

November 2010

## NEW CALIFORNIA “SHORT SALE” LEGISLATION CREATES RISKS FOR LENDERS

By [Neil J. Rubenstein, Esq.](#)

California recently enacted legislation governing “short sales,” which inadvertently may create substantial risks for lenders. The legislation, which takes effect on January 1, 2011, had a very limited and non-controversial objective—if an owner of a home who is in default on his or her mortgage sells the home through a “short sale” (i.e., a sale for less than the amount owed), with the consent of the lender and with all proceeds going to the lender, the owner should be in the same position as if the lender foreclosed by a non-judicial foreclosure sale. Under a non-judicial foreclosure sale, the owner would not be personally liable for the deficiency. The bill was designed to address the perceived problem that lenders would sometimes encourage or allow their consumer borrowers to do a short sale, and then try to make them pay the deficiency.

The legislation is set forth in California Senate Bill 931, which added a new Section 580e to the California Code of Civil Procedure.<sup>1</sup> The first part of the bill is patterned on Code of Civil Procedure Section 580d, which states that “No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property or estate for years therein” when the property is sold by the mortgagee or trustee under a power of sale contained in the mortgage or deed of trust (i.e., a nonjudicial foreclosure). Other statutes and court decisions have given meaning to that phrase—namely, that the prohibition against deficiency judgments bars a personal judgment against the debtor for recovery of the difference between the debt and the amount realized by the

sale, but does not extinguish the debt. Accordingly, under Code of Civil Procedure Section 580d, the creditor remains entitled to proceed against other collateral that secures the debt<sup>2</sup> and retains the right to recover from a guarantor, if the guarantor has waived certain statutory protections.<sup>3</sup>

SB 931, read literally, goes far beyond its intended purpose. By its terms, it applies to any note secured by a first deed of trust or first mortgage for a dwelling of not more than four units, except when the trustor or mortgagor is a corporation or political subdivision of the state. It is not limited to consumer transactions, nor is it limited to situations in which the dwelling is the residence of the obligor. Furthermore, it goes beyond the scope of Code of Civil Procedure Section 580d, since it not only bars a deficiency judgment against the obligor, but states that a lender’s written consent to the sale “for less than the remaining amount of the indebtedness due at the time of the sale” “shall obligate that holder to accept the sale proceeds as full payment and to fully discharge the remaining amount of the indebtedness on the first deed of trust or first mortgage.”

This language could have significant practical consequences. It is fairly common in commercial loan transactions for the obligor or obligors to provide multiple items of collateral to secure the loan. Sometimes, all of the collateral is provided by the borrower. Other times, some of the collateral is provided by a third party. Some of that collateral may include residential real estate. Read literally, SB 931 could be construed to mean that a sale of one item of the pledged residential real estate for less than the outstanding loan balance would amount to “full payment” of the debt and preclude recovery from the other collateral or from guarantors. California courts have historically taken the position that the anti-deficiency laws were established for a public reason and, under many circumstances, cannot be contravened by a private agreement.<sup>4</sup> Accordingly, even if the lender and its borrower agree that it is preferable for the pledged residential real property to be sold to pay down the debt—with the lender retaining its rights against other

<sup>1</sup> New CCP Section 580e reads:

(a) No judgment shall be rendered for any deficiency under a note secured by a first deed of trust or first mortgage for a dwelling of not more than four units, in any case in which the trustor or mortgagor sells the dwelling for less than the remaining amount of the indebtedness due at the time of the sale with the written consent of the holder of the first deed of trust or first mortgage. **Written consent of the holder of the first deed of trust or first mortgage to that sale shall obligate that holder to accept the sale proceeds as full payment and to fully discharge the remaining amount of the indebtedness on the first deed of trust or first mortgage.**

(b) If the trustor or mortgagor commits either fraud with respect to the sale of, or waste with respect to, the real property that secures the first deed of trust or first mortgage, this section shall not limit the ability of the holder of the first deed of trust or first mortgage to seek damages and use existing rights and remedies against the trustor or mortgagor or any third party for fraud or waste.

(c) This section shall not apply if the trustor or mortgagor is a corporation or political subdivision of the state. (emphasis added)

<sup>2</sup> See, e.g., California Uniform Commercial Code Section 9604; *Dreyfuss v. Union Bank of California*, 24 Cal.4<sup>th</sup> 400, 101 Cal.Rptr.2d 29 (2000).

<sup>3</sup> See California Civil Code Section 2856.

<sup>4</sup> See discussion at *Cadle Company II v. Harvey*, 83 Cal.App.4<sup>th</sup> 927, 100 Cal.Rptr.2d 150 (2000).



November 2010

collateral and against guarantors—they might be precluded from doing so.

Another ambiguity in the statute is that it states that it applies when the owner “sells the dwelling for less than the remaining amount of the indebtedness due at the time of sale.” The word “due” has different meanings. Sometimes it is interpreted to mean the amount owed on the debt, even if the debt has not matured. Other times, it is interpreted to mean a debt that has matured. Under the former interpretation, the statute would apply even if the loan has not matured and is not in default.

On October 8, 2010, after the bill had passed the Legislature and been signed by the Governor, its author published a letter in the California Senate Journal to “clarify” her “intent” in authoring the bill. In that letter, she stated that she did not intend the bill to apply in certain of the circumstances described above, including commercial loans where a single note is secured by multiple collateral.<sup>5</sup> It is uncertain what effect the author’s letter will have on how courts interpret SB 931. The California Supreme Court has described the rules governing statutory construction as follows: “In ascertaining the Legislature’s intent, we turn first to the language of the statute, giving the words their ordinary meaning. We must follow the statute’s plain meaning, if such appears, unless

doing so would lead to absurd results the Legislature could not have intended. If our examination of the statutory language leaves doubt about its meaning, we may consult other evidence of the Legislature’s intent, such as the history and background of the measure.”<sup>6</sup>

The statute, in its current form, creates significant risks for lenders who consent to a short sale under the circumstances described above. Although the courts might interpret the statute in such a way as to avoid those problems, there is no certainty that they will do so. The ideal way to address this situation is for the Legislature to amend the statute so that it more clearly expresses the Legislature’s intent. In the absence of such a clarification, it will often be in the lender’s interest to foreclose on its deed of trust in those circumstances rather than incurring the risk of agreeing to a short sale.



*Neil J. Rubenstein is a Shareholder in the San Francisco office of Buchalter Nemer. He can be reached at 415.227.3559 or [nrubenstein@buchalter.com](mailto:nrubenstein@buchalter.com)*

<sup>5</sup> The letter from Senator Denise Ducheny reads, in part, as follows: “As I have indicated in my testimony and as evidenced in the policy committee and floor analyses for this measure, ‘the purpose of this proposed legislation is 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.’ The measure applies to a note secured by a first deed of trust or first mortgage on a single parcel of real property consisting of a dwelling for not more than four families. As drafted, the term ‘a dwelling’ is intended to apply to one parcel of residential real property consisting of no more than one to four living units, and should not be construed to apply to additional multiple parcels of property that are collectively secured by one first deed of trust or first mortgage. Further, Senate Bill 931 is meant to apply to loan transactions with individuals and is therefore not intended to apply to commercial loan transactions with legal entities which were not created as part of an individual’s estate planning. As such, the bill is not intended to apply to residential subdivision loans and other commercial loans to legal entities where a single note is secured by multiple collateral, such as multiple residential 1-4 unit properties, or a residential 1-4 unit property and a commercial property, or a residential 1-4 unit property and a parcel of vacant land. As such, the bill is not intended to extinguish that portion of the debt obligation that is secured by another residential, commercial, or vacant land property, or other personal property related to or used in connection with the property.” California Senate Journal, pages 5260-5261 (October 8, 2010).

<sup>6</sup> *People v. Birkett*, 21 Cal.4<sup>th</sup> 226, 231, 87 Cal.Rptr.2d 205, 209 (1999).