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A Legal View: The Protection of California's Antideficiency Law Depends Upon the Lenders and the Type of Loans

by Craig B. Forry, Esq.

Q: I obtained a loan to purchase my single family residence in 2002 from Bank 1, and then I obtained a line of credit secured by a second deed of trust on my residence in 2005 from Bank 2. Although I remain employed, the value of my property is less than the amount I owe on both loans and I have stopped paying the mortgages. If Bank 1 forecloses on its loan to me, will I still be liable for the amount I owe to Bank 2 on its loan?

A: A determination regarding whether a borrower remains liable for a debt secured by real property depends upon whether the California antideficiency statutes provide protection from a deficiency judgment. A deficiency judgment is a personal money judgment against the debtor for the difference between the price realized for the secured property at a foreclosure sale, and the balance remaining on the deed of trust being foreclosed and any other loans on the property.

Buyers of real property should always be concerned whether the particular kind of financing they obtain that is secured by their real property will be subject to a deficiency judgment because if the loan does not have antideficiency protection, the borrower can be exposed to personal liability on the loan obligation after a foreclosure of the security. More than one loan secured by the same real property creates more complexity in determining the liability of the borrower to the respective lenders.

The antideficiency law applies to any purchase money loan, and it bars a deficiency judgment after a judicial or nonjudicial foreclosure. Most foreclosures are nonjudicial, and a lawsuit is required to obtain a judicial foreclosure. The law requires the purchase money lender to assume the risk that the security is inadequate. For example, if a lender could make a loan for an amount that is far in excess of the fair market value of the property and then after foreclosure obtain a deficiency judgment against the borrower for the amount remaining on the loan after deducting the amount received from the foreclosure sale, it would encourage the sale of real property for a price in excess of its reasonable value at the risk of the borrower, even though the lender is more sophisticated to evaluate the risk.

Although the purchase money loan is the most commonly recognized type of loan subject to the antideficiency law, it is not always a simple task to determine whether the antidificiency law applies. The facts and circumstances that exist when the debt is created determine whether it is a purchase money loan and a legal analysis may be required.

Once determined to be a purchase money debt, the obligation may retain that character and the protection after a refinance, but this normally requires that the new note and trust deed are substantially the same debt as the prior note secured by the same property from the same lender. A purchase money debt is a deed of trust given to a lender to secure repayment of a loan used to pay all or part of the purchase price of a residence of four or fewer units, with at least one of the units occupied by the borrower. The typical example is a single family residence that is occupied by the borrower.

A seller financed loan (e.g., seller agrees to act as the lender) for any kind of real property, including commercial or residential, is also considered a purchase money loan protected by the antideficiency law. The benefits of the antideficiency law cannot be waived by the debtor at the time the loan is made or renewed. However, if a refinance is made by a new lender, it is likely that the new loan will not be considered a purchase money loan.

Furthermore, a second loan obtained after the residence has been purchased, is a non-purchase money loan with no protection from a deficiency judgment. The most typical example is a sold-out junior lien holder whose security has been lost because of the foreclosure of the senior lien. Such a sold-out junior lien holder is permitted to sue directly on its note, after the security is lost because of the foreclosure of the senior lien.

Even if the antideficiency statutes apply, they do not protect debtors from liability for "bad faith waste" resulting from their failure to properly maintain the property. Whether there is bad faith waste is dependent upon the circumstances and includes reckless, intentional or malicious despoiling of property, and not neglect due to the owner's financial inability to properly maintain the property. Therefore, even if the borrower would be protected by the antideficiency statute, the protection can be lost to the extent the borrower has engaged in bad faith waste that decreases the value of the property.

California's antideficiency statutes have been given "broad and liberal construction" to effect their purposes. The purposes of the antideficiency law are to prevent a multiplicity of actions (foreclosure and then a lawsuit), an overvaluation of the security by the lender, aggravation of an economic recession that would likely occur if debtors lost their property to foreclosure and then were also burdened with personal liability, and lenders from making an unreasonably low bid at the foreclosure sale, acquiring the security below its value, and then recovering a personal judgment against the debtor.

In general, there can be but one form of action for the recovery of any debt or the enforcement of any right secured by a mortgage on real property, and that form of action is foreclosure of the security. This rule compels the secured lender, in a single action, to exhaust his security judicially before he may obtain a monetary "deficiency" judgment against the debtor.

The one action rule applies to any proceeding or action by the lender for recovery of the debt, or enforcement of any right, secured by a mortgage or deed of trust. The rule is violated when a secured lender sues to recover a personal money judgment against the debtor without first foreclosing all of its security.

However, the one action rule does not bar a junior lienholder (e.g., second or third deed of trust) from suing the borrower directly after the security has been extinguished by foreclosure of the senior lien. The premise of this rule is that the junior lienholder's right to recover should not be controlled by the whim of the senior lienholder.

The sold-out junior lienholder exception does not apply where the same lender holds both the senior and junior liens (e.g., purchase money loan and line of credit). In other words, a lender holding two successive trust deed liens cannot properly characterize itself a sold out junior lienholder by foreclosing on the senior lien because it is holder of both liens.

Therefore, it appears from the question that the loan made by Bank 2 is not subject to the antideficiency law or the one action rule, and after the foreclosure, Bank 2 can sue on its note and if it obtains a judgment, garnish the borrower's wages to collect the judgment. Because a short sale requires the approval of both lenders, it is not an option if Bank 2 does not agree to a short sale. The result would have been different if the second loan was a line of credit from Bank 1 because it would not be a bona fide sold-out junior lien holder. Therefore, careful thought should always be given when loans are obtained that are secured by a residence to reserve the full protection of the antideficiency law and the one action rule.

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