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In California, the ability of lenders to demand that their short selling borrowers agree to remain personally liable for the shortfall after the sale is significantly impaired by our antideficiency statutes. However, the relatively incomprehensible language of those statutes invites the courts to divine the result from a consideration of their perception of the "purposes" behind that legislation. This is from 36 Real Property Law Report 99 (Cal CEB September 2013):

SHORT SALES AND DEFICIENCY LIABILITY: THE POINTLESSNESS OF PURPOSES

The issue of an owner's continuing liability for a deficiency following a short sale of her property has finally made it to the appellate level. Members of the bar have at last been given some guidance by the courts as to borrowers or lenders seeking advice as to the legal environment under which they are operating. But while the outcomes of these new cases may have been entirely predictable, the reasons given by the courts for reaching those conclusions are so quirky as to lead me to recommend that attorneys attend only to the results announced and ignore entirely the stated reasons given by the judges for reaching those results.

Bank of America v Roberts, Coker v JP Morgan Chase Bank, and *Enloe v Kelso* all involved homeowners who saw the values of their properties fall below the amount of the loans carried on them. (All three cases are more fully summarized elsewhere in this issue of the Reporter.) These developments made it unwise for any of them to continue paying their mortgages, if that could be avoided. All of the borrowers proposed that their lenders write down the loans to amounts that equaled what the properties could be sold for. In all three situations the lenders consented—on the condition that each borrower stay liable for the difference remaining unpaid on the old loans after the short sale proceeds were applied to the loans. Although each seller agreed, each later sought to avoid having to honor that promise. In one case, the borrower's defense was upheld; in the others, it was rejected.

Bank of America v Roberts

In *Bank of America, N.A. v Roberts* (2013) 217 CA4th 1386, the bank held a second deed of trust that secured a home equity line of credit and agreed to release it, so that the homeowner, Roberts, could make a short sale of her house. The sale generated only $27,000 on the $235,000 that she owed on her second, but Roberts agreed to remain liable for this unpaid balance (which was now unsecured because of the released deed of trust). The short sale occurred in 2009. In 2010, the bank sued Roberts for her failure to pay that shortage. Roberts defended on the ground that CCP §§580e and 726 rendered her promise unenforceable, but lost on both grounds.

CCP §580e

Code of Civil Procedure §580e explicitly prohibits collection of deficiency claims following short sales. (They are sensibly not called "deficiency judgments" because there were not preceded by any foreclosure by the lender or by any senior lienor, but it is legitimate to call them "deficiency" claims in light of the fact that the lender has already gotten all that it could from the security it previously held.) The section says that "no deficiency shall be owed or collected" on one-to-four-unit dwellings (not required to be owner occupied) that are sold voluntarily by a borrower for less than the balance owing on her deed of trust, if the lender has consented and has received all of the available proceeds. While the bank in *Roberts* had consented and had received the available remaining proceeds, the deed of trust it held was a second. Section 580e, as first enacted in 2010, applied only to first deeds of trust; it was not until 2011 that an amendment extended coverage of this code section to *all* deeds of trust (as long as the collateral consisted of one-to-four-unit residences). Since the original version of §580e referred solely to first deeds of trust and the amended version did not take effect until two years after this transaction had occurred, it was easy for the court to hold that §580e did not apply and that the debtor's promise to pay the deficiency balance was enforceable.

The court's ruling in *Roberts* that §580e did not apply was then immediately followed by its gratuitous volunteering of a legislative "policy"—offered as an additional justification for this result. According to the court, the goal of this legislation was "to encourage the approval of short sales as an alternative to foreclosure." 217 CA4th at 1393. But since the statute, when it applies, prohibits lenders from obtaining deficiency recoveries if they consent to short sales, one must wonder: How can such a prohibition possibly "encourage" a lender to give its consent? Section 580e does not mandate lenders to consent to short sales or provide that those who do not consent can have no further recovery thereafter; instead, it allows lenders to elect not to consent to short sales (and thereby not incur the deficiency waiver sanction). In this little universe of choices, lenders can be expected to consent to a short sale only when its payoff funds are likely to be large enough to make that sale itself seem less unprofitable than foreclosure, and not because of the bar against further recourse. No one should take the *Roberts* announced policy of encouraging short sales seriously or as a true predictor of judicial decision making in other contexts.

CCP §726

Elimination of §580e as a defense to enforcement of Ms. Roberts's promise to pay her deficiency liability did not eliminate all of her other possible defenses to that arrangement. Her loan had initially been secured by a deed of trust, meaning that the lender was limited by the explicit language of CCP §726 to foreclosing on the security and prohibited by the judicial construction of that language from seeking a money judgment from the borrower before so exhausting its security. The lender had not foreclosed first, thereby possibly entitling the borrower to claim that she was protected by §726 even if she did not come within the protection of §580e.

The court's response to that possibility was to deem that the debtor waived the protection of §726 by virtue of having requested approval of a short sale and by consenting to remain personally liable after it occurred. (The opinion did not say whether both of these factors—the borrower's request and/or her consent to continued liability—were equally necessary. My guess is that only the second consideration really mattered; I think that the result would have probably been the same even if the bank had been the one who proposed the short sale.)

Should such a §726 waiver be valid? The classic presumption in the mortgage context is that debtors are so necessitous as to consent to any onerous condition demanded by their lender, so that courts must therefore protect them from their ruinous concessions by treating their rights as superior equities that cannot be waived. (In this case, it would be the debtor's waiving of the one-action rule by agreeing to remain liable for the deficiency without a foreclosure.) While it once was true that the judicial objection to waivers applied only to contemporaneous ones, *i.e.,* those given at the same time as the loan was made, that limitation was premised on the assumption that that was the moment when a borrower was most necessitous (see *Hamud v Hawthorne* (1959) 52 C2d 78), whereas later decisions have recognized that a borrower in default on an existing loan may be no less desperate, meaning a subsequent waiver of rights by her is no less suspect. See *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, reported at 22 CEB RPLR 139 (July 1999). Thus, Ms. Roberts's agreement to become personally liable for the short sale deficiency might not be enforceable, since it was made under such distressed circumstances. Nothing in the language of CCP §726 resolved that question, so the courts have treated it as another issue of policy (purposes), and that means more unpredictability.

The opinion states (as many others have stated) that the "two fundamental purposes of section 726 are (1) preventing a multiplicity of lawsuits against the debtor, and (2) requiring exhaustion of the security before a resort to the debtor's unencumbered assets." 217 CA4th at 1397. Notwithstanding its repetition, no judge or scholar has ever cogently explained why a creditor would ever be motivated to file multiple actions to collect a single obligation—which would probably only lead to multiple bills from its attorneys, multiple nonappearances from its defaulting debtor, and little likelihood of a multiple recovery. This makes it difficult to understand why a simple prohibition against splitting a cause of action would not work as well or better than this rule, which has caused so much agonizing over what an action is and when the antimultiplicity principle is triggered or appeased. Nor has anyone ever shown why a simple election of remedies rule would not treat borrowers just as well as our present security-first gloss on the statute does. (Why, for instance, is it automatically better for a debtor to lose her house before, rather than after, losing her car or her jewelry?)

Such judicial statements of §726 purposes give practitioners little help as to when or how they may negotiate for or draft effective waivers or partial waivers on behalf of their clients (say, as part of a workout), or when such efforts simply amount to a waste of time in trying to do so. One reads the lecture in *Roberts* on the purposes of and exceptions to §726 without being able to remotely guess where it will lead. The agreement that was upheld in *Roberts* followed a short sale that was not an action, and the proceeds it generated were applied to the loan. But those consequences were also present in *Security Pac. Bank v Wozab* (1989) 51 C3d 991, reported at 12 CEB RPLR 139 (Aug. 1989), the decision on which *Roberts* relied for its purpose analysis, in which the consequences of a creditor's having reached into its debtor's bank account to apply funds to its mortgage debt were held to constitute an action for §726 purposes—the opposite of the result reached in *Roberts*.

Overall, the *Roberts* decision probably means that lenders can generally enforce pre-2011 short sale promises that they got from borrowers, notwithstanding CCP §§580e and 726. But it is probably a different story for transactions that happened after 2011, especially when the original loan involved was a purchase money one.

CCP §580b

The *Roberts* case involved a nonpurchase money line of credit, whereas *Coker v JP Morgan Chase Bank* and *Enloe v Kelso* dealt with purchase money loans. *Coker* involved funds advanced by a third party lender to enable the borrower to acquire a house in which she apparently then resided, while the junior financing in *Enloe* entailed a third deed of trust being taken by the vendor, rather than by a third party. Because purchase money financing was involved in both, those two creditors would have been prohibited from recovering deficiency judgments against their borrowers had either foreclosed on its loan in any conventional way.

But neither creditor had foreclosed; they had, as in *Roberts*, agreed to their borrowers' proposals to release their deeds of trust in return for receiving the funds generated by short sales of the property, and they had also obtained their borrowers' agreements to remain liable for the differences thereafter. (That is not stated explicitly in *Enloe*, but seems to be the case.) The question in both cases was whether CCP §580b rendered such promises invalid.

The language of §580b does not precisely fit the facts of a short sale. It provides:

No deficiency judgment shall lie in any event for the following:
....

> (2) Under a deed of trust or a 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]
>
> (3) 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.

That was the wording of the statute at the time these three decisions were written. Since then, new versions of both §§580b and 580d have appeared, inserting "no deficiency shall be owed or collected" in front of the old "no deficiency shall lie." Apparently, this was done to stop debt collectors from hassling "protected" trustors to get them to pay those subsequently uncollectible debts and to stop credit reporting agencies from listing them on credit scores. However, as an article in the August 21, 2013, Los Angeles Daily Journal by Gregory Strausberg ("Unintended Consequences in Amended Anti-deficiency Statutes") points out, that change could have adverse tax consequences through treatment as cancellation of debt income. For this article, however, those words are not in issue.

Unlike California's other antideficiency statutes, the operation of §580b depends on the facts that occurred at the time the loan was made, not when it was later foreclosed. That makes it rather hard to determine application of the section in the context of a post-purchase, nonforeclosure, short sale transaction. However, if one starts from the premise that the statute makes a purchaser's or borrower's promise to pay what she initially borrowed unenforceable against her personally, then it is not going very far beyond that to say that the section would also make any later or second promise to become personally liable for the balance due (after application of short sale proceeds to the obligation and a release of the deed of trust) similarly inoperative. Since lenders have lived with the consequences of holding nonrecourse purchase money loans in California for over half a century, making that characteristic further survive a borrower's second promise to pay should be no great shock to them. Recent amendments to §580b have paradoxically given such treatment to short sale promises, while withholding it from refinancing arrangements by purchase money borrowers. See Akawie, *A Long-Awaited Answer to a Purchase Money Problem*, 35 CEB RPLR 129 (Sept. 2012).

Coker v JP Morgan Chase Bank

In *Coker v JP Morgan Chase Bank, N.A.* (2013) 218 CA4th 1, it appeared that the short sale and borrower's agreement to owe the balance occurred before the amendment to CCP §580e had taken effect, which eliminated that court's ability to deny a recovery on that basis. This difficulty led to a complicated linguistic exposition of §580b to enable the court to arrive at that same result. Section 580b, according to the *Coker* court, applies after any sale of the property, including a short sale, and not merely to foreclosure sales.

This, according to the court, was the plain meaning of the statutory phrase "after a sale of the property" in subsection (1) of §580b when that language is combined with "in any event" in the statutory preamble. Regrettably, for statutory construction analysis purposes, that argument entirely ignores the remaining language of subsection (1): "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." This subsection (1) of §580b is referring to installment contracts, not to deeds of trust, which are covered in subsections (2) and (3). Real estate purchasers who are financing their acquisition through a deed and deed of trust rather than an executory installment land contract do not come under subsection (1) at all, where the "sale" reference is contained, and there is no mention of a sale in subsections (2) and (3), where deeds of trust are covered. Since it is subsections (2) and (3) that govern the *Coker* (and *Enloe*) situation, there is simply no such plain meaning of CCP §580b as would control this case.

The Purposes of §580b—For Lenders

The *Coker* opinion proceeds to further justify its result by recourse to the oft-proclaimed purposes of §580b—preventing overvaluation of land and not aggravating financial depressions. This, however, only adds to the confusion. It is clear that our courts believe that a major purpose of §580b is to prevent the overvaluation of the property—this was the supreme court's famous pronouncement in *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35—but how does overvaluation come into play when the creditor involved is a third party lender rather than the vendor of the property being sold? When Justice Trainor declared in *Roseleaf* that a purpose of §580b was to prevent overvaluation, he was dealing with a vendor who had taken a deed of trust to cover the price it had set for the sale of its land—and imposing antideficiency restrictions on vendors seemed to be intended to induce them to set lower prices. Whatever one may think of that logic, it looks clearly inappropriate when a third party lender, rather than a vendor, is the party barred by §580b. *Coker*'s vendor may have overvalued his property, but he got away with it, despite §580b, by having the purchaser pay him in cash with funds borrowed from a bank. Thinking about the overvaluation purpose seems misleading when bank financing is involved. Furthermore, the other stated purpose of §580b—preventing aggravation of financial downturns—seems equally ill-suited to a third party lender, who—if its (hard money) loan goes unpaid—will suffer a real economic loss (as the national financial bailout of the lending industry illustrated). If a borrower loses her house and also owes a deficiency judgment, the depression may get worse, but how are those economic effects different from what occurs when a lender advances funds to a borrower and is then unable to recover them?

If attorneys take overvaluation and antidepression as the truly serious purposes behind CCP §580b, how accurately will they be able to predict what results follow when third party purchase money lenders and short sales are involved? Is overvaluation better avoided, when a lender writes down a loan, by allowing it or disallowing it to seek the balance later? Are depressions best averted by making borrowers pay their balances or by making lenders swallow the shortages? As attorneys, are we expected to be able foresee how the courts will decide those questions? Additionally, are short sales a new form of standard rather than "variant" transactions, as the supreme court has labeled the distinction, meaning that application of the rules should be done automatically rather than by way of purpose analysis, with all the judicial talk on that topic simply dicta?

Waiver

The borrowers' promises to pay in these three cases occurred long after their loans were originally made. Sections 726 and 580d have been held to be waivable as long as the waiver is subsequent to the making of the loan, according to our supreme court. *Salter v*

Ulrich (1943) 22 C2d 263. But new CCP §580e explicitly declares that it cannot be waived, and while it makes no distinction between contemporaneous and subsequent waivers, it seems hard to conceive of the section as applying at any time other than when an existing loan has gone into later default. As to §580b, the supreme court held that it was different from the other antideficiency rules and could not be waived at any time—originally or later. *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659. *Coker* reached the same conclusion as *DeBerard*, although it did not cite that case as authority. Whether one finds the reasoning of *Coker* to be persuasive or incoherent, its holding is clear: When the loan is a purchase money loan, its lender *cannot* obtain an enforceable promise to pay the balance from its borrower, even as consideration for a subsequent release of its deed of trust at a reduced amount, done so at the request of the borrower.
As is also true for §580e, no lender is required to consent to a short sale. When it holds a nonpurchase money loan, a lender may well decide to deny that assent so that it may instead enforce its rights to a deficiency judgment after a foreclosure or obtain a money judgment as a sold-out junior. When the lender holds a purchase money loan, its calculus should be different, since it lacks the alternatives of a nonpurchase money lender. If a purchase money lender believes that its collateral is worth more than the proposed short selling price, it will probably not agree to release its security; conversely, if the proposed short sale price seems bona fide, the lender will probably accept the offer, since that is all it will get anyway.

Enloe v Kelso

Enloe v Kelso (2013) 217 CA4th 877 differs in two significant respects from *Coker*. First, it involved vendor instead of third party financing. Second, the loan was, despite the fact that a vendor was involved, arguably not a purchase money loan. (The case is also different in involving a junior deed of trust—a third—rather than a senior first lien, as was the case in *Coker*, but nothing was made of that feature.)

Vendors and Lenders

Section 580b treats vendors differently than lenders, barring them from obtaining deficiency judgments in all cases (subsection (2)), whereas lenders are barred only when their collateral consists of one-to-four-unit owner-occupied dwellings. This vendor/lender distinction should also bear on the judicial policy question of the overvaluation purpose because vendors directly set sales prices, whereas third party lenders do not.

But to highlight overvaluation only seems to make that purpose more dubious. Why would a vendor be deterred from asking or accepting a higher price for her property because of the §580b denial of deficiency recovery? If she has set an overinflated price that was ultimately paid, then she was clearly better off for having done so; whereas, if that bloated price was ultimately unpaid (*i.e.,* the purchaser defaulted), she appears no worse off than she would have been had a lower price not been paid. Either way, a higher price seems better for a vendor than a lower one. Viewed from the other side, informing a purchaser that he has purchase money antideficiency protection should induce him to be willing to take greater risk on the property being considered, *i.e.,* to be more, rather than less, agreeable to overpaying. (The notion that CCP §580b keeps prices down appears to have come from judges who did not have to manage their own accounts or pay their own bills.) In terms of the overvaluation purpose, *Enloe* took readers through the standard mantra about §580b but gave them no explanation to enable them to see how a true purpose analysis might operate.

Purchase Money or Not?

The major issue in *Enloe* was whether the deed of trust involved was purchase money at all, since it had not been delivered to the vendor until after the sale had closed. The court was confident that this temporal feature did not alter the purchase money nature of the deed of trust, but I would have been less certain.

Had the security been personal rather than real property, the one-day delay would have made a big difference. Comment 3 to §9103 of Article 9 of the UCC observes that "a security interest does not qualify as a purchase-money security interest if a debtor acquires property on unsecured credit and subsequently creates the security interest to secure the purchase price." So for other, general purposes, a note given afterwards is just not a purchase money note. (Of course, purchase money in the Article 9 context gives superpriority benefits rather than antideficiency drawbacks, but the section's language still says what it says, forcing decision-makers to explain why they are going the other way.)

On the real property front, the 2012 amendments to §580b provided that "refinances" of purchase money loans kept their original character, except to the extent of "new advances"— which I do not believe sheds much light on the *Enloe* issue. But perhaps more to the point is the fact that our supreme court once dealt with this kind of issue and seemed to say that parties could take advantage of technical distinctions in order to obtain for themselves different results.

Kistler v Vasi

In *Kistler v Vasi* (1969) 71 C2d 261, the purchaser gave a note for part of the price to the seller's broker (rather than to the seller). Since the property was commercial, the supreme court held that the note was not a vendor's purchase money note under §580b, even though it was really just paying a sales commission that the vendor owed to its broker. I quote the opinion at length, in part because it was written by Justice Trainor, who is also the source of California's overvaluation and antidepression purpose arguments—about as authoritative as one can get (71 C2d at 263):

Defendants contend, however, that even if plaintiffs are not precluded from recovering a deficiency judgment as lenders, they are also vendors within the meaning of section 580b and are therefore barred from recovering a deficiency judgment regardless of the character of the property involved. Defendants point out that the note and deed of trust plaintiffs accepted was given to discharge Agajanian's and Santa Anita's obligation as vendors and they conclude that therefore it must be deemed to be a note and deed of trust given to the vendors. To hold otherwise, they contend, will open the door to evasion of the protection that section 580b was enacted to provide.

The answer to this contention is that under the plain language of the 1963 amendment to section 580b plaintiffs are lenders and not vendors. That amendment expressly distinguishes between lenders of purchase money and vendors and contemplates that the parties to a sale of real property, other than the defined residential property, may freely elect to arrange for the financing of the purchase price in ways that may wholly or in part limit the vendee's protection from deficiency judgments. If the parties wish to afford full protection to the vendee, they may provide that all security instruments be given to the vendor, in which case subsequent assignees from the vendor would take subject to section 580b. If the vendor is not willing to accept such extensive risks, however, he may insist that all or part of the purchase price be financed by third parties, whose remedies are not affected by section 580b. Moreover, in such a case it is immaterial whether the third party who assists in the financing makes a payment of part of the price to the vendor in exchange for the vendee's note and deed of trust or, as in this case, discharges an existing obligation of the vendor in exchange for the vendee's note and deed of trust.

The parties could have chosen another method for the payment of plaintiffs' commission that would have afforded defendants the protection of section 580b. Thus, defendants could have given the note and deed of trust to Agajanian and Santa Anita with the understanding that they would in turn assign them to plaintiffs and guarantee payment. Such a transaction, however, would have been substantially different from the one the parties entered into, for it would have afforded defendants protection against a deficiency judgment at the risk of Agajanian, Santa Anita, and plaintiffs. It is reasonable to assume that had defendants bargained for the protection of section 580b with respect to plaintiffs' note and deed of trust, they would have given some *quid pro quo*.

Since the note and deed of trust for plaintiffs' commission was given by defendants, not to a vendor but to a third-party lender of purchase money for commercial property, defendants are precluded by the express terms of the 1963 amendment to section 580b from invoking the protection of that section against a deficiency judgment.

That language leads me to conclude that if our courts will permit a vendor to avoid §580b by telling her purchaser to make his note payable to a third party rather than to her, then why should they not similarly allow her to propose that her purchaser give her the note one day after closing, if everyone is willing to do it that way? Why should one version of the device work but not the other? Or is *Kistler* in fact dead, but no one has the temerity to repudiate a Trainor pronouncement?

Conclusion(?)

Attempting to predict outcomes under California's antideficiency statutes by way of analyzing their "purposes" as determined by our courts is never going to be an easy job. If a situation lines up in all particulars with a settled judicial result, it may be safe to predict a repetition of the same outcome again. But one should not be too willing to sign an opinion letter predicting the result if the circumstances are at all novel, or to try to explain to an outsider just how the reasoning works.