if a loan for $500,000 is secured by property that sells for only $200,000 at foreclosure, there is a $300,000 deficiency, or shortfall, still owing on the loan.

California law includes several provisions that restrict a lender's ability to recover a deficiency from the borrower. For example, California Code of Civil Procedure § 580d prohibits the recovery of a deficiency after a nonjudicial foreclosure sale. In the example above, this means that even though the lender is still owed $300,000, it cannot sue the borrower for that amount.

Short Sales

What happens, though, if the lender agrees to a "short sale"? In a short sale, the borrower sells the property for less than the amount owing, and the lender agrees to release its deed of trust on the property, normally receiving all of the sale proceeds in return. A lender is often motivated to agree to a short sale if the price is reasonable, because the sale avoids the necessity of foreclosing, taking title to the property, and trying to resell it.

However, that leaves open the question of a deficiency. After a short sale that generates only $200,000 for the lender, can the lender then sue the borrower for the $300,000 deficiency?

New Limitation on Short Sale Deficiency Recoveries

Legislation signed by Governor Schwarzenegger yesterday answers that question in the residential lending context, at least to some extent. Effective January 1, 2011, new CCP § 580e will prohibit recovery of a deficiency after a short sale if:

- the obligation in question is a note secured by a *first* deed of trust;
- the property is a dwelling of not more than four units;
- the short sale is made with written consent of the holder of the note; and
- the trustor under the deed of trust (i.e., the borrower) is not a corporation or a political subdivision of the state.

In these circumstances, the new statute will provide that the holder's written consent to the short sale "shall obligate that holder to accept the sale proceeds as full payment and to fully discharge the remaining amount of the indebtedness on the first deed of trust or first mortgage." In other words, the lender can make no further recovery from the borrower on the debt. (However, the new statute does not prevent the holder from suing the borrower for fraud with respect to the sale or waste with respect to the property.)

The new statute is expressly limited to *first* deeds of trust, so it has no application to the holders of junior deeds of trust such as "HELOCs" (Home Equity Lines of Credit). Existing law will continue to govern junior interests. When the junior interest is subject to the anti-deficiency rule discussed next, there may be some uncertainty as to the effect of a short sale and the lender's ability to recover a deficiency, even if the short sale documents so provide.

Vetoed Legislation Regarding Refinancings

Existing CCP § 580b prohibits the recovery of a deficiency after foreclosure on a deed of trust that secures payment of a loan of all or part of the purchase price of a dwelling for not more than four families, occupied in whole or part by the purchaser. Because of this statute, lenders cannot recover deficiencies on residential purchase-money loans in California. (The statute also prohibits recovery of a deficiency after foreclosure of a deed of trust given to the seller of property of any type to secure all or a portion of the purchase price.)

Section 580b is silent on what happens if a purchase-money loan is refinanced. Does the anti-deficiency protection that applied to the original loan carry over to the refinancing loan? Does it depend on whether the refinancing comes from the same lender or a new lender? Does it depend on whether the home owner received any cash in the refinancing? These questions have not been definitively answered by cases interpreting § 580b.

A new rule addressing these questions was passed by the California legislature, but was vetoed yesterday by Governor Schwarzenegger and so will not become law. SB1178 would have provided that for purposes of § 580b's anti-deficiency rule, a loan used to pay all or part of the purchase price of real property "shall include subsequent loans, mortgages, or deeds of trust that refinance or modify the original loan, but only to the extent that the subsequent loan was used to pay debt incurred to purchase the real property." This would have extended the anti-deficiency rule to cover refinancings, whether made by the same lender or a new lender, to the extent that the refinancing loan went to pay the original loan.

This new rule would have become effective June 1, 2011. It would have applied retroactively to loans made before that date, which was very controversial. Governor Schwarzenegger vetoed the legislation for that reason, commenting that "this bill fundamentally alters the nature and impairs the value of previously negotiated contracts, leading to negative consequences for the value of those loans held in a lender's portfolio and a deleterious impact on the secondary market." The veto message also commented that "the bill would encourage borrowers to strategically default on loans they have the capacity to repay simply because the mortgaged properties have lost value."

Contacts

Luce Forward has a team of legal professionals available to answer your questions regarding the rights of lenders, borrowers and guarantors in the myriad of scenarios that can arise in foreclosure, whether involving residential or commercial property.

If you have any questions regarding this topic, please contact:

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