

POST-FORECLOSURE LIABILITY FOR MORTGAGE DEBT

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The last several years have seen a drastic increase in the number of foreclosures. Even though 2010 is on track to have the largest number of foreclosures in recent California history, there have been boom and bust cycles for land (and land speculation) in California for a long time. One of the main problems that many people face in foreclosure is that the land is worth less than the amount that they owe on it. This raises the question as to whether the owner should be liable for the difference between the fair market value of the land at the time of foreclosure and the outstanding debt on it. If the amount owed is a “purchase money” loan, meaning the loan proceeds were used to actually purchase the land, then - in almost all instances - the answer is that the owner will not be liable for the difference.

As a result of the Great Depression, the California legislature passed California Code of Civil Procedure Section 580b, which states:

“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.”

The key elements to obtain protection under Section 580b are as follows: (i) the loan was used to purchase the property; (ii) the loan is secured by the property that was purchased; and (iii) the property is residential property for four families or less. If a borrower meets these criteria and the lender forecloses on the property, then the borrower will not be liable for any deficiency.

The legislature’s reasons for enacting Section 580b are as follows: (i) it discourage speculative land transactions by preventing overvaluing the property by sellers and lenders; (ii) it places the risk of inadequate security on the lender because the lender is theoretically in a better position to evaluate the risk; and (iii) if the security becomes devalued below the loan balance (e.g. negative equity) and the borrower loses the property, the borrower is not placed in an even worse position by still owing the deficiency to the lender. Based upon these reasons, the legislature enacted Section 580b to protect homeowners that lose their property in foreclosure.

Over the course of many years, the courts have liberally applied the protection of Section 580b to a variety of real estate transactions. Courts have expanded the interpretation of Section 580b to

apply to any real property purchase (including vacant land and commercial properties) and not just single family residences. Courts give great deference to the protections provided by Section 580b and are quite hesitant to remove them and to hold a homeowner liable for the deficiency.

Certain cases have come before California courts that have resulted in the courts carving out certain exceptions to the protection provided by Section 580b. The first exception is for a purchase loan that is subordinated to a construction loan. This situation arises when a seller finances the sale of property to a buyer (e.g. the seller carries back financing) and agrees that it will subordinate its loan to a larger construction loan. The court carved out this exception because the seller has no control over what the buyer builds on the property and whether the buyer is going to stay current with the construction loan. Since the seller has little or no control to ensure that the property retains its value in order to satisfy the seller's carry-back financing, the courts have removed the Section 580b protection in this transaction.

There is also an exception if the seller refinances the original purchase money loan with a new loan of greater value. Since part of the new loan proceeds are used to pay off the original loan but the remaining loan proceeds are used for some other purpose, then the courts do not consider this to be a purchase money loan and there is no Section 580b protection.

There is some uncertainty as to whether refinancing a loan for the current outstanding balance (and not taking out any additional loan proceeds) will still be considered a purchase money loan. If the loan refinancing is with the original lender (e.g. with the same bank or with the original seller), then the courts have said that the new loan will keep the purchase money status of the original loan and Section 580b will apply. However, if the refinancing is with a different lender, the courts have not definitively ruled as to whether the new loan will keep the purchase money status of the original loan. For example, if a person originally had a \$500,000 loan with Bank of America that was paid down to \$450,000 and the person refinanced with a new loan from Chase for \$450,000, then the Chase loan may or may not be a purchase money loan. If the person had refinanced with Bank of America for only \$450,000, then this would be a purchase money loan and the protections of Section 580b would apply.

Finally, Section 580b has never protected a borrower that commits fraud or bad faith waste to the property. If a borrower lied on his or her loan application and the lender relied on the lie in making the loan, then Section 580b will not protect the borrower from liability to the lender after a foreclosure. Also, if a borrower commits bad faith waste to the property (which is defined as reckless, intentional or malicious damage to the property), then Section 580b does not apply to this borrower.

Anyone that is going into foreclosure needs to keep Section 580b in mind to evaluate their potential personal liability for any deficiency after foreclosure. If you are not certain about whether you may be liable for the deficiency, you should consult with a knowledgeable real estate attorney or real estate broker.

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