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State high court expounds on short sales

By Francis N. Scollan and Andrea M. Schoor

As the number of residential "short sales" skyrocketed as an alternative to foreclosure, California enacted legislation in 2010 expressly addressing the practice and prohibiting deficiency judgments after qualifying short sales. Code of Civil Procedure 580e. But as determined in a recent California Supreme Court case, it turns out that for "purchase money" borrowers, that protection already existed for decades under Code of Civil Procedure Section 580b: The purchase money antideficiency protection of Section 580b applies not only to foreclosures, but to short sales as well.

Under long-standing California law, when a lender forecloses either judicially or non-judicially on a four-family-or-less home purchased with a "purchase money loan," the lender may not obtain a deficiency judgment against the borrower. Code of Civil Procedure Section 580b; see also Section 580d (no deficiency after non-judicial foreclosure). But a short sale, in which the lender receives the proceeds from a sale of the property to a third party arranged by the borrower at a price "short" of the outstanding loan balance, is not a foreclosure. Taking the position that Section 580b only applied to foreclosure sales, some lenders asserted a right to deficiency claims against purchase-money borrowers for the shortfall after a short sale; some borrowers resisted, asserting that 580b applied equally to short sales.

The U.S. District Court for the Central District of California addressed the dispute as a matter of first impression in *Rex v. Chase Home Finance LLC*, 905 F.Supp.2d 1111 (2012), holding that Section 580b applies to bar a deficiency after a short sale. The issue separately reached the state Supreme Court in *Coker v. JPMorgan Chase Bank N.A.*, 2016 DJDAR 707 (Jan. 28, 2016), which came to the same conclusion.

In *Coker,* plaintiff Coker purchased her condominium with a $452,000 loan secured by a deed of trust recorded against the property, a classic purchase money loan. Coker defaulted on the loan and applied for a short sale. Coker's lender agreed to the short sale, on the condition that all proceeds would go to the lender and that Coker would remain liable for any deficiency — i.e., the remaining loan balance. Coker accepted and the property was sold to a third party.

After the short sale, Coker received a collection letter for the deficiency. She filed a declaratory relief action against the lender, claiming Section 580b prohibited the lender from collecting. The trial court sustained the lender's demurrer to the complaint without leave to amend. The Court of Appeal reversed and the state Supreme Court granted review. The Supreme Court affirmed the appellate decision, finding that the antideficiency protections of Section 580b applied to Coker's short sale. Moreover, because Section 580b is intended to serve a public benefit, Coker's purported waiver of its protections was invalid.

The court started with a parsing of the statute itself: Did the statute's use of the term "deed of trust" modify the word "sale" thus implying a foreclosure sale, as the lender urged, or were "sale" and "deed of trust" part of separate clauses, as amici curiae urged? (As the court noted, in 2012 the Legislature literally reformatted Section 580b to break it into subsections reflecting amici curiae's version.) But the driving force of the opinion is the court's lengthy consideration of 50 years of cases which it characterized as concluding, "that the statute limits a lender's recovery on any standard purchase money loan, regardless of how the security has been exhausted and regardless of whether a sale has occurred under the deed of trust." The court found that the loan at issue

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A home for sale in Monterey, California.

was a standard purchase money loan, and the statute therefore applied.

The court rejected the argument that the lender's release of security converted the loan from secured to unsecured and thus removed it from the purview of Section 580b altogether. It noted that the lender never released the security until the lender had *realized* upon that security by receiving "its entire liquidated value."

The court also found its interpretation consistent with the often-cited twin policy aims of Depression-era antideficiency statues: deterring overvaluation of property by imposing the risk of doing so on the lender and dampening the impact of economic declines by avoiding imposing personal liability on top of the borrower's loss of property.

The court declined to use the enactment of Section 580e to interpret Section 580b as it stood in the case. The Rex case did examine the legislative history of Section 580e and found several indications that the Legislature believed Section 580b already applied to short sales, and that Section 580e was enacted to "expand the *type of mortgages*" to which short sale antideficiency protections extended.

Interestingly, the court also answered the question of whether Coker had waived her rights under Section 726, the "one-action" and "security-first" rule. It found that Coker's consent to a short sale constituted a waiver of Section 726. Arguably, this determination was unnecessary because even with the waiver, "section 580b remains a barrier to any deficiency judgment after the lender collects the full value of its security from the sale." It may be that this part of the decision is a precursor to another pending case, *First California Bank v. McDonald*, S222858. Briefing in that case was deferred pending a ruling in *Coker*. As framed in the petition for review, *First California Bank* addresses Section 726 and short sales more directly, including the impact of one borrower's consent to the short sale of that borrower's property without the consent of a non-owner co-borrower and the potential remedies or penalties for a violation of Section 726.

When *First California Bank* is decided, it, together with *Coker*, will go a long way in providing lenders with further guidance when it comes to applying California's laws governing real property security, including the enforcement of their rights and remedies in the event of default. Additionally, the cases should be heeded by lenders on the front end when making underwriting decisions, as they may significantly impact lenders' recovery in the event of another economic downturn.

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