

Date of Hearing: June 21, 2010

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Mike Eng, Chair
SB 931 (Ducheny) – As Amended: June 1, 2010

SENATE VOTE: 31-0

SUBJECT: Mortgages: deficiency judgments

SUMMARY: Provides that in the case of a short sale on residential real property, the holder of the first mortgage or deed of trust shall fully discharge any remaining borrower's indebtedness following the sale when the sale has been agreed to in writing. Additionally, that nothing shall limit the ability of the holder of the first deed of trust or first mortgage to seek damages, or use existing rights or remedies in those cases where the homeowner has committed fraud or waste in connection with the sale of the real property.

EXISTING LAW

- 1) Prohibits a lender from pursuing a borrower for a deficiency judgment on a purchase money mortgage or deed of trust that is secured by single-family residential real property (Code of Civil Procedure 580b). Note: There is some disagreement among legal professionals about the circumstances under which the purchase money protection provided by CCP 580b applies. However, it is generally believed to provide protection to a purchase money note that becomes the subject of a judicial or nonjudicial foreclosure action or a short sale.
- 2) Prohibits a lender from pursuing a borrower for a deficiency judgment on a note on which that lender exercised its power of sale through the nonjudicial foreclosure process (Code of Civil Procedure 580d). Note: There is some disagreement among legal professionals about whether this statute additionally applies to notes that become the subject of a judicial foreclosure.
- 3) Defines a deficiency judgment as a personal judgment against a debtor for a recovery of secured debt, measured by the difference between the debt and the net proceeds received from a foreclosure sale (case law).
- 4) Defines waste, in the context in which it is used in this bill, as any unlawful act or omission, by the tenant or other person in possession of land, which causes a permanent injury to the inheritance, by injuriously affecting the market value of the property. There must be a permanent diminishment or depreciation in the value of the property for waste to have occurred (case law).
- 5) Prohibits any person whose interest is subject to the lien of a mortgage from performing any act that will substantially impair the mortgagee's security.

FISCAL EFFECT: None

COMMENTS:

According to the author:

The purpose of this proposed legislation is primarily to protect distressed homeowners who have non-purchase money recourse loans on residential property (1-4 units), when the fair market value of the subject property is less than the balance of the first deed of trust. The legislation will make sure that these homeowners do not incur a higher dollar amount of liability after a short sale than they would otherwise have after a foreclosure sale. For many homeowners in the group described above, a short sale would result in greater personal liability.

Before proceeding further with the overview of this bill it is necessary to provide some context to this subject by defining some key concepts and terms.

- 1) Short Sale: A transaction in which a lender allows the property securing the loan to be sold for less than the remaining mortgage amount due and accepts the proceeds as full payment of the loan.
- 2) Purchase Money: If the loan securing the property was obtained to purchase the residential property in which all or part of the property is owner occupied, the loan is considered a "purchase money loan."
- 3) Non-recourse loan: A loan in which the borrower is not liable for any outstanding balance if the borrower defaults. Typically, purchase money loans are non-recourse.
- 4) Recourse loan: A loan in which the borrower is liable for any outstanding balance leftover if the borrower defaults. Refinance loans are typically recourse loans, except in the case of where the borrower refinances the purchase money loan with the same lender and takes out no additional money.
- 5) "One form of action rule": Simply stated, this rule provides, under Section 726(a) of the Code of Civil Procedure that a creditor may only choose one action to collect on a mortgage or deed of trust. For example, if the lender forecloses, they may not pursue the borrower in court for the difference between the foreclosure price and the loan amount.

Background.

Foreclosures continue to be an on-going problem in California and across the nation. In April of 2010, almost 28,000 notices of default were filed in California. While this is a decrease of 16% over the previous month, homeowners continue to face difficulties in a weak economy. In many cases a short sale is an option that is better for both the borrower and lender, as foreclosure is rarely a win-win situation for anyone. While federal efforts continue to attempt to mitigate foreclosures through loan modifications, it is accepted logic that not every borrower in trouble would benefit, or be able to afford a loan modification. In these cases, a short sale may be the best option. Even the federal efforts aimed at loan modification acknowledge the role of short sales. The U.S. Treasury Department announced, in March of 2010 the Home Affordable Foreclosure Alternatives Program (HAFA). HAFA provides incentives to borrowers, servicers, and investors who agree to short sale or deed in lieu instead of foreclosures, if a borrower is not

eligible for the Home Affordable Modification Program. HAFA requires that the short sale agreement must include an agreement that once the HAFA short sale is complete that borrowers are released from all further liability under the first mortgage.

However, and in spite of the use of short sales as a loss mitigation strategy, a disincentive exists under CA law that could, and may have up this point, forced borrowers into foreclosure in order to avoid the potential for additional debt that could occur under a short sale. Due to vagueness in current law a borrower with a non-purchase money loan could become liable for debt under a short sale, where a foreclosure would not result in any additional debt. Additionally, evidence suggests that some lenders are using language in short sale contracts that states that borrowers would be liable for any difference between the sales price and the amount owed. This language is sometimes specific, while at other times, vague enough to create legal confusion.

This bill seeks to clear up any legal confusion between purchase money and non-purchase money loans in regards to short sales by simply providing that the lender may not pursue the borrower for any deficiency that may occur as a result of the short sale when the holder of the note has provided written consent of such agreement.

Based on information provided to the committee, the following are various scenarios of how borrowers are effected under current law and how this bill would effect them once enacted.

Scenario 1 (the problem this bill is attempting to fix): Borrower has first deed of trust for \$300,000 and second deed of trust for \$90,000. Both loans are recourse loans, due to a refinancing.	
<u>Foreclosure Scenario:</u> Holder of first deed of trust forecloses; holder of second deed of trust takes no action and becomes a sold-out junior lienholder.	<u>Short Sale Scenario:</u> Holder of first deed of trust agrees to a short sale for fair market value of \$250,000, but states in its approval letter that it reserves the right to pursue the borrower for the difference between what the property fetches at sale and the outstanding, unpaid principal balance of the loan. Holder of second deed of trust agrees to the short sale (Note: the holder of the second deed of trust must agree to the short sale, before it may go forward).
Impact on the borrower: When the holder of the first deed of trust forecloses, it has no further ability to pursue any deficiency under the one form of action rule. Because the second deed of trust is a recourse loan, the sold out junior lienholder may pursue the borrower for a deficiency judgment of \$90,000.	Impact on the borrower: The holder of the first deed of trust may pursue the borrower for \$50,000 (the difference between the \$300,000 the borrower owes on the note and the \$250,000 the sale generates). Because the second deed of trust is a recourse loan, the sold-out junior lienholder may pursue the borrower for a deficiency judgment of \$90,000
Net result: Borrower has \$90,000 in personal liability.	Net result: Borrower has \$140,000 in personal liability and is worse off financially under a short sale.

Scenario 2 (another example of the problem this bill is trying to fix): Borrower has first deed of trust for \$300,000 and second deed of trust for \$90,000. Both loans are purchase money loans and thus non-recourse.	
<u>Foreclosure Scenario:</u> Holder of first deed of trust forecloses.	<u>Short Sale Scenario:</u> Holder of first deed of trust agrees to a short sale for fair market value of \$250,000, but states in its approval letter that it reserves the right to pursue the borrower for the difference between what the property fetches at sale and the outstanding, unpaid principal balance of the loan.
Impact on the borrower: When the holder of the first deed of trust forecloses, it has no further ability to pursue any deficiency under the one form of action rule. The holder of the second deed of trust becomes a sold-out junior lienholder but lacks any recourse against the borrower, because the loan is non-recourse.	Impact on the borrower: The holder of the first deed of trust may attempt to pursue the borrower for \$50,000 (the difference between the \$300,000 the borrower owes on the note and the \$250,000 the sale generates). The question of whether such an action is prohibited by CCP 580b has not yet been litigated, and is thus unresolved. The holder of the second deed of trust agrees to the short sale and becomes a sold-out junior lienholder, but lacks any recourse against the borrower, because the loan is non-recourse
Net result: Borrower has \$0 in personal liability.	Net result: Borrower may have \$50,000 in personal liability and could be worse off under a short sale.

Scenario 3 (how this bill would work, if enacted): Borrower has first deed of trust for \$300,000 and second deed of trust for \$90,000. Both loans are recourse loans, due to a refinancing.	
<u>Foreclosure Scenario:</u> Holder of first deed of trust forecloses.	<u>Short Sale Scenario:</u> Holder of first deed of trust agrees to a short sale for fair market value of \$250,000 and must accept that value as full payment.
Impact on the borrower: When the holder of the first deed of trust forecloses, it has no further ability to pursue any deficiency under the one form of action rule. The holder of the second deed of trust becomes a sold-out junior lienholder. Because the second deed of trust is a recourse loan, the sold out junior lienholder may pursue the borrower for a deficiency judgment of \$90,000.	Impact on the borrower: When the holder of the first deed of trust agrees in writing to the short sale, it has no further recourse to pursue any deficiency against the borrower. The holder of the second deed of trust becomes a sold-out junior lienholder. Because the second deed of trust is a recourse loan, the sold-out junior lienholder may pursue the borrower for a deficiency judgment of \$90,000
Net result: Borrower has \$90,000 in personal liability	Net result: Borrower has \$90,000 in personal liability and is not worse off after a short sale.

Scenario 4 (another example of how this bill would work, if enacted): Borrower has first deed of trust for \$300,000. The loan is a recourse loan, due to a refinancing.	
<u>Foreclosure Scenario:</u> Holder of first deed of trust forecloses.	<u>Short Sale Scenario:</u> Holder of first deed of trust agrees to a short sale for fair market value

Scenario 4 (another example of how this bill would work, if enacted): Borrower has first deed of trust for \$300,000. The loan is a recourse loan, due to a refinancing.	
	of \$250,000 and must accept that value as full payment.
Impact on the borrower: When the holder of the first deed of trust forecloses, it has no further ability to pursue any deficiency under the one form of action rule and CCP 580d.	Impact on the borrower: When the holder of the first deed of trust agrees in writing to the short sale, it has no further recourse to pursue any deficiency against the borrower.
Net result: Borrower has \$0 in personal liability.	Net result: Borrower has \$0 in personal liability and is not worse off under a short sale.

REGISTERED SUPPORT / OPPOSITION:

Support

Innovative Financial Resources, Inc.
Law Office of Michael Spilger
Laturno Kuick Ralty

Opposition

None on file.

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