



## **BUSINESS LAW SECTION**

### **INSOLVENCY LAW COMMITTEE**

THE STATE BAR OF CALIFORNIA

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### ***PROPOSAL TO EXTEND ANTI-DEFICIENCY PROTECTION TO REFINANCED MORTGAGE OBLIGATIONS***

#### **LEGISLATIVE PROPOSAL (BLS-2012-04)**

**TO:** Office of Governmental Affairs  
**FROM:** Robert G. Harris  
Business Law Section (the "Section") Insolvency Law Committee  
**DATE:** May 27, 2011  
**RE:** Proposed Amendment to C.C.P. §580b to Extend Anti-Deficiency Protection to  
Refinanced Mortgage Obligations

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#### SECTION ACTION AND CONTACTS

Date of Approval by Section Executive Committee (the "Executive Committee"): June 3, 2011  
Approval Vote: For: 15 Against: 0

<b>Executive Committee Contact:</b>	<b>Committee Contact:</b>
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## **HISTORY, DIGEST AND PURPOSE**

The mission statement of the Insolvency Law Committee of the State Bar of California (the “Committee”) provides that it shall seek “to promote predictability, efficiency and consistency in the administration of the federal and California laws governing insolvency and the rights and duties of creditors and debtors.” The mission statement further provides that the Committee “evaluates and advocates changes in federal and state statutes and regulations affecting creditors and debtors.” The proposed change to California Code of Civil Procedure section 580b (“CCP §580b”) affects both creditors and debtors. The Committee has concluded that it is consistent with its mission to propose a limited extension of existing anti-deficiency laws to refinanced “purchase money” mortgage obligations, so as to create certainty under (and efficiency in) enforcement of the law following judicial foreclosures of owner-occupied residential real property within the state.

California has enacted several anti-deficiency statutes to protect borrowers in real estate transactions. A “deficiency” is the liability of a borrower to the lender for the amount of the loan in excess of the value of the real property, as determined by a judicial foreclosure. In the case of a non-judicial foreclosure (i.e., a privately conducted foreclosure not involving the courts), borrowers are separately protected by a different section of the Code of Civil Procedure, CCP §580*d*.

Under current CCP §580b, residential borrowers are protected against deficiency liability on their original purchase money obligations, regardless of the method of foreclosure chosen by the lender. But if the purchase money obligation has been refinanced, then current case law holds that the anti-deficiency protection of CCP §580b has been lost, thus exposing the homeowner to the potential of deficiency liability if the lender chooses to foreclose judicially.

The Committee proposes an amendment to CCP §580b to extend purchase money anti-deficiency protection to homeowners who have refinanced their home loans. The proposed amendment will protect homeowners who have refinanced their original home mortgages from deficiency judgments after a judicial foreclosure, but only up to the principal amount of the original purchase loan that remains unpaid at the time of foreclosure.

While judicial foreclosures have historically amounted to only 1% of all foreclosures each year, this proposal would alleviate the disproportionate consequences that follow inadvertent and unwitting waivers of anti-deficiency protection in refinancing. The proposed amendment would apply to loans refinanced after the effective date but would not impact any existing loans refinanced before the effective date. The proposed amendment would also codify the right of sold-out property vendors who subordinate their liens to new construction financing to obtain a deficiency against the developer after foreclosure.

## Relevant Existing Code Sections.

Existing California law is set forth in CCP §580b. In part, that section prevents a secured lender under a deed of trust or mortgage, after a judicial foreclosure, from obtaining a deficiency judgment against the owner of an owner-occupied dwelling for not more than four families. The refinancing of home mortgage obligations by homeowners has become widespread in recent years. Refinancing comes with a penalty of which few, if any, homeowners are aware: loss of the anti-deficiency protection provided by CCP §580b. Refinancing lenders are not required to disclose the loss of anti-deficiency protection that results from the refinancing of a purchase money obligation.

## Proposal.

The primary effect of the proposed amendment would be to prevent a refinancing lender from pursuing the homeowner, after a judicial foreclosure, for payment of the remaining balance of the original purchase loan. The protection offered by the amendment is limited: it applies only to the extent that the loan being foreclosed upon represents a refinancing of the unpaid principal amount of the original purchase money mortgage loan. A completely new home loan, taken out at some time after the original home mortgage loan has been fully paid off, would not qualify as purchase money and hence would not qualify for the proposed extension of anti-deficiency protection.

Under the proposed amendment, the anti-deficiency protection enjoyed by the purchase money obligor is strictly limited to the original principal balance of the purchase money obligation that remains unpaid. Thus, if the purchase money obligation is refinanced and additional principal is advanced by the refinancing lender (commonly called a “cash out” refinancing), the borrower’s protection does not extend to the additional sums advanced. By the same token, the proposed amendment would not extend protection to “home-equity” loans or lines of credit. Finally, to the extent that the refinancing is designed to encompass unpaid interest on the original purchase money obligation, the protection afforded by the statute would not apply to that additional indebtedness.

A second part of the amendment is intended to memorialize in the statute the case of Spangler v. Memel, 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr. 807 (1972), which is a very narrow, judicially created exception to the rule barring vendors from obtaining deficiency judgments. Under the proposed amendment, property vendors who hold purchase money trust deeds would be able to obtain deficiency judgments should foreclosure by a senior construction lender extinguish the vendors’ liens.

Several illustrations show how the amendment would operate:

**ILLUSTRATION 1:** A buyer purchases a single family home for \$500,000 with no money down. The buyer refinances the home loan after five years for all sums then owing, at which time the original loan principal balance has been reduced to \$475,000. There is no second mortgage or junior non-purchase money against the home. The buyer suffers financial reverses

and is subsequently unable to repay the new obligation, so the refinancing lender forecloses judicially. Under current law, the refinancing lender can foreclose judicially and obtain a deficiency judgment for any portion of the debt remaining after recovery through foreclosure. Under the proposed amendment, the lender would be barred from obtaining a deficiency judgment for any portion of the refinanced purchase money debt of \$475,000 remaining unpaid.

**ILLUSTRATION 2:** A buyer purchases a single family home for \$500,000 with no money down. The home loan accrues interest at a rate greater than the monthly payments cover. As a result, after 5 years of negative amortization, the outstanding principal balance of the loan has increased to \$525,000. The buyer then refinances the home loan. The buyer suffers financial reverses and is subsequently unable to repay the new obligation, so the refinancing lender forecloses judicially. If the property does not generate sufficient proceeds through foreclosure to pay the refinanced obligation in full, then the lender, under current law, can bring an action to recover whatever remains unpaid. Under the proposed amendment, the lender would be unable to obtain a deficiency judgment with respect to any portion of the refinanced obligation that represents the original principal amount of the purchase money debt that remains unpaid. In this case, the lender would not be able to seek recovery of the \$500,000 (representing the purchase money debt) but would be able to go after the \$25,000 (which represents non-purchase money debt).

**ILLUSTRATION 3:** A buyer purchases a single family home for \$500,000 with no money down. After 5 years, the outstanding principal balance of the loan has been reduced to \$475,000. The buyer then refinances the home loan, by taking out a new home loan in the amount of \$525,000. She uses the proceeds to repay the original home loan and uses the additional \$50,000 to pay down her credit cards. The buyer then makes five years of payments on the refinanced home loan, reducing the outstanding principal amount to \$505,000. She subsequently suffers financial reverses and is unable to repay the new obligation, so the refinancing lender forecloses judicially. If the property does not generate sufficient proceeds through foreclosure to pay the refinanced obligation in full, then the lender, under current law, can bring an action to recover whatever remains unpaid. Under the proposed amendment, the lender would be unable to obtain a deficiency judgment with respect to any portion of the refinanced obligation that represents the original principal amount of the purchase money debt that remains unpaid. In this case, the lender would not be able to seek recovery of the \$455,000 (representing the purchase money debt in the original amount of \$500,000, less the \$25,000 of payments made in reduction of the principal amount of the original loan and less the \$20,000 of payments in reduction of the principal amount of the refinanced loan) but would be able to seek recovery of the \$50,000 (which represents non-purchase money debt). Note that the payments of principal made on the refinanced loan, for purposes of the proposed amendment, would be applied in reduction of the purchase money portion of the loan first.

**ILLUSTRATION 4:** As part of the purchase price of a parcel of real property, a vendor takes back a promissory note secured by a purchase money deed of trust. Pursuant to the agreement between the purchaser and the vendor, the vendor subordinates his, hers or its lien to a construction loan obtained by the purchaser in order to develop the property. The proposed

development entails a material change in the use of the property (e.g. from vacant land to developed land, or from residential property to commercial property or some other material intensification of the use of the property). Subsequently, the construction loan goes into default. The construction lender forecloses, either judicially or non-judicially. The vendor's junior lien is extinguished. Under the language of current CCP §580b, the vendor would be barred from seeking a deficiency judgment against the developer. But, under the exception articulated in Spangler v. Memel, 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr., 807 (1972), the vendor may nevertheless seek a deficiency judgment. The proposed amendment would codify this result from Spangler v. Memel.

### **History.**

CCP §580b was originally enacted during the Great Depression of the 1930s, as part of a package of legislation designed to protect debtors in transactions secured by real property. It originally provided that *vendors* holding purchase money trust deeds could not obtain deficiency judgments. The statute was amended in 1963 to provide that *lenders* holding purchase money trust deeds on owner-occupied residential property could not obtain deficiency judgments.

In 1972, the California Supreme Court in Spangler v. Memel, 7 Cal.3d 603, 498 P.2d 1055, 102 Cal.Rptr. 807 (1972), created a judicial exception to the statute, to the effect that vendors holding purchase money trust deeds subordinated to certain types of construction loans could obtain deficiency judgments, after the senior lienholder has foreclosed. Subdivision (b)(2) of the proposed amendment would codify that result.

In 1976, the court in Union Bank v. Wendland, 54 Cal.App.3d 393, 126 Cal.Rptr. 549 (1976), held that a residential homeowner who refinances his or her original purchase money loan thereby loses CCP §580b protection against deficiency liability. The court interpreted the statute literally. Further, the court's cursory discussion of the purposes of §580b inexplicably focused on the pre-1963 language of the statute, which barred vendors (but not lenders) from obtaining deficiency judgments:

Section 580b was drafted to protect purchasers under the standard purchase money mortgage transactions in which the *vendor* of real property retains an interest in the land sold to secure payment of part of the purchase price . . . . "Variations on the standard are subject to section 580b only if they come within the purpose of that section." . . . . The loan transactions with [the refinancing lender] are variations from the standard that do not come within the purpose of section 580b. Accordingly, when [the homeowner] refinanced the property . . . he lost the purchase money protection afforded by section 580b. [Id., 54 Cal.App.3d at 399-400; citations omitted and emphasis added.]

Subdivision (b)(3) of the proposed amendment would overturn Wendland and its progeny as to loans refinanced after the effective date of the amendment but would not impact any potential challenges to Wendland arising from loans refinanced before that effective date.

This affirmative legislative proposal was initially proposed in 2009, for potential introduction in 2010. On January 26, 2010, the Board Committee on Operations, acting on behalf of the Board of Governors between regular meetings, declined on a 4-3 vote to approve the proposal. The Business Law Section Insolvency Law Committee is bringing this proposal back in light of additional legislative experience with the specific issues raised by this proposal. A bill similar to this legislative proposal passed the legislature in 2010, but was opposed and vetoed primarily on the grounds that it would have applied retroactively. In contrast, this legislative proposal is prospective only, and because of this difference we do not anticipate opposition.\*

### **Reasons for the Proposal.**

The proposed amendment is based, in part, on the language of section 9103(f)(3) of the Commercial Code, which provides (in essence) that the refinancing of a purchase money security interest in personal property does not destroy its purchase money status. Similarly, the primary goal of the proposed amendment to §580b is to preserve the purchase money characterization of a lien given to a lender to secure the purchase price of an owner-occupied dwelling, even if the obligation is later refinanced.

Under current law, residential purchase money borrowers who wish to refinance their home loans are faced with a dilemma: if they refinance (thus obtaining a lower interest rate), they will lose their purchase money protection under §580b. See, e.g., Union Bank v. Wendland, 54 Cal.App.3d 393, 126 Cal.Rptr. 549 (1976). Worse yet, most homeowners are completely unaware of the fact that refinancing destroys their anti-deficiency protection. The amendment is intended to overturn the rule in Wendland and its progeny.

Under the proposed amendment, the character of the obligation as one within the scope of this statute is determined as of the moment of its creation, even if the obligation is later assumed

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\* SB 1178 (Corbett), introduced in 2010, was sponsored by the California Association of Realtors. Like this legislative proposal, SB 1178 extended anti-deficiency protection to refinanced mortgage obligations, but SB 1178 was broader because it would have had retroactive effect as to existing loans. Governor Schwarzenegger's veto message highlighted the retroactivity of the bill, and provided as follows: "This bill, by extending anti-deficiency protection to refinancing, would fundamentally alter and impair the nature of pre-existing, previously negotiated mortgage loan contracts. In addition, the bill would encourage borrowers to strategically default on loans they have the capacity to repay simply because the mortgaged properties have lost value. This bill's anti-deficiency protection would apply to pre-existing, previously negotiated mortgage loan contracts that are the subject of actions filed on or after June 1, 2011. As a result, this bill fundamentally alters the nature and impairs the value of previously negotiated contracts, leading to negative consequences for the value of those loans held in a lender's portfolio and a deleterious impact on the secondary market. Fundamentally altering the nature of a contract after its consummation is a bad precedent and will provide uncertainty for future lending transactions." In 2011, SB 1178 was re-introduced as SB 458 (Corbett), in substantially the same form. That bill did not move forward with the provisions relating to anti-deficiency protection for refinanced mortgage obligations, but instead was amended to deal solely with CCP section 580e (a provision addressing a different aspect of deficiency judgments), as a result of negotiations involving the proponents of SB 458 and groups who had opposed that bill. SB 458 has been signed into law.

by a subsequent purchaser. This is consistent with the rule that “[t]he character of the obligation as a purchase-money debt, once determined by the facts that exist at the time of its creation, retains that character after subsequent transactions.” DMC, Inc. v. Downey Savings & Loan Assn., 99 Cal.App.4th 190, 196, 120 Cal.Rptr.2d 761, 765 (2002).

In order to ensure the uniform application of the statute, the proposed amendment makes it clear that the purchase money status of an obligation will not be lost, even if the obligation has been renewed, refinanced, consolidated, restructured, modified, assigned, or assumed. Under current §580b as interpreted by the courts, purchase money obligations that have simply been assigned or assumed are already protected by the statute. Purchase money obligations that have been renewed, modified, or consolidated might not be protected by the current statute, depending on the degree of alteration of the underlying terms of the obligation resulting from the renewal, modification, or consolidation. And purchase money obligations that have been restructured or refinanced are not protected under the current statute, as interpreted by Wendland.

In order to ensure certainty and uniform application of the statute with regard to payments of principal made prior to a foreclosure sale, the proposed amendment would apply any such payments first in reduction of the purchase money obligation(s). The proposed amendment places the burden of establishing the purchase money characterization of the obligation on the obligor, which is seemingly the opposite of the way that Commercial Code section 9103(g) operates (under which the creditor bears the burden). In reality, however, the two approaches are entirely consistent: the Commercial Code places the burden of establishing purchase money status on the creditor precisely because a creditor seeking purchase money status under the Commercial Code is seeking the advantage of special priority. Here, the party seeking purchase money status (the obligor) is the one seeking the advantage of anti-deficiency protection. Thus, rather than requiring the creditor holding the residential trust deed to establish a negative (the absence of purchase money status), the obligor must bear the burden of establishing a positive fact (the extent to which the debt is protected by the defense provided by section 580b).

The statute does not limit the ability of the borrower to trace his or her anti-deficiency protection from the original purchase money obligation through subsequent refinancings; therefore, even if the original note has been refinanced several times, the borrower would still be entitled to assert the benefit of purchase money protection, but only to the extent that the borrower can show that the unpaid principal amount of the original purchase money obligation is still represented by some portion of the refinanced debt.

Addition of the phrase “by reason of this section” in subdivision (c) is intended to confirm that section 580b is intended to work in harmony with Commercial Code section 9604. In summary, that section permits holders of commercial obligations secured by mixed real and personal collateral to foreclose in several different ways, without running afoul of the anti-deficiency statutes. Section 9604(a)(2) broadly states, in essence, that many anti-deficiency protections do not apply to mixed collateral transactions. However, section 9604(3)(A) states that “Paragraph (2) does not limit the application of Section 580b of the Code of Civil Procedure.” The proposed amendment to the final paragraph of section 580b simply confirms the harmony between section 580b and section 9604.

## **APPLICATION**

The proposed amendment provides that it only applies to loans renewed, refinanced, consolidated, restructured, modified, assigned, or assumed after the effective date of amendment of CCP §580b.

## **PENDING LITIGATION**

No pending litigation would be affected. Some of the changes would codify existing law and others would be prospective only.

## **LIKELY SUPPORT AND OPPOSITION**

SB 1178 (Corbett) of 2010, discussed above, was supported by CALPIRG, the Center for Responsible Lending, and Consumers Union. The bill was opposed by the California Bankers Association, California Chamber of Commerce, California Mortgage Association, and other groups representing the lending industry and collectors. The Committee anticipates that the same groups who supported SB 1178 are likely to support this proposal. The Committee also anticipates that the groups who opposed SB 1178 are likely to remove that opposition as a result of the fact that this legislative proposal is not retroactive.

## **FISCAL IMPACT**

No direct fiscal impact is anticipated.

## **GERMANENESS**

The proposed amendment would alter the rights of California homeowners, affecting the amount of debts they would face after loss of their homes in judicial foreclosure. It would also alter the rights of future lenders seeking to refinance purchase money obligations, since they would no longer be able to judicially foreclose and collect post-foreclosure deficiency judgments against residential borrowers. It is appropriate for the Committee to submit the proposal because the matter requires the special knowledge, training, experience and technical expertise of the lawyers of the Committee. The Committee is composed of 28 lawyers practicing in the area of bankruptcy and financial law.

## TEXT OF PROPOSAL

SECTION 1. Section 580b of the Code of Civil Procedure is amended to read:

580b. (a) *As used in this section, "purchase money obligation" means an obligation secured by a deed of trust or mortgage on a Qualified Dwelling. A "Qualified Dwelling" means a dwelling for not more than four families as to which a deed of trust or mortgage has been given to a lender to secure repayment of a loan that was in fact used to pay all or part of the purchase price of that dwelling occupied, entirely or in part, by the purchaser. A loan that is used to refinance a purchase money obligation is a "purchase money obligation" for all amounts used to reduce or discharge the then-outstanding principal of the original purchase money loan or a subsequent purchase money loan so long as the loan is secured by a Qualified Dwelling.*

(b) *No deficiency judgment shall lie in any event after a sale of real property or an estate for years therein --*

(1) *for failure of the purchaser to complete his or her contract of sale, or*

(2) *under a deed of trust or 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 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~~ except if --*

(A) *the vendor has contractually subordinated his or her lien to the lien of a construction lender; and,*

(B) *the construction loan involves a commercial project that contemplates a material change in the use or a material increase in intensity of an existing use of the real property; and,*

(C) *the construction lender has actually funded a substantial portion of the project; and,*

(D) *the construction lender has foreclosed on the property, extinguishing all or part of the lien held by the vendor; or*

(3) *under a purchase money obligation. To the extent that a purchase money obligation is covered by this subdivision, it does not lose its status as such, even if any or all of the following are true:*

(A) *The collateral securing the purchase money obligation also secures an obligation that is not a purchase money obligation, or*

(B) *The purchase money obligation has been renewed, refinanced, consolidated, restructured, or modified, on or after January 1, 2013, or*

(C) *The purchase money obligation has been assigned or assumed on or after January 1, 2013.*

*The protection against deficiency liability provided by this subdivision extends to the amount of purchase money obligation remaining outstanding against a Qualified Dwelling. An obligor seeking the protection against deficiency liability provided by section 580b shall have the burden of establishing the extent to which the obligation is a purchase money obligation. Any payments that have been applied to the principal balance due on any loan for which the protection of section 580b is sought, even where subdivision 580b(b)(3)(B) applies, shall be deemed first to have reduced the outstanding principal balance of the obligor's purchase money obligation and then to have reduced the remaining outstanding principal balance of the loan.*

(c) Where both a chattel mortgage and a deed of trust or mortgage have been given to secure payment of the balance of the combined purchase price of both real and personal property, no deficiency judgment shall lie at any time under any one thereof if, *by reason of this section*, no deficiency judgment would lie under the deed of trust or mortgage on the real property or estate for years therein.