



Foreclosures in California

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Introduction

When a borrower defaults under a loan secured by a deed of trust in California, the lender may elect to enforce the loan through either judicial or nonjudicial foreclosure. Under judicial foreclosure, the lender must bring an action against the borrower in court. A nonjudicial foreclosure (also known as a foreclosure by private power of sale) is accomplished by a trustee's sale, which does not involve court action. Because nonjudicial foreclosure is a statutory alternative that is intended to be a faster and more efficient remedy, it is the more common type of foreclosure used by lenders.

Nonjudicial Foreclosure

When the borrower defaults under a loan, the lender has the right to declare a default and to proceed with foreclosure of the deed of trust pursuant to a private power of sale. With certain limited exceptions for fraud or waste, a trustee's sale will terminate any remaining enforcement rights the lender may have against the borrower for any amounts that may still be owed following such sale.

No Court. A significant advantage of the nonjudicial foreclosure process is that the parties can avoid having to go to court. This means that the matter can usually be handled much faster and with less expense than judicial foreclosure. The entire process can often be completed within four (4) months after the notice of default is recorded.

No Deficiency Judgment. A lender cannot obtain a deficiency judgment following a sale of the property under a nonjudicial foreclosure. A deficiency judgment is a

judgment against the borrower for the difference between (a) the unpaid balance of the loan, plus expenses, and (b) the proceeds from the foreclosure sale or the "fair value" of the property, whichever is greater (see discussion below on fair value). Since court proceedings are required to establish the borrower's remaining liability following foreclosure, a lender that pursues nonjudicial foreclosure will not be entitled to a deficiency judgment after the trustee's sale. This means that if the underlying property is sold for less than the amount of the debt, the lender is not entitled to the difference. The borrower is relieved from any further liability on the secured obligation.

No Redemption. In nonjudicial foreclosure sales, the borrower does not have a post-sale redemption right (see discussion below on redemption).

Procedural Matters:

(i) Trustee's Role. The trustee is granted the power of sale under the deed of trust and has the limited purpose of conducting a trustee's sale after a borrower defaults under the loan or reconveying the deed of trust after a borrower has fulfilled all of its obligations under the loan.

(ii) Notice of Default; Notice of Sale. The first step in foreclosing the security under the power of sale is the recordation of a notice of default and election to sell.¹ A copy of the notice is also delivered by registered or certified mail within ten (10) business days after recording. The purpose of this notice is to give notice to the world, including to the borrower, its successors,

¹ In response to the foreclosure crisis, the legislature enacted additional timing requirements for certain residential loans to homeowners. Before recording a notice of default, a lender must wait at least 30 days after making its initial contact with the borrower, or 30 days after satisfying the certain due diligence requirements in attempting to contact the borrower. These requirements only apply to loans made from 2003 through 2007 and, as of this writing, are scheduled to expire on January 1, 2013.

junior lienholders or other interested persons, that there has been a default and the nature of such default. The notice also serves to inform such parties that the default can be cured by paying the delinquencies within the required time period (see discussion below on reinstatement). The contents of the notice of default must comply strictly with the statutory requirements or else the subsequent trustee's sale will be invalid. After recording the notice of default, the trustee must wait for at least three (3) months and then record a notice of sale and satisfy certain other posting and publishing requirements.² The trustee must then wait an additional twenty (20) days before conducting the actual sale. Trustees are permitted to record the notice of sale as early as five (5) days before the end of the initial three-month period, so long as the total period between recording the notice of default and the actual sale date is at least three (3) months plus twenty (20) days.

(iii) Reinstatement. When a notice of default has been recorded, the borrower, its successors, or junior lienholders can reinstate the delinquent debt and "cure" the default by paying the amount in arrears plus costs at any time until five (5) business days prior to the date of the sale if the power of sale is exercised in nonjudicial foreclosure, or any time before entry of a decree of foreclosure under a judicial foreclosure. If the principal amount of the loan has been accelerated as a result of the borrower's default, the borrower is only required to pay the delinquent amounts and is not required to pay portions of principal that weren't otherwise due prior to the date of reinstatement. Once the cure payment is made, the original terms of the loan are reinstated as if no default had occurred. The right of reinstatement is restricted to certain limited and specified monetary defaults and does not apply to other noncurable defaults.

Judicial Foreclosure

Despite the speed and efficiency of nonjudicial foreclosure, a lender may decide to pursue judicial foreclosure if, for example, the lender desires a deficiency judgment, the deed of trust fails to have the proper power

² At least 20 days before the sale, the notice of sale must be (i) recorded in the county where the property is located, (ii) posted conspicuously at the property, (iii) posted in a public place, and (iv) published weekly for 3 consecutive weeks, with the first publication made at least 20 days before the sale.

of sale provisions, or there are other unsettled claims between the parties that need to be resolved in court. Under a judicial foreclosure, the lender will ask the court to determine that the loan is in default and order the sale of the property to satisfy the outstanding debt. The court will also make a determination as to whether the borrower is liable for any deficiency if the proceeds from the foreclosure sale are not sufficient to cover the entire debt and enter a deficiency judgment if the lender is entitled to such judgment.

Deficiency Judgment. One of the main reasons a lender will elect to pursue a judicial foreclosure over a nonjudicial trustee's sale is to obtain a deficiency judgment. To obtain a deficiency judgment, the court must first determine that the lender is entitled to a deficiency judgment at a fair value hearing. In the residential context, a new law was recently enacted with respect to short sales of residential property with four units or less. Subject to certain exceptions, if a lender with a first deed of trust on such property gave the borrower written consent to a short sale, the lender is prohibited from then recovering a deficiency from the borrower after the short sale.

Fair Value. In order to obtain a deficiency judgment, the lender must return to court to apply for a fair value determination of a deficiency judgment within three (3) months after the foreclosure sale. The court will conduct a hearing and take evidence of the fair value of the property sold at foreclosure. If, after determining the fair value of the property, the court determines that the lender is entitled to a deficiency judgment, the court will enter a judgment against the borrower for the difference between (i) the total amount due the lender, and (ii) the greater of either the fair value of the property or the actual gross sales proceeds from the foreclosure sale.³

Post-Sale Redemption:

(i) Redemption Right. After a judicial foreclosure sale, if the lender has a right to seek a deficiency judgment, the borrower is entitled to a statutory right of redemption. This allows the borrower to repurchase the property during the

³ **Fair Value Example:** If the lender is owed a balance of \$8,000,000 and the highest bid at the foreclosure sale is \$7,500,000, the lender does not necessarily get a deficiency judgment in the amount of the \$500,000 difference. If the court finds that the fair value of the property at the time of sale was really \$7,800,000, the deficiency judgment is limited to \$200,000 (the difference between the debt and the fair value). If the fair value was found to be \$7,400,000, the deficiency judgment would not be \$600,000, but the difference between the debt and the amount of the bid, which is \$500,000.

applicable time period for the amount of the sale price under the foreclosure sale, plus interest. Therefore, the purchaser at the foreclosure sale does not have marketable title to the property until the borrower's redemption rights have expired. The borrower also has the right to possession of the property for the duration of the redemption period.

(ii) Redemption Period. If the proceeds of the foreclosure sale are sufficient to satisfy the secured debt plus interest and the costs of the action and the sale, the redemption period is three (3) months after the date of sale. If the proceeds are *not* sufficient to satisfy the debt plus interest and costs, the redemption period is one (1) year after the sale date.

(iii) Waiver of Deficiency Judgment. Because of the borrower's statutory right of redemption and possession, the bidding at judicial foreclosure sales tend to be lower than at nonjudicial private sales. The lender can waive its deficiency judgment to avoid redemption after foreclosure, but since the right to a deficiency judgment is often the main reason for pursuing judicial foreclosure in the first place, such waiver would most likely be asserted if the lender has other reasons for electing judicial foreclosure.

Nonrecourse Loans. Many term loans are structured as nonrecourse loans. In the event of a default under such a loan, the lender is only entitled to the proceeds of the foreclosure sale, and not the personal assets of the borrower if there is a deficiency. If the borrower is in default under a nonrecourse loan, then even if the lender pursues a judicial foreclosure, the lender is not entitled to a deficiency judgment.⁴

Purchase Money Loans. Deficiency judgments are prohibited after the foreclosure sale of real property that is secured by a deed of trust for a purchase money loan, which is a loan from a seller to a buyer to finance the buyer's purchase of the seller's property. Deficiency

⁴ Many nonrecourse loans have nonrecourse carveouts that allow the lender to recover against the borrower's personal assets in addition to the underlying property in certain circumstances. Such carveouts are typically for acts such as fraud, misrepresentation, waste, misapplication of rents or insurance proceeds, prohibited transfers and other particularly bad acts. Depending on the severity of such bad acts, some carveouts entitle the lender to recover against the borrower's personal assets to the extent of the loss suffered by the lender from the bad acts, and certain other carveouts convert the entire loan into a recourse loan.

judgments are also prohibited when funds are loaned to a buyer by a third party if those funds are used to pay for all or part of the purchase price of a dwelling of four (4) units or less, which is occupied at least in part by the buyer, where the loan is secured by such dwelling.

Election of Remedies

The lender does not need to decide which type of foreclosure to pursue as soon as a default occurs, because neither filing a complaint for judicial foreclosure nor recording a notice of default constitutes an election of remedies. Lenders often commence both judicial and nonjudicial foreclosures simultaneously and wait until the last moment to choose which foreclosure to follow, depending on such factors as the result of an appraisal or marketing analysis. However, this "dual-tracking" approach raises questions about the lender's recovery of duplicative foreclosure costs.

One-Action Rule

Rule. Under Code of Civil Procedure §726(a), a secured lender gets only one form of action for the recovery of any debt or the enforcement of any right that is secured by a deed of trust, and that one remedy is foreclosure. This only applies where there is a lien on real property located in California, and to affect personal property, the debt has to be secured by *both* personal and real property.



Effect. The one-action rule has two major components:

(i) "One Action" Component. The lender can't bring more than one action to exhaust the security, so it must foreclose on the property.

(ii) "Security-First" Component. And the first thing the lender has to do is exhaust all the security by foreclosure proceedings. The lender can only recover a personal judgment against the Borrower by getting a deficiency judgment after a judicial foreclosure sale.

Judicial Foreclosure Only. A trustee's sale under a nonjudicial foreclosure is not considered an "action" under this rule since no court action is involved.

Consequence of Violation. If the lender violates the one-action rule, the lender loses the lien of its deed of trust and as a result is unable to foreclose the lien.

Environmental Issues.

(i) Election to Waive. Under CA Code of Civil Procedure §726.5(a), if the property is “environmentally impaired,” the lender is allowed to waive its security and exercise the rights of an unsecured creditor. The property is “environmentally impaired” when (i) there exists hazardous waste that wasn’t known by or disclosed in writing to the lender at the time the loan was entered, and (ii) the estimated cost to remediate exceeds 25% of the fair market value of ALL security for the loan at the time the loan was made or at the time lender discovered the release of such hazardous waste. The property is also “environmentally impaired” if it is listed as contaminated property by any federal or state agency.

(ii) Environmental Indemnities. Under CA Code of Civil Procedure §736(a), a lender can still bring a separate action against the borrower to enforce any “environmental provisions,” which are written representations or covenants by the borrower made in connection with the loan that relate to hazardous substances. It doesn’t matter if the provisions are secured or unsecured, or if the provisions are in the deed of trust or in a separate agreement. The environmental provisions in a deed of trust continue in effect even after the deed of trust is reconveyed or foreclosed.



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