Foreclosure Law in California and Related Matters

Introduction. Lenders often require that their loans be secured by real property. If the borrower defaults, the lender is entitled to sell the property to pay the borrower's entire debt at once. This act of selling the property to pay the borrower's debt is called a foreclosure: It is the pre-emptive or premature closing of a loan transaction by summary sale of the collateral that secured the loan, with an immediate pay-off of the entire loan obligation from the sale proceeds.

This article aims to provide an overview of the laws on foreclosure proceedings in California and related matters. As it a rather dry subject, your author has tried to enliven it by providing colorful illustrative examples.

A Commonplace Example. Suppose you recently bought a home in the Silicon Valley for, say, $680,000. The home is nothing spectacular at all: It is split-level, and has two bedrooms, one bathroom, a cramped kitchen, a small garage, and a fenced-in tiny backyard that is not large enough for a decent football game for your kids and their friends. But in today's roaring real estate market, you were forced to pay $680,000 for this modest property, which ten years ago very likely would have sold for $250,000, and ten years before that for $70,000 or less.

Those familiar with the Silicon Valley or California generally will know that my above example is by no means an exaggeration. I have personally known people who have paid about as much to get far less (though I have one close friend, whose name I shall withhold to protect him from the fury of the envious, who somehow managed to get a lovely home in the heart of Palo Alto for a mere $360,000!)

So there you have it then: You, who are an ordinary, routine purchaser, have just agreed to pay $680,000 for your ordinary, routine home. Like most purchasers, you must provide a down-payment of 20% of the purchase price, which in this case is $136,000 – a sum that you raised by selling all your stock, emptying your savings account, emptying your wife's saving account, foregoing vacations for the past two years, and getting loans from relatives and in-laws who live in less expensive places and chortle at your struggle to stay alive in the booming new age of California prosperity.

You have thus posted a down-payment of $136,000 and have taken a loan of $544,000 for the remainder of the purchase price. You got the loan from, say, the Wells Fargo Bank. Did the bank give you the loan on the strength your solemn promise "to repay every penny if it's the last thing I ever do"? No, of course not. Did they give you a loan because of your fantastic good looks? Or because the stars were aligned properly when you applied? No. Did they do so in reliance on your future earnings from your employer, which is an unknown dot-com that doesn't provide any useful service and has no visible source of ongoing revenues? Again, the answer is no.

Rather, Wells Fargo (or any other sensible lender) must consider the value of the property that you mean to purchase with the loan, your financial history, your likely ability to pay the loan according to its terms, and other, related criteria.

A Purchase-Money Loan, Defined. Above all, Wells Fargo made the loan to you only on condition that it be secured by your new home, that is, by the very property that the loan was used to purchase. In other words, Wells Fargo made a purchase-money loan – i.e., a loan which is made for the purpose of purchasing a parcel of real estate, and which is secured by the very same parcel. In California, a purchase-money loan is treated as a *non-recourse loan*. If a borrower defaults on a purchase-money loan, the lender's sole recourse as a matter of law is to take title to the property by foreclosure proceedings or some alternative arrangement. When the underlying loan is a purchase-money loan, the lender cannot obtain a "deficiency judgment" from the borrower — i.e., it cannot obtain a personal judgement against the borrower for the difference between the amount owed under the loan and the amount recouped by foreclosure proceedings. This restriction is set forth at Section 580b of the California Code of Civil Procedure. No other kind of loan enjoys this statutory protection.

The all-important statutory definition of a purchase-money loan is as follows. Under Section 580b of the California Code of Civil Procedure, a loan is treated as a purchase-money loan when it is *any* of the following:

1. A promissory note and deed of trust that a buyer gives directly to the seller of a property in exchange for title to the property (or any other debt that a buyer owes directly to a seller under a contract of sale for the purchase of real property).

2. A loan made by a lender to a borrower, which the borrower then applies towards the purchase of a residential property that (1) has no more than four units; and (2) part or all of which the borrower uses as his or her primary residence for the indefinite future. The borrower might not move in immediately after taking the loan, but might instead make allowance for repairs and moving arrangements after making the purchase, but a purchase-money loan by definition is one that the borrower takes in order to buy a property that he or she plans to use as his or her primary residence for the indefinite future. The borrower might later move away from the property. The character of the loan is determined by the circumstances present when the borrower took the loan. Of course, if the borrower intended to live at the property only for a brief period in order to obtain a loan that would then be treated as a purchase-money loan, the loan is likely not a purchase-money loan, since the borrower never had a present intention of residing at the property indefinitely, but only for a brief, finite period. (The law does not provide a clear answer when the borrower purchases a property to use as his primary residence, knowing that he must move away, say, after a few years or even

after a year. I expect that the remedy would be for the borrower to disclose his plans to the lender and to obtain a purchase-money loan made on the express understanding that the borrower plans to move away from the property at the close of a fixed term or upon a condition subsequent.)

3. Any new loan used to refinance a purchase-money loan, but only to the extent that the new loan is used to pay off (defray) the purchase-money loan, plus the transaction costs associated with the new purchase-money loan, but not any additional principal or credit made available to the borrower over and above the amount used to defray the purchase-money debt. This provision is new and of enormous consequence. Practically speaking, it will allow borrowers to obtain new loans secured by their residences without fear of losing the purchase-money protections that they enjoyed before the refinancing. Before this change in the law, a borrower lost his purchase-money protection any time he took a loan to refinance his original purchase-money loan. This sensible revision ends the old, arbitrary distinction.

4. A loan used to purchase both real and personal property that is secured by both, where the loan would have been treated as purchase-money debt if it had been used solely to purchase the real property.

The Loan Agreement. Your loan is explained, or rather obscured, in a confusing series of documents written in impenetrable legalese that Wells Fargo will present to you for signing on a "take-it-or-leave-it-basis". Of course, you will sign. These documents, taken together, constitute a contract, or a loan agreement, between you, who are the borrower, and Wells Fargo, which is the lender.

The loan agreement will include a promissory note, a deed of trust, a disclosure statement that satisfies the "Truth-in-Lending Act" and all other lender disclosure requirements, as well as the other ordinary terms and conditions of a typical purchase-money loan.

Secured Loan Agreements: The Promissory Note and Deed of Trust. The promissory note recites the schedule of payments that you must make to pay off your loan. Typically, you will have monthly payments for twenty-five to thirty years, and your payments will be the same amount each month if the interest charged is at a fixed-rate, but they will differ in amount if the interest is charged at a variable rate (variable-rate loans usually call for the lender to raise or lower the amount of the monthly payment once each year, typically according to a complicated formula that depends upon the rise or fall of a specified index).

Your promissory note, by which you legally obligate yourself to pay Wells Fargo according to the terms recited in the promissory note itself, is secured by the deed of

trust, which is the central document in a foreclosure. If you fail to make the payments scheduled in the promissory note, you will default on the loan, and the lender will become entitled to foreclose the deed of trust, which is a proceeding by which it sells your property, pays off the loan (along with all kinds of unpleasant late fees, penalty fees, foreclosure fees, and attorney's fees), then gives any remaining funds to you or others according to law. The entire procedure is sometimes referred to as foreclosing upon the property, though technically the lender has foreclosed the deed of trust that secures its loan, and by so doing has become authorized to sell your property at a special sale, pay itself your entire loan debt from the sale proceeds, then allot any remainder to you or others according to law.

This concept can be explained in another way. The purchaser buys the property with a down-payment and loan proceeds given by the lender. The purchaser becomes the owner of title to the property, but the lender is authorized to sell the property to pay off the loan if the purchaser fails to make the loan payments. The schedule of loan payments is given in the promissory note, and, if this schedule is not kept, the lender invokes its powers under the deed of trust to sell the property. The selling of your property to satisfy the debt is an act of foreclosure – a premature closing of the entire loan transaction by a liquidation of the asset that secured the loan.

When you acquire the property, you record your ownership of title to it at the recorder's office of the county where the property sits. Likewise, the lender records its deed of trust at the same place. This way everyone in the world is deemed to have constructive notice of (1) your ownership of the property, and (2) the lender's security interest in the property until the loan is paid off. If you pay off the loan, the lender will reconvey the deed of trust to you, and you will record the reconveyance, so that the lender will no longer have a recorded security interest against the property, and you will have an official record of having paid off the loan that you took from the lender.

Pre-Payments and The Usury Laws. To return to our colorful example, you have just acquired title to your $680,000 home, but have given a deed of trust to Wells Fargo, which authorizes it to sell your home if you fail to make the payments called for in the promissory note that you have just made in favor of Wells Fargo (you are the "maker" of the promissory note, and Wells Fargo is its "holder").

If all goes well, you will dutifully pay off the loan according to the schedule of payments set forth in the promissory note, or "note". Or perhaps you will pay the entire loan before you are obliged to do so because you have won the lottery, or, what is much the same thing, you have liquidated your momentarily valuable stock-options. If you defray your loan in advance, it becomes important that the loan agreement not include a pre-payment penalty, which is a special fee that some lenders charge if you are prosperous enough to pay their entire loan before you must do so: In such an arrangement, you are charged extra if you pay late or if you pay early! Wells Fargo and most institutional lenders do not charge pre-payment penalties, but these fees are perfectly legal so long as they are properly disclosed to you in the loan agreement and do not violate California's usury laws, which recite a formula to specify how much interest a lender can lawfully charge on its loans, though the usury laws have many exceptions, exclusions, and special

rules for certain kinds of loans and certain categories of lenders. One type of loan that receives special, indulgent treatment under the usury laws is a loan secured by real property.

No serious lender will ever violate the usury laws, a violation of which will entitle the borrower to avoid paying any interest at all on the loan, and, in the most egregious cases, to more serious remedies as well.

An Obnoxious, All-Too-Commonplace Example. Suppose your boss has an affair with your wife and the two of them fall in love. One day, when you return home, rather than find yourself greeted with the usual barrage of derision and complaints from your wife, you discover that she, the children, and all the belongings are gone. You then read the letter that she has left for you, in which she announces that she and your boss have decided to live openly as a couple, and that you shouldn't bother showing up for work, because you will just be an eyesore and embarrassment if you do so. Naturally, you decide that you will take a long road trip to the Hudson Bay, taking with you a crate of whiskey and your dog, Scooter. You intend to spend a little time with Scooter in the northern hinterlands, where you hope to "sort things out" before returning to start your life anew.

But of course there is the little matter of the "note" – as in, the promissory note that is secured by the deed of trust, which in turn is recorded against your property, which therefore might be sold by your lender to satisfy your obligation under the note. If the lender forecloses the deed of trust, there will be a black mark against your credit when you return. Besides, the foreclosure provides the lender with a perfect opportunity to impose all kinds of late fees, penalties, special surcharges, attorney's fees, and foreclosure fees – all of which will be taken from the proceeds from the sale of your home at the foreclosure sale.

Surrender of Title Deed in Lieu of Foreclosure. Here is your problem. You know that you will inevitably default on the note (because you are headed north to frolic with your dog while drinking whiskey from a crate). But you do not wish to suffer the credit stigma or pay the many fees and extra costs of the inevitable foreclosure. You therefore tell your lender that it needn't bother with the formalities and technical requirements of a foreclosure because you will simply turn over your title to the property, which is called your deed of title, rather than lose it by a foreclosure proceeding. This is called a surrender of title in lieu of foreclosure. Some lenders will sometimes accept the surrender, while others typically refuse to do so, but the matter is often one that can be negotiated.

As with all other debts, the one thing that you must not do is simply ignore the debt, hoping that somehow it will miraculously disappear. Unlike your ex-wife, your debts will not disappear, but rather will increase and involve you in further and further complications until you attend to them.

A surrender of title in lieu of foreclosure suggests to future onlookers that you acted responsibly upon realizing that you would be obliged to default on your note. It is not

nearly as good as paying off the note on time or before it fell due, but it is better than a foreclosure.

To arrange such a surrender, the borrower should probably consult an attorney who has experience handling these kind of matters.

It is also clear that, if a borrower surrenders his deed to the lender, the lender will certainly report the matter to credit rating agencies, and the borrower's credit will be significantly impaired. Even so, a borrower can point to the surrender to indicate that at least he did not simply disregard a mounting debt problem that he could no longer manage.

Foreclosure Proceedings. There are various options that a distressed borrower might wish to consider before submitting to a dreaded foreclosure. Some of these options are discussed below. But suppose that your lender refuses to agree to any of your proposals for a loan modification? Or suppose that you lack the patience right now for humorless exchanges with your lender about a loan modification that you cannot afford? Or suppose the lender proposes only a deed surrender on terms that are unfair and make no sense? Suppose the only short sale in sight is to a dreadful vulture buyer who will likely sue you after buying your property for a miserable pittance?

Perhaps you lack the stamina at the moment for such interactions. No, right now you are a man who must at once escape to the Great North, where you hope to forget your wife's treachery and gain a fresh perspective on things.

If you default on the loan and make no arrangement such as a short-sale or surrender of your title deed, your lender will become entitled to conduct foreclosure proceedings against your property. Remember, the note and deed of trust that you gave to your lender in order to get its loan entitle the lender to foreclose the deed of trust and sell the property in foreclosure if you fail to pay the loan according to the terms stated in the note.

The only question now is whether the lender will conduct a speedy private sale or initiate a much longer proceeding called a judicial foreclosure.

Private Sale or Judicial Proceeding? The foreclosure process can take place in one of two ways. Either the lender will invoke its powers of a private trustee's sale, which are given under the deed of trust, or it will bring a lawsuit for a judicial foreclosure, pleading that it has a deed of trust against the property, that you have defaulted on the loan secured by the deed of trust, and that the Court should therefore order the deed of trust foreclosed and decree that the property be sold to pay off the entire loan debt.

In either event, the lender will send you and all other lienholders written notices of your default on the loan and its intention to conduct a foreclosure unless you cure your arrears and pay all late fees. If the lender fails to do so in the manner prescribed by the foreclosure statutes, it will not be entitled to a foreclosure at all.

A private sale is far faster than a judicial foreclosure: It will happen approximately four to seven months after the lender first gives notice of the default (depending on the loan in question and the diligence of the foreclosure trustee). In contrast, a judicial foreclosure takes as long as any other lawsuit on the regular civil calendar – that is, approximately one year or longer — and a civil litigation entails attorney's fees, procedural complications, and the risk of cross-claims from a desperate or aggrieved borrower who suddenly has every incentive to assert them. A private sale is therefore much better for the lender because it is typically quicker and less expensive to conduct, unless the property lacks sufficient value to pay off the borrower's entire debt. In this one instance, the judicial foreclosure is better because it allows the lender to obtain a personal judgment against the borrower for the outstanding amount owed on the loan after the foreclosure sale. This outstanding amount is called the deficiency, and the judgment against the borrower is called a deficiency judgment. However, a lender cannot obtain a deficiency judgment if the underlying debt arises from "purchase-money loan," which is either a "seller carry-back loan" (see above) or a third-party purchase-money loan for a owner-occupied residential property that has no more than four units (see above).

The matter can be summarized as follows. A lender cannot get a deficiency judgment if it forecloses by private sale, nor can it do so if the underlying loan was a purchase-money loan. Therefore, a lender will choose to sell the property at a private sale if (1) the sales proceeds will pay the entire loan or (2) the loan was a purchase-money loan.

It is often the case that the lender will forgo a judicial foreclosure and use a private sale even if (1) the sale will likely or certainly fail to yield funds sufficient to pay the full debt; and (2) the lender is entitled to a deficiency judgment for the remainder against the borrower. Often the lender will simply prefer the convenience and expediency of a private sale, but this will depend in part on whether it would be profitable for it to pursue the borrower for the likely deficiency, and this depends on the likely amount of the deficiency and the borrower's ability to pay it.

There is an additional advantage to conducting a foreclosure by private sale. The purchaser of property at a private sale will become its owner, save where the defaulted borrower is able to attack the sale on grounds of procedural irregularity or gross lack of fair consideration for the sale. (Moreover, a foreclosing lender cannot claim more from the sales proceeds than what it is strictly entitled to take under the foreclosure statutes.) Generally speaking, the purchaser of a property at a private sale take the property and owns it free and clear of any lien subordinate to the deed of trust under which the foreclosure has been conducted.

In contrast, the purchaser of a property at a judicial foreclosure might be required to sell back the property to the defaulting borrower under the redemption statutes, which entitle the defaulting borrower to redeem his property by paying the foreclosure purchase price to the purchaser at foreclosure (along with redemption fees and related surcharges). For this reason, a property in judicial foreclosure is typically sold at a special discount, which compensates the purchaser for the risk of being forced to sell the property at a specified price to the defaulting borrower under the redemption statutes.

There are thus “pros” and “cons” to each kind of sale. The private sale is far quicker, and gives certain title to the new purchaser, therefore allowing the sales price to be higher, but the lender cannot recover the deficiency for any outstanding balance.

The judicial sale entitles the lender to a deficiency judgment, unless the loan was a purchase-money transaction. At the same time, it entitles the defaulting borrower to redeem his property if he can pay the necessary charges and cure his arrears.

Lastly, a judicial foreclosure is the proper approach when there are several encumbrancers, and dispute has arisen between them as to the priority of their rival liens. In a judicial foreclosure, the court will rule on the order of priority of the competing liens, thereby resolving the dispute.

Our Example Revisited. To return to our lovely example, in which you find yourself driving north to forget your wife’s abandonment and the simultaneous loss of your job under humiliating circumstances, we can now easily apply the above rules. Wells Fargo, having made a purchase-money loan to you, has no interest in convening a judicial foreclosure: It cannot recover any deficiency because the loan was a purchase-money transaction (you used the loan to buy the home). Moreover, the value of your home is so high that Wells Fargo will have its entire loan paid off from the sales proceeds. Moreover, there is no controversy between competing lenders, and therefore no need for any sort of judicial determination of priorities. Wells Fargo will therefore foreclose upon your home by use of a private sale, which will take place 120 days after you first receive a formal notice of your default from Wells Fargo, unless you cure your default in the meantime, or, failing this, convince Wells Fargo to accept your title deed in lieu of foreclosure.

But suppose you encumbered the property not only with the Wells Fargo loan, but also with a second loan from Second Place Loans, Inc., which made a loan to you of $100,000 and secured it by a deed of trust, which was second in priority, after Wells Fargo’s deed of trust. In this case, Wells Fargo is said to hold the first deed of trust, and Second Place Loans, Inc. is said to hold the second deed of trust.

If you default on the Wells Fargo debt, and Wells Fargo forecloses, the foreclosure will have the effect of extinguishing Second Place’s deed of trust: The foreclosure of a senior lien always has the effect of extinguishing all junior liens. In this event, Second Place will no longer be your secured creditor, but will find that it is merely an unsecured creditor for its entire loan in the exact same manner as, say, Visa is your unsecured creditor for credit-card charges that you have made but not yet paid. Second Place will therefore not allow Wells Fargo to foreclose; it will “cure” your arrears to Wells Fargo rather than suffer the loss of its security, and will make these payments part of your obligation to Second Place; if you fail to meet this obligation, Second Place will foreclose its second deed of trust, and most likely it will use a private sale to conduct its foreclosure, since this is the quickest way to have the property sold and your debt paid.

But suppose the value of the property falls significantly after you take the loan from Second Place. In this instance, Second Place might decide that it is better to conduct a

judicial foreclosure, so that after the property is sold it can obtain a judgment against you for the outstanding amount still owed after the sale. Unlike Wells Fargo, Second Place did not make a purchase-money loan to you, and therefore it is entitled to a deficiency judgment if there is a shortfall after the foreclosure sale.

Remember, if the lender uses a private sale, it can only recover the proceeds from the sale of the property, but cannot otherwise recover a penny more of the debt that the borrower might still owe even after the foreclosure sale. But in a judicial foreclosure, the lender is entitled to a deficiency judgment against the borrower for any outstanding amount still owed after the sale of the property. Therefore, a lender might wish to use a judicial foreclosure, despite the long delay that it entails, if there will likely be a significant debt owed on the loan even after the foreclosure, since at a private sale the lender waives this outstanding amount (or "deficiency"), but at a judicial foreclosure the lender gets the foreclosure proceeds, plus a personal judgment against the borrower for any deficiency, so long as the loan was not a purchase-money loan.

Let us again consider that accursed home that you unwisely purchased in the Silicon Valley when you still loved your ex-wife and loyally reported to your ex-boss every day. You will recall that you paid $680,000 for it by making a down-payment of $136,000 and using a Wells Fargo loan of $544,000. Suppose that the foreclosure happens five years later – after you have paid down the loan to, say, $525,000 (typically, you pay mostly interest during the early years of loan repayment, then begin to retire principal more and more quickly as your repayment continues). Suppose that the fair-market value of the home has since risen to, say, $800,000.

You have also taken the second loan for $100,000 from Second Place. You therefore hold $175,000 of equity in the Property – that is, the $800,000 value of the property, less the Wells Fargo encumbrance of $525,000, less the Second Place encumbrance of $100,000.

If you default on the Wells Fargo note but not on the Second Place note, Second Place will cure the Wells Fargo arrears and charge you for it (otherwise, Wells Fargo will foreclose, thereby extinguishing Second Place's second deed of trust). If you fail to pay Second Place for its "service" of curing the Wells Fargo arrears, it will foreclose on the second deed. It will do so by private sale, since the property has enough value to support its lien: A purchaser will pay at least $100,000 to buy the property with the Wells Fargo encumbrance of $525,000. Indeed, a sensible purchaser will be willing to pay up to $200,000 – $250,000 to buy the $800,000 property with the $525,000 encumbrance. In this instance, $100,000 and fees price goes to Second Place, and the remainder, which is called the surplus, is disbursed to junior lienholders in order of priority, with the remainder to you (in our example, there are no such junior lienholders, and therefore the entire surplus would be remitted to you).

But if real estate prices have tumbled since Second Place made its loan, it might elect to conduct a judicial foreclosure, even though it will take a long time to be done, and even though the sales price will be a little lower to account for the defaulting borrower's right

of statutory redemption: After the judicial foreclosure, Second Place will receive a judgment against you personally for the outstanding balance.

Say that real estate prices have fallen dramatically: The country has been dragged into a catastrophic depression, and your home is no longer worth $800,000, but rather is worth only $200,000. In this instance, Second Place will conduct the judicial foreclosure, since no one will pay $100,000 (plus the surcharge for curing the Wells Fargo debt) to acquire a $200,000 property that is encumbered by a $525,000 purchase-money loan. After the judicial foreclosure, Second Place will have a deficiency judgment against you for the outstanding amount owed on your obligation.

If you never took a second loan, but merely owe $525,000 to Wells Fargo at the time of foreclosure, Wells Fargo will perform the foreclosure by a private sale, even if the value of the property has fallen far below the amount of the debt, since there can be no deficiency judgment on a purchase-money loan. The rationale for this should by now be clear: If there is a general collapse of the economy, a simple homeowner who borrowed only to purchase his home should not be forever undone by a deficiency judgment for the balance of his loan; his loss should be limited only to the loss of his home, unless he has taken additional loans against it after acquiring title.

The One-Action Rule. In addition to all the foregoing, there is the one-action rule, which requires the lender in a secured loan transaction to foreclose on the real property before seeking to recover the debt from the borrower by any other means, save where the property has become worthless to the lender as a practical matter or where the lender's lien has been extinguished by a prior foreclosure of a senior lien. Unless one of these two exceptions apply, the lender must recover the loan obligation by foreclosing on the property, and cannot use other judicial or even quasi-judicial proceedings in effort to collect the debt: The lender is limited to a foreclosure (a quick private sale or a judicial foreclosure along with a deficiency judgment). This is the one authorized action that a secured lender may properly take, and the entire concept is referred to as the one-action rule. If the lender violates the rule, it might find itself unable to proceed against the borrower at all, or at best it will become an unsecured creditor.

The one-action rule does not apply to claims of fraud that the lender might assert against the borrower, say, for having provided misleading information on his loan application.

Practically speaking, secured lenders who know their business always look first to recover the property by foreclosure, and if they wish to obtain something else from the borrower they conduct a judicial foreclosure and seek a deficiency judgment, and when so doing they have the prerogative to assert claims for fraud against the borrower.

What It All Means. If you find yourself hopelessly confused by all of this, do not despair. The law on foreclosures in California are perplexing and counter-intuitive even to attorneys who specialize in real estate matters. It is easiest to understand the laws if you grasp their underlying principles, which are as follows:

1. No borrower should be forever ruined, or plunged into insuperable debt, merely because he took a single loan to buy a property whose market value later collapsed during a general downturn in real estate values. This explains the one-action rule and the prohibition on deficiency judgments in purchase-money foreclosures: If the borrower defaults, he loses his property to the foreclosing lender, but nothing else. But this also explains why lenders insist upon a substantial down-payment before they will loan money for the purchase of real estate: The lender wants to ensure that the borrower truly has a stake in preserving his title to the property. (Lenders obviously stopped observing this practice during the recent subprime boom, and now the birds have come home to roost!)

2. If the borrower takes a loan for purposes other than the purchase of a property, and he later defaults on the loan, the lender must first foreclose upon the property to satisfy the debt, but can thereafter obtain a deficiency judgment for the balance of the loan. But any such deficiency can be recovered only if the lender uses a judicial foreclosure rather than a private sale. *Moreover, after the recent revision of Section 580b of the California Code of Civil Procedure, a lender cannot obtain a deficiency judgment to recoup either any part of a refinancing loan used to defray purchase-money debt or the transaction costs used to obtain a refinancing loan that was used at least in part to defray purchase-money debt*. If the lender pursues a judicial foreclosure, the borrower will have the redemption right to buy the property from the purchaser at the foreclosure sale. If the lender uses a private sale, it cannot obtain a deficiency, nor can the borrower redeem the property after the sale. If the lender tries to circumvent all of this, it might find itself barred under the one-action rule from recovering any part of the debt from the borrower, or at best its secured debt will become an unsecured one.
3. A junior lien is extinguished by the foreclosure of a senior lien, but no foreclosure may take place without written notice in the statutory manner to the borrower as well as to all lienholders, who therefore have occasion to cure the default of the senior lien before it is foreclosed.

4. A borrower can slightly mitigate the harm to his credit report and avoid certain foreclosure fees by surrendering his title in lieu of losing it in a foreclosure proceeding. A surrender of the deed at least suggests that the borrower sought to act responsibly when confronted with his inability to pay the loan, but many lenders make the process complicated and use it to (1) force the borrower to continue to make

payments on the doomed loan while the request is administered; and (2) determine whether the borrower of a non-purchase-money loan has sufficient means to pay a deficiency. Even so, a defaulting borrower should think twice before deciding to squat in his property until his lender forecloses. This is often a fool's bargain: The borrower gains a short period of free rent, but the ensuing foreclosure is then listed on his record, harming his credit and good name for many years. Yet again, a surrender of the deed also entails significant harm to the borrower's credit, but there is no public record of a foreclosure. Sometimes deliberate squatting is the last best option. Each case turns on its own facts.

Certain Comments on the Foreclosure Crisis/Mortgage Market Crisis of 2007-11 (Added at intervals from 2008 to 2011). As most readers of this article understand only too well, there has been an extraordinary surge in foreclosures since early 2007. I therefore turn my attention briefly to certain topics that anxious lenders and troubled borrowers might wish to understand better in these troubled times.

These matters are as follows: Short-sales, deed surrenders, bankruptcy relief, relief for IndyMac borrowers, and the recent landmark housing legislation enacted by the federal government. My comments on each of these matters are brief and introductory in nature.

Short Sales, Surrendering the Deed, and Walking Away. Sometimes property values lose substantial value over time. This can happen in a particular region that suffers from local problems that afflict the local housing market. As we have recently seen, it can also happen across the entire country at the same time: The national drop in prices that occurred across all markets from 2007 to 2011 showed that property values across the country had been over-estimated and did not properly reflect the fundamentals of the properties in question (i.e., the ratios between property prices and rental values were excessively high, as were the ratios between property prices in given locations and the average incomes of the people in these locations who might wish to purchase the properties, etc).

If there has been a local or national collapse of property values, as has recently occurred, many borrowers might find themselves burdened with loans that exceed the dwindling value of their properties.

Some might decide that the struggle is not worth the effort. They will wish to renounce ownership and the accompanying burden of paying the loan. Others might not have a meaningful choice, if they have taken a variable-rate loan that has become unaffordable or if they have suffered a loss of income (many borrowers have lost income, have seen their interest rate "re-set" at an unaffordable price, and have seen the value of their properties fall well below the amount owed on their unaffordable loan).

These circumstances are discouraging and have imposed anxiety and suffering on countless households during the past few years. The hapless anti-hero of my foreclosure story is not the only one to face the loss of his home under the foreclosure laws. Here are a few comments in passing about different options that a distressed borrower might wish to consider when keeping current on the loan is no longer possible or is not worth the effort.

A purchase-money borrower in particular should have no qualms about considering these different options. The bargain between a lender and a purchase-money borrower in California is that, if the borrower defaults, the lender's sole recourse will be to foreclose on the property. The lender understood this point when agreeing to make the loan. It is an essential condition of the transaction, imposed by the laws of California.

The first option to consider is obtaining a loan modification or a refinancing of the loan on more favorable terms. A modification alters the terms of the existing loan. A refinancing loan is an entirely new loan on different terms. A borrower should not lightly re-finance a purchase-money loan, since the new loan will not be a purchase-money loan, and borrower will become exposed to personal liability for any "deficiency" owed under the refinanced loan.

Another option, mentioned in passing above, is to surrender the deed in lieu of foreclosure (i.e., turn over title to the lender, sparing the necessity of foreclosure proceedings). This requires a negotiation with the lender, or perhaps simultaneous negotiations with more than one lender. The success and terms of the endeavor critically depend on whether the loan or loans are purchase-money loans. Lenders often try to require the borrower to sign a promissory note in exchange for agreeing to accept the surrender. A purchase-money borrower has little incentive to give such a note. The details of these negotiations can be tricky.

Another option is to "walk-away", or simply allow the foreclosure process to run its course. ("Walk-away" is a curious term for this approach, since the distressed borrower typically chooses to "walk away" from the obligation by staying put at the property while paying nothing until being forced to leave!).

Still another option is to attempt to negotiate a short-sale. A short-sale is the sale of the property for less than is owed on the loan, done with the lender's approval, so that the lender removes its lien against the property upon the sale and releases the borrower from further liability. Section 580e of the California Code of Civil Procedure, which is a new provision, clarifies that after such a sale no deficiency will lie as a matter of right against the borrower. Short-sales require the lender to agree in advance to the arrangement. But lenders sometimes propose that the would-be short-seller agree to sign a promissory note in exchange for the lender's consent to the short sale, so as to avoid the anti-deficiency provisions of Section 580e. Such an arrangement has dubious value if the borrower's underlying loan is purchase-money debt. If the borrower has more than one lender or other encumbrancers, he usually must negotiate an arrangement that satisfies all of his lenders and encumbrancers. If a short-sale is done

with the lender's approval and is not accompanied by any new obligation, such as a promissory note, it is entitled to the anti-deficiency protections of Section 580e.

When considering these different alternatives, there is another key consideration: Does the borrower wish to qualify for another home loan in the foreseeable future? These days most borrowers cannot obtain a home loan unless the loan is underwritten by Freddie Mac or Fannie Mae, which are two government-sponsored entities that re-purchase and guarantee most of the home loans made in today's mortgage markets. These two entities take a very dim view of borrowers who simply allow a foreclosure to happen. Their policies on the matter are as follows: If a borrower allows a foreclosure to occur, he will not be eligible for a loan underwritten by Freddie Mac or Fannie Mae for the next five years. If however there are extenuating circumstances (e.g., catastrophic illness), Freddie Mac or Fannie Mae may agree to underwrite a new home loan three years after the foreclosure. For deeds in lieu of foreclosure, the time periods are somewhat shorter: Four years for an ordinary surrender, and two years when there are extenuating circumstances. For short sales, however, the time period is always two years. (These time periods are subject to change, so you should check the latest credit guidelines posted by Freddie Mac or Fannie Mae.)

This in turn means the following. For all practical purposes, a distressed borrower who "walks away" cannot qualify for a new home loan for at least three years and possibly not for five years, and if he surrenders his deed he cannot qualify for at least two years and possibly for as long as four years. But if he negotiates a short sale, he can qualify two years after the unhappy event. (Obviously, whether a borrower can qualify for a new home loan will also depend upon his overall credit situation when he applies for a new loan.)

Before deciding which alternative to pursue, it is always necessary to consider the possibility of a deficiency judgment. "Walking away", or allowing a foreclosure to occur, might be a poor option if the loan is not a purchase-money loan. Where the loan is not a purchase-money loan, the lender can seek a "deficiency judgment" against the borrower for the difference between the foreclosure proceeds and the final arrears owed under the loan. To obtain such a "deficiency judgment", the lender must prosecute a judicial foreclosure (see above)..

To avoid a deficiency judgment, the borrower of a full-recourse loan (non purchase-money loan) must either (1) await confirmation that the lender will choose to conduct a trustee sale and thereby waive its right to a deficiency or, (2) try to negotiate a loan modification, a loan refinancing, a surrender of the deed, or a short sale.

Short-sales, however, have their own disadvantages. The seller of a property owes certain obligations to the buyer: These obligations are imposed by the disclosure statutes, other statutes, and the contract of sale. In contrast, a defaulted borrower does not owe these obligations to his foreclosing lender.

A borrower who contemplates negotiating a short-sale should work with an experienced real estate broker or real estate attorney to make certain that the matter is properly conducted.

Bankruptcy Relief. Bankruptcy proceedings can offer specific, limited relief to a distressed borrower who cannot manage his home loan or loans. (By the term "home loan," I refer to any loan that is secured by a deed of trust or mortgage recorded against the primary residence of the borrower.) To consider the intersection of bankruptcy law and foreclosure law, it is necessary to consider the following points:

Bankruptcy Proceedings. "Bankruptcy" refers to the various proceedings conducted in the United States Bankruptcy Courts, which sit in the various federal judicial districts located across the United States. These courts conduct their proceedings in accordance with "bankruptcy law" – i.e., the United States Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, applicable federal case law, various local bankruptcy rules, and in some instances applicable state case law.

The Automatic Bankruptcy Stay. A borrower who seeks relief in bankruptcy is called a "debtor." As soon as a debtor files a petition for bankruptcy relief, all creditor actions against the debtor are automatically stayed by operation of law and in accordance with Section 362 of the United States Bankruptcy Code. This means that any foreclosure proceeding is automatically stayed if the borrower files a petition for relief in his local United States Bankruptcy Court.

No Modification of Home Loans in Bankruptcy Court. Of critical importance, the bankruptcy courts cannot modify a deed of trust or mortgage that secures a home loan: The underlying debt can be discharged, but if the lender can salvage part or all of its loan by foreclosing on the property, it will typically be given relief from the bankruptcy stay in order to conduct a foreclosure sale, and even if it does not obtain this relief, it will be treated as a secured creditor who can conduct the sale under the auspices of the bankruptcy court.

Limited Relief Under Chapter 13. If a borrower is in arrears on a home loan, and if he is otherwise eligible for relief, he can file a petition for relief under Chapter 13 of the United States Bankruptcy Code, asking the local bankruptcy court to approve of a proposed "reorganization" of his debt. His plan must provide that he will make all future monthly payments owed on his home loan or home loans, and his plan must also propose to cure any arrears on the loan or loans by making specified payments over time. By filing for this relief, the borrower can stop foreclosure proceedings, but only if (1) he can make all new monthly payments in full, (2) is otherwise eligible for relief under Chapter 13 relief, and (3) proposes to pay the outstanding arrears over time. This is a complicated matter, as relief under Chapter 13 has many eligibility requirements and is governed by various specific procedural and substantive requirements. You may wish to refer to our article on bankruptcy.

Lien-Stripping: Avoiding Worthless Junior Liens. A debtor in bankruptcy can rid himself of junior deeds of trust. It is a procedure called "lien stripping," and it works as

follows. If a debtor in a Chapter 11 or Chapter 13 proceeding owes a home loan secured by a deed of trust in junior position, he can have the deed of trust voided upon showing that it is worthless: To do so, he must bring a "Lamb motion" in order to establish that the current fair-market value of the home is insufficient to support any part of the deed of trust – in which case the bankruptcy court will declare the deed worthless and voided. The debtor can then treat the underlying loan as an unsecured, non-priority debt in his plan of reorganization. "Lien-stripping" is not available in Chapter 7 proceedings. The necessary prerequisite to "lien-stripping" is a clear showing that the junior deed of trust is wholly unsecured and therefore worthless. If granted, the lien-stripping takes effect only upon the debtor's discharge, which in turn is given only after the confirmation and subsequent performance of his plan of reorganization.

Lenders Can Obtain Relief From the Automatic Bankruptcy Stay. A home-loan lender can obtain relief from the automatic bankruptcy stay in order to conduct foreclosure proceedings upon a showing that (1) the debtor has no equity in the property, and (2) the administration of the property is not necessary to the debtor's proposed reorganization. This relief is afforded by Section 362 (d) (2) of the United States Bankruptcy Code. Since Chapter 7 cases by definition do not entail a reorganization, a lender can routinely obtain relief in Chapter 7 proceedings upon a sufficient showing that the debtor lacks any equity in the property – a point that can often be deduced from the debtor's own bankruptcy schedules. If however the lender cannot make this showing, it will be treated as a secured creditor in the bankruptcy, and as such the lender can sell the asset and obtain its relief under the auspices of the bankruptcy court. In Chapter 13 cases, the lender's relief from the bankruptcy stay will turn on the issue of equity and on the additional issue of whether the borrower proposes a plan under which he keeps current on all future payments and pays down the arrears over time. The plan must otherwise meet the requirements of Chapter 13. If the lender cannot obtain relief from the stay in a Chapter 13 proceeding, it will be treated as a secured creditor, and it can either sell the asset in bankruptcy or receive full monthly payments and eventual payment of the arrears in accordance with the debtor's plan.

A home-loan lender can also obtain relief from the bankruptcy stay "for cause" upon making a proper showing under Section 362 (d) (1) of the United States Bankruptcy Code. One such ground is if the borrower has failed to maintain adequate property insurance on his home. Another ground is that the property lacks a sufficient "equity cushion" – i.e., sufficient equity to provide full security for the loan. If however the loan has become completely unsecured, an otherwise eligible borrower can remove the deed of trust in a Chapter 11 or 13 proceeding by means of "lien-stripping" (see above).

A home-loan lender can also obtain relief from the bankruptcy stay if the debtor has initiated successive bankruptcy filings in effort to delay foreclosure proceedings, but otherwise without proper bankruptcy objectives that he reasonably can accomplish by his proceedings. This relief is afforded by Section 326 (d) (4) of the United States Bankruptcy Code.

Bankruptcy Reform Unlikely. One proposal that was earlier floated in Congress was the offer of loan modifications in bankruptcy for distressed homeowners who cannot handle

their mortgage payments. Such legislation, whose enactment appears highly unlikely, would have authorized the bankruptcy courts to (1) modify loans secured by primary-residence properties; and (2) do so even when the loan has been securitized and has many different owners. At present this relief is not available: The current bankruptcy laws do not permit a bankruptcy court to modify an obligation secured by the borrower's primary residence: The debt itself can be reorganized or discharged, but only to the extent that it is not secured by the home residence, so that bankruptcy law cannot protect a homeowner from foreclosure, save as described above (limited relief under Chapter 13 and lien-stripping).

Consult an Attorney for Bankruptcies. Bankruptcies are complicated, highly technical matters that must take into account the entire financial condition of the debtor. Be certain to consult a bankruptcy attorney if you are contemplating bankruptcy relief. You may also wish to see our article on bankruptcy law.

Government-Sponsored Loan Modifications/Private Loan Negotiations. The Obama Administration has put into place programs under which distressed borrowers can qualify for loan modifications and refinancing of their existing loans. A loan can be modified by one or more of the following means: (1) a lowering of the interest rate; (2) a reduction in the amount of loan principal; and/or (3) an extension of the term of loan, possibly with periods of forbearance on collecting the loan. There is abundant information at other websites about the particulars of these government programs. The official government website for these programs is located at this link.

Moreover, the California Legislature now requires lenders to attempt to negotiate a loan modification before foreclosing on broad categories of loans secured by primary residences. There has also been a mandatory extension of the statutory waiting period before a non-judicial foreclosure can proceed against certain broad categories of such loans.

In addition, an enterprising borrower might be able to persuade his lender to agree to a modification all on his own and even in the absence of any public subsidy or public coercion. The task has been trickier than anticipated because (1) lenders have been averse to acknowledging write-downs on the value of their assets, which include their loans to distressed borrowers who cannot pay a dime; and (2) many or most of these loans have been "securitized" and sold to countless, nameless investors across the world, so that the servicer of the loan is unable or unwilling to make an agreement that might be objectionable to one or more classes of investors who have a stake in the loan. The Obama Administration has attempted to address this matter, but so far with very uneven, middling success.

["Securitization" of home mortages, which in theory was supposed to make home loans more readily available to a larger number while spreading the risk of default, has in practice proven a ruinous double-edged sword that favors only those who earn quick commissions at source or upon re-sale: Many of these loans were (1) made to wishful, credulous borrowers who could not afford them; and then (2) placed in "pools" of loans, against which fancy investment banks sold bonds to wishful, credulous investors who

since then have lost their principal! This writer favors three clear remedies: Force the primary lender to bear part of the risk of the loan rather than act as a glorified loan broker; force banks to maintain more capital reserves during "boom periods", but less during "bust periods"; and return to a clear segregation of deposit banks and trader/investment banks, so that deposit banks can serve as the necessary financial conduits for our society and enjoy public insurance, while investment banks can enjoy as much risk as they can convince others to allow them to take, but if their risks prove foolish, they will have to fend for themselves without any public assistance at all. These are simple remedies, and they will work. The same "wizards" who involved us all in this mess are now the ones who say that things are too "complicated" for such measures. The only thing that is too complicated are the dizzying explanations that the financial wizards offer for irresponsible, casino-style manipulations that do not further the proper aims of high finance -- the organization of capital, the protection and productive investment of capital, and the lending of capital to those who wish to put it to productive use, etc. But I digress.]

IndyMac Loans. If you are the borrower of a loan made by the failed IndyMac bank, which is now under the control of the Federal Deposit Insurance Corporation ("FDIC"), you are likely eligible for a modification of the terms of your loan agreement. This program, which became known to the public on August 21, 2008, might in turn become a model program that the federal government might use to help other struggling borrowers or that it will at least use when administering loans made by other banks that fail before the present financial crisis runs its course.

Federal Housing Legislation. In July, 2008, the federal government enacted significant housing legislation. This legislation has been modified by the Obama Adminstration programs. Among other things, this legislation does the following:

Provides federal loan guarantees for troubled loans: A willing lender can now obtain federal loan guarantees of its troubled purchase-money loans. The lender must agree to (1) write down the principal owed on the loan to 87% of current market value, and (2) charge permitted interest at a fixed rate. This is a complicated program that will be administered by the Federal Housing Authority. It makes the federal government a prospective guarantor of a large part of the purchase-money loans made in recent years.

Provides explicit support to Freddie Mac and Fannie Mae. In the end the federal government has made good on its implicit promise to guarantee the obligations of these two government-sponsored entities, which re-purchase or guarantee certain kinds of purchase-money loans. At present these two firms hold or or have guaranteed more than $5 trillion of mortgage debt. The U.S. government has long given an implicit guarantee of this debt. The guarantee has become explicit, subject to various qualifications and mechanisms. This means that U.S. taxpayers have agreed to foot the bill for their possible losses. The repercussions might prove enormous. Federal intervention was surely necessary, and if it succeeds it will have saved the financial system from a ruinous collapse of confidence and funding. This is a very complicated matter that I have not even begun to explain in this brief note.

Provides housing funds to local government agencies. These agencies will use these funds to purchase foreclosed and distressed properties on specified terms and conditions.

This legislation was breathtaking in its scope, but not in its subsequent application, at least so far. Until now it has not received as much attention as its scope and significance would suggest it requires. If this legislation succeeds in its aims, it will help to alleviate the current crisis and restore long-term confidence in the housing and mortgage markets. It means however that the federal government has assumed enormous risks and obligations.

Treasury Authority. The Department of Treasury has obtained authority from Congress to expend as much as $700 billion to protect the financial system from systemic collapse. Under this program, the Treasury Department has authority to provide certain kinds of assistance to distressed homeowners who are confronted with foreclosure. The incoming Obama Administration has announced that it will direct the Treasury Department to avail itself of this authority to provide this relief in certain kinds of cases.

Tax Consequences of Forgiven Debt. A borrower might find himself relieved of part of his debt obligation to a lender because of a modification, re-financing, short-sale, deed surrender, foreclosure of a purchase-money loan , or non-judicial foreclosure of any secured loan. This borrower might have certain tax liabilities that are imposed against the forgiven debt: The forgiven debt can be treated as taxable income. Any such borrower should confer with his accountant or attorney about the tax consequences arising from the forgiveness of his debt.

Each of these different options deserves a separate article of its own, as does the topic of the mass-scale securitization of home loans. I have merely referred to certain important points in passing.

Conclusion. I certainly hope that none of my readers ever undergo the indignity of a faithless wife, a conniving boss, or a foreclosure of overpriced real estate that was an insufferable burden all along. If you are a secured lender, I hope you never lose your loan for having failed to follow the foreclosure rules. Lastly, I hope that this short article has provided a useful overview of California's bewildering foreclosure laws, but of course you must not deem this as legal advice, as this is merely an article that I have published for general circulation, not specific advice intended for a client.
