

SB 931: Prohibiting Lenders Holding First Deed of Trust from Recovering Deficiencies

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Being a real estate attorney, I get a lot of questions about foreclosures such as, “what are my options,” “should I consider a short sale,” “how will a foreclosure affect my credit score,” and “should I file for bankruptcy?” In order to answer these questions, I usually need more information about the borrower(s), the lender, and the debt. However, in the end, deciding how to proceed usually depends on the answer to a single question, “can the bank come after me if they don’t recuperate the full amount of what I owe on the loan?”

The generally preferred option for homeowners with only a first mortgage was a short sale because of its reduced credit impacts. However, unless the loan was non-recourse (not typical for residential properties) or the homeowner could convince the lender to accept the short sale offer as satisfaction in full for the entire loan amount, the lender could reserve the right to recover the deficiency from the former homeowner. For homeowners with only a first mortgage who were more concerned about the deficiency, foreclosure might have been a more attractive option because prior to January 1, 2011, California law only prohibited foreclosing lenders who sold the property at a trustee’s sale from trying to recover any deficiency.

Last February, Senator Denise Moreno Ducheny introduced SB 931, which sought to prohibit first mortgage lenders who approve a short sale on a residential property with 1-4 units from getting a judgment against the former homeowner for the deficiency resulting from the short sale. SB 931 was signed by Governor Schwarzenegger on September 30, 2010 and became effective on January 1, 2011 as California Code of Civil Procedure Section 580e.

The effect of SB 931 was to make short sales as appealing to homeowners as foreclosures. A first mortgage lender accepting a short sale is now prohibited from pursuing the former homeowner for the deficiency. Homeowners with a first mortgage receive the same deficiency protections in a short sale situation as they would in foreclosure. When you add to that the reduced credit impacts, short sales have certainly become more attractive to homeowners facing foreclosure.

It is important to note that the protections created by SB 931 extend to homeowners with only a first mortgage. Second mortgages and home equity lines of credit are specifically exempted from the SB 931 protections. For homeowners with a second mortgage or home equity line of credit, foreclosure may still be the more preferable option depending on the circumstances of the loan(s). However, it is important that a homeowner facing foreclosure contact a real estate professional and/or an attorney in order to fully understand the options and their impacts prior to making a final decision on how to proceed.

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