

Deficiency Judgments and California Law

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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).)

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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.)