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Preface

This fourth edition of Roger Bernhardt's renowned contribution to legal scholarship could not have arrived at a more auspicious time. The unthinkable happened—the mortgage and financing industry was thrown into the worst crisis since the 1930s. Fortunately the foundation for understanding and applying some of the most difficult principles of real property law had already been laid in the first three editions of this book.

The original edition was published more than 30 years ago and provided a much-needed practice-oriented guide for attorneys representing parties to real property secured transactions. The first edition combined transactional and litigation forms, checklists, and other practice aids with extensive substantive discussion. After publication of the second edition, CEB published a separate and comprehensive transactional guide on real property financing: California Real Estate Finance Practice: Strategies and Forms (Cal CEB 2000). This allowed CEB in the third and fourth editions of this book to deliver even more practical guidance for enforcing real property security devices and to emphasize a wider range of remedies for disputes and defaults in real property secured transactions. In 2003, CEB expanded this book with three new chapters covering secured loan workouts, bankruptcy, and lender liability, all of which have been updated and expanded in this fourth edition to provide even more creditor and debtor strategies.

Many changes have occurred in the law governing real property security since publication of the third edition. For instance, the state and federal legislatures made extensive changes in laws governing the foreclosure process, bankruptcy, lender liability, and taxation of debt forgiveness and enacted new consumer protection laws on predatory lending and elder abuse. The case law continues to evolve on foreclosure trustee liability, distribution of surplus funds from a trustee sale, rights of bona fide purchasers, remedies for fiduciary fraud, reasonableness of late charges, and recovery of attorney fees. The antideficiency statutes continue to be fodder for complex and sometimes conflicting judicial interpretation.

Because this area of law is fraught with pitfalls and complications, we once again asked Professor Bernhardt to apply his expertise to aid practitioners in understanding the scope and intricacy of California real property secured transaction remedies. (See Author's Foreword, below.) We also invited attorneys and other experts specializing in litigation, foreclosures, tax law, loan workouts, bankruptcy law, consumer law, lender law, and forensic accounting, including professional receivers and foreclosure trustees, to write, review, and consult on this fourth edition, making it more relevant than ever to modern mortgage practice. Because of other commitments, Professor Bernhardt was not able to fully review the entire final version of this text; therefore, much of the final editing was done by CEB staff and consultants. Also, Professor Bernhardt was not the original author of chapters 10, 11, and 12.

We have been fortunate to have Charles A. Hansen of Wendel, Rosen, Black & Dean, Oakland, as our primary coauthor of this fourth edition. Mr. Hansen contributed annually on third edition updates and provided invaluable strategies for litigating attorneys. His thoughtful analysis and contribution of practical explanations and suggestions have helped make this fourth edition immensely useful.

CEB acknowledges and thanks the practicing attorneys and judges who consulted with CEB staff on practice strategies and procedures or reviewed chapters and provided many helpful suggestions to the text. Their names are listed in the Acknowledgments.

CEB plans to update this book on a regular basis. We eagerly solicit your suggestions and comments to help us expand its coverage, address the common issues you handle in practice, keep it accurate, and include the latest developments.

January 2010 Update

CEB is very grateful to the following attorneys for their continuous dedication to this fourth edition and for their contributions to the 2010 update: Charles A. Hansen and Mark S. Bostick of Wendel, Rosen, Black & Dean, Oakland; Michael T. Andrew, of counsel with Luce, Forward, Hamilton & Scripps LLP, San Diego; Jonathan Sears, Owen P. Gross, and Erik C. Loomis of Cox, Castle & Nicholson LLP, Los Angeles; Pamela D. Simmons, Soquel; Roger Bernhardt, Golden Gate University, San Francisco; Louis J. Esbin, Valencia; Kurt F. Eggert, Chapman University,

Orange; and Glen L. Moss, Hayward. We extend special thanks also to Heather Stern of Cox, Castle & Nicholson LLP, Los Angeles; Mike Brody of Ellman Burke Hoffman & Johnson APC, San Francisco; Darya Druch, Oakland; and Dena R. Thaler, Oakland, for their special consulting work on the new edition and this 2010 update.

CEB Attorney Editors Bonnie C. Maly (Managing Editor) and Janis L. Blanchette and Legal Editors Philip Weverka, Ragnhild Fougner, and Kenneth Marr contributed to this update. Administrative support was provided by Kenya Denman and Nila Kanzaria. Elizabeth J. Asborno handled copyediting and production. Robert W. Burke updated the index. Composition was performed by CEB's Electronic Publishing staff.

John K. Chapin
Practice Group Manager
Real Property

Pamela J. Jester
Director

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Author's Foreword

On publication of this fourth edition, CEB had two books in its library on real property secured transactions: California Real Estate Finance Practice: Strategies and Forms (on negotiating and drafting loan documents) and the third edition of this title, California Mortgage and Deed of Trust Practice. Although Real Estate Finance Practice deals with the typical "front end" issues facing attorneys as they draft the documents for mortgage loan transactions, this fourth edition is probably the book most readers should take up first. Even though the primary focus of the book is the treatment of existing mortgage loans, only an attorney who appreciates the special difficulties in the collection (or resistance of collection) of mortgage loans can sensibly approach the negotiating and drafting considerations at the inception of the loan.

To newcomers, the preparation of mortgage loan documents may seem like an easy task because the debtor is expected to obediently sign all documents that the creditor's lawyers have drafted. However, getting the documents signed is the easy part; enforcing their provisions is what is so hard. The legislature and the judiciary do not accept the premise that parties to a mortgage loan should be bound by what they have signed; freedom of contract defers to public policy (although discerning what that policy is remains a major mystery to most observers). Creditors—as initiators of most documents—can often only guess at whether the protective provisions of their paperwork will function effectively in this peculiar legal environment. This situation remains as true today as it was when the previous edition was published.

I wish to thank Charles A. Hansen of Wendel, Rosen, Black & Dean for the valuable Practice Tips, new developments, and revisions he has added since 2000; because of them this book is far more useful than what a mere academic could have produced. I am also grateful to the staff of CEB who put the text into final shape when—at the end—I was required to attend to other matters.

Finally, as always, I apologize for the even greater wordiness of the new title, California Mortgages, Deeds of Trust, and Foreclosure Litigation that now "graces" the cover. Despite its length and awkwardness, it is more accurate than before. California attorneys continue their peculiar tradition of calling themselves mortgage lawyers while drafting documents labeled deeds of trust and then litigating furiously over their provisions.

Roger Bernhardt
San Francisco

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About the Authors

Principal Book Authors

Roger Bernhardt, who received his B.A., M.A., and J.D. degrees from the University of Chicago, is Professor of Law at Golden Gate University, San Francisco. He is also the editor of CEB's California Real Property Law Reporter and the author of Real Property in a Nutshell (West Publishing, 5th ed 2005), Black Letter Law of Real Property (West Publishing, 5th ed 2006), California Real Estate Finance (Carolina Academic Press, 5th ed 2008), Casebook on Real Property (Carolina Academic Press, 2005), and Bernhardt's California Real Estate Laws (Deerings, 2010). Admitted to practice law in both California and New York, Professor Bernhardt is a member of the American Law Institute, the American College of Real Estate Lawyers, and the American College of Mortgage Attorneys.

Charles A. Hansen, B.A., 1973, University of California, Los Angeles; J.D., 1977, University of California, Berkeley, School of Law, is a partner in Wendel, Rosen, Black & Dean, Oakland, with a focus on real estate, commercial, and secured transactions litigation. He has been retained as a consultant and expert witness in a variety of transactional and state and federal court litigation matters relating to commercial and real estate lending, real estate transactions, mortgages, trust deeds, brokers, escrow, title insurance, commercial leasing, real estate development, guaranties, and personal property secured transactions. He teaches real property secured financing law at the University of California, Berkeley, School of Law and is a frequent lecturer on mortgage remedies for CEB.

New Edition Coauthors

Chapter 7

Louis J. Esbin, B.S., 1981, Albany State (SUNY); J.D., 1984, Golden Gate University, San Francisco, contributed to chapter 7. Mr. Esbin has practiced law in Valencia, California, since 1993, where he provides bankruptcy, corporate formation, transactional, and merger and acquisition services to clients throughout California. He represents both corporate and individual clients, including small emerging businesses, corporations, and individuals, as debtors and creditors. Mr. Esbin counsels his clients on approaching their matters with a practical cost-benefit analysis. He is a founding board member of the Santa Clarita Valley Bar Association, a founding member of the Central District Consumer Bankruptcy Attorneys Association, a California Certified Legal Specialist in Bankruptcy Law, and a member of the Financial Lawyers Conference and California Bankruptcy Forum.

Chapter 9

Michael T. Andrew, B.S., 1974, Regis College, Denver; J.D., 1979, Stanford Law School, Palo Alto, contributed to chapter 9. Mr. Andrew is of counsel with Luce, Forward, Hamilton & Scripps LLP, San Diego. Mr. Andrew practices and consults in the areas of real and personal property secured transactions, commercial law, and business bankruptcy. His primary practice is representing real property secured lenders in matters ranging from negotiation, structuring, and documentation of loan transactions to enforcement and bankruptcy. He is a frequent lecturer and writer on commercial and bankruptcy law, and he has taught at Stanford Law School, the University of Colorado School of Law, and the University of San Diego School of Law.

Chapter 10

Randy Sugarman, B.A., M.B.A., Stanford University, contributed to chapter 10. Mr. Sugarman, a certified public accountant, is the managing partner of Sugarman & Company LLP, San Francisco. He serves as a financial consultant on loan workouts and bankruptcies for a wide range of industries, including construction, financial institutions, professional service firms (including accounting, engineering, and law), and real estate investment. He provides litigation support to both defense and plaintiff legal counsel, prepares financial analyses, and provides expert witness testimony on management and financial issues. Mr. Sugarman has assumed management responsibilities, implemented cost controls, negotiated with creditors, and supervised the orderly liquidation of assets. He acts as a State Court Receiver, Federal Bankruptcy Trustee, Assignee for Benefit of Creditors, and Examiner.

Substantial portions of chapter 10 were based on chapter 1 of 2 California Real Property Financing (Cal CEB 1989), written by Bernard Kolbor, Aaron M. Peck, and Stephen E. Traverse and updated in 2003 by Joan M. Cambray, Martin M. Fleisher, and Timothy S. Williams.

Chapter 11

Richard M. Adler, B.A., 1981, University of California, Santa Barbara; J.D., 1984, University of California, Davis, School of Law, was the original author of chapter 11 and an update author for several years on the third edition. An attorney in Berkeley, Mr. Adler specializes in bankruptcy, including business restructuring and creditors' rights. He represents financially distressed public and private companies, creditors, and other interested parties including lessors, purchasers of assets, and creditors' committees in connection with matters related to financial workouts and restructurings, bankruptcy cases, and assignments for the benefit of creditors.

Mark S. Bostick, B.A., 1978, University of California, Berkeley; J.D., 1983, University of San Francisco School of Law, has updated chapter 11 continuously since 2007. Mr. Bostick is a partner in Wendel, Rosen, Black & Dean, Oakland, and represents debtors, committees, trustees, creditors, and other interested parties in bankruptcy proceedings and workouts. He has served as lead counsel to debtors in possession or trustees in Chapter 11 bankruptcy cases for a wide range of companies. He also represents numerous official and informal creditors' committees, trustees, and receivers. His practice emphasizes bankruptcy administration and litigation. He is a member of the California Bankruptcy Forum, the Alameda County Bar Association, the American Bankruptcy Institute, and the National Association of Bankruptcy Trustees.

Chapter 12

Pamela D. Simmons, J.D., Lincoln Law School, San Jose, contributed to chapter 12. Ms. Simmons is a partner with Simmons & Purdy, Soquel. She represents homeowners on mortgage loan and loan servicing issues. Before private practice, she was an assistant district attorney prosecuting real estate, mortgage, and other white-collar fraud in Santa Cruz County. Since 1995 she has represented borrowers in litigation on violations of federal and state lending laws, including the Truth in Lending Act (TILA). One of her specialized skills involves the "audit" of payment records provided by lenders. She teaches secured real estate transactions at Lincoln Law School in San Jose. Ms. Simmons regularly speaks on mortgage-related matters to real estate professionals, homeowners, elders, and investors and at the American Bar Association's annual real estate symposia.

Kurt F. Eggert, B.A., Rice University, Houston; J.D., University of California, Berkeley, School of Law, contributed to chapter 12. Mr. Eggert is a professor of law at Chapman University School of Law, Orange. He has published several articles in legal journals on the holder in due course doctrine, the securitization of mortgages, mortgage servicing issues, and the subprime mortgage market. He is a former member of the Federal Reserve Board's Consumer Advisory Council and has testified to Congress on mortgage issues. Previously, he litigated mortgage and other consumer finance issues at Bet Tzedek Legal Services, a legal aid organization.

Substantial portions of chapter 12 are based on chapter 4 of 2 California Real Property Financing (Cal CEB 1989), written by William J. A. Weir, a member of Luce, Forward, Hamilton & Scripps LLP, San Francisco, and the late David T. Lowell; chapter 12 was substantially updated by David C. Winton, Novato, in 2008.

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About the 2010 Update Authors

Principal Update Authors

Charles A. Hansen is an update author for all chapters. See biography in the About the Authors section of this book.

Michael T. Andrew is an update author for chapter 9. See biography in the About the Authors section of this book.

Jonathan Sears, B.A., 1984, University of California, San Diego, Revelle College; J.D., 1989, University of California, Los Angeles, School of Law, is an update author for chapter 10 on commercial loan workouts. He is a partner in the Los Angeles office of Cox, Castle & Nicholson LLP. He represents clients in all aspects of commercial real estate, with an emphasis on structuring and negotiating sophisticated real estate finance transactions, including credit facilities, portfolio and multi-state financings, syndicated and securitized loans, construction financing, mezzanine loans and preferred equity investments, standby letters of credit, interest rate hedging instruments, and defeasance transactions. Mr. Sears also advises clients in workout strategies for distressed commercial real estate, including restructuring loans, discounted payoffs, short sales, deeds in lieu, extensions, forbearances, and defensive strategies.

Owen P. Gross, A.B., 1988, University of Southern California; J.D., 1994, University of Southern California Law School, is an update author for chapter 10 on commercial loan workouts. He is senior counsel in the finance practice group of the Los Angeles office of Cox, Castle & Nicholson LLP. He is an expert in real estate secured financing transactions and has represented institutional, commercial, and equity lenders. Mr. Gross has significant experience representing borrowers as well. As a transactional attorney, he has reviewed, drafted, and negotiated documents for a variety of clients, from individuals to national real estate companies, as buyers, sellers, equity partners, developers, lenders, borrowers, landlords, or tenants on nearly all types of real estate transactions.

2010 Update Co-Authors

Roger Bernhardt is a contributing editor for all chapters. See biography in the About the Authors section of this book.

Mark S. Bostick is an update author for chapter 11. See biography in the About the Authors section of this book.

Pamela D. Simmons is an update author for chapter 12. See biography in the About the Authors section of this book.

Louis J. Esbin is an update author for chapter 7. See biography in the About the Authors section of this book.

Kurt F. Eggert is a contributor to chapter 12. See biography in the About the Authors section of this book.

Glen L. Moss, B.A., 1965, University of California, Los Angeles; J.D., 1968, University of California, Berkeley, School of Law, contributed to chapters 2, 7, and 12. He is a partner in Moss & Murphy, Hayward, and represents consumers and small businesses in a variety of litigation and appeals on real estate, taxation, decedent estates, and other matters. He serves as a mediator on commercial disputes and is on the arbitration panel for the United States District Court of Northern California. Mr. Moss is a member of the Trust and Estates and Taxation Sections of the State Bar.

Erik C. Loomis, LL.M., 2006, New York University School of Law; J.D., 2004, University of California, Davis, School of Law, contributed to chapter 10 on income tax consequences of workouts. He is an associate in the tax practice group of the Los Angeles office of Cox, Castle & Nicholson LLP. His practice includes federal and California income tax planning for individuals and business entities and their real estate investments. His particular focus is on tax issues arising in the context of joint ventures, acquisitions, dispositions, workouts, and exchanges involving real estate investments. He has expertise in California real property taxation and documentary transfer, limited liability company, and sales and use taxes. He represents clients in federal, state, and local civil tax disputes.

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Acknowledgments

CEB is grateful to each of the following judges and attorneys, who served as consultants on this book and its updates or previous editions by reviewing and commenting on one or more chapter manuscripts, consulting with CEB staff on practice strategies and procedures, recruiting authors, or adding valuable text. Their helpful insights, assistance, and suggestions make the book more accurate, more practical, and more reflective of California practice.

Honorable Richard A. Adler, Judge, Los Angeles County Superior Court, Van Nuys

Basil J. Boutris, tax attorney, Vaught & Boutris LLP, Oakland

Michael P. Brody, real estate financing and workouts counsel, Ellman Burke Hoffman & Johnson APC, San Francisco

Darya S. Druch, debtors' bankruptcy counsel, Oakland

Zachary Epstein, tax attorney, Berkeley

Liv Kristin Hassett, real property attorney, Santa Cruz

Keith A. McDaniels, creditor's bankruptcy counsel, Winston & Strawn LLP, San Francisco

Heather Elizabeth Stern, real property litigation counsel, Cox, Castle & Nicholson LLP, Los Angeles

Lawrence Teplin, mid-construction workouts and construction litigation counsel, Cox, Castle & Nicholson LLP, Los Angeles

Dena Rosenberg Thaler, counsel for foreclosure trustees and creditors, Oakland

The trustee sale forms in chapter 2 were updated and revised with the generous assistance of the legal department of Chicago Title Company, San Francisco office.

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Selected Developments

January 2010 Update

Book enhancements: For this 2010 update, all parts of chapter 9 covering secured loan guarantor and surety rights and liabilities were completely rewritten. Substantial discussion and strategies for both residential loan modifications and commercial loan workouts were added to chapter 10. More than six new state-of-the-art forms on commercial loan modifications were added to chapter 10. The summary of federal consumer laws (including Truth in Lending Act) that govern residential secured loans was expanded in chapter 12. A new section on short sale strategies was added to chapter 7.

General updates: In November 2009, the United States Treasury Department modified rules and guidelines first issued last May to encourage streamlined short sales of residential property. The program simplifies short sale and deed in lieu processes by providing standard performance time frames and standard documentation. Treasury provides incentives to borrowers and other parties, including relocation expenses of up to $1500 for selling borrowers. See §7.21A.

A general release with a CC §1542 waiver in settlement of an unlawful detainer case brought by the buyer against the former owner is ineffective to prevent rescission of a sales contract that fails to comply with the Home Equity Sales Contract Act (HESCA) (CC §§1695-1695.17). *Hoffman v Lloyd (In re Lloyd)* (Bankr ND Cal 2007) 369 BR 549, aff'd (9th Cir 2009) 572 F3d 999. See §2.8.

In *Spencer v Marshall* (2008) 168 CA4th 783, 85 CR3d 752, the court of appeal held that a sale that violated HESCA was not immunized by the fact that the sale had been approved by a bankruptcy trustee and allowed by the bankruptcy court. See §§2.8, 5.72.

A lender may be sue the borrower for unjust enrichment following a mistaken reconveyance of the deed of trust by the lender. *FDIC v Dintino* (2008) 167 CA4th 333, 84 CR3d 38. See §§4.41, 5.54, 8.92.

Trustee sales: For a relatively limited class of residential loans, the California Foreclosure Prevention Act (ABX2 7 and SBX2 7; CC §§2924, 2923.52-2923.55) temporarily imposes an additional 90-day waiting period following the usual 3-month mandatory waiting period that follows the recordation of a default notice and before a notice of sale issues. See §§2.62A-2.62C, 7.38, 7.61, 7.107, 10.8-10.8D.

In trustee sale proceedings, residential borrowers and tenants have additional notice rights granted to them under CC §§2923.5-2923.6 and 2924.8, as enacted by as SB 1137 (2008) and SB 306 (2009). These laws, scheduled to sunset on January 1, 2013, were enacted by the legislature in response to the "skyrocketing" residential foreclosure rates. See §§2.37-2.38, 2.49, 2.63, 2.65, 2.68, 7.38, 7.61.

A party who is not the trustee of record will not have the authority to conduct a nonjudicial foreclosure or deliver a valid trustee's deed. *Pro Value Props., Inc. v Quality Loan Serv. Corp.* (2009) 170 CA4th 579, 88 CR3d 381. See §§1.40, 2.25-2.26, 2.74, 7.67, 12.144.

Federal courts have ruled in unpublished decisions that a creditor need not produce the note or prove that it is a holder in due course in possession of the note in order to foreclose on property by a trustee sale in California. See, *e.g., Bouyer v Countrywide Bank* (ND Cal, June 25, 2009, No. C 08-5583) 2009 US Dist Lexis 53940; *Sicairos v NDEX W., LLC* (SD Cal, Feb. 13, 2009, No. 08cv2014) 2009 US Dist Lexis 11223. See §§2.34, 12.37.

In carrying out its statutory duties under the foreclosure law, a trustee is entitled to rely on information provided to it in good faith by the beneficiary, and the trustee incurs no liability for good faith errors resulting from such reliance. CC §2924(b). See §§2.38, 2.47, 12.9.

Debt collection agencies that prepare and serve notices of default under CC §2924 must comply with the federal Fair Debt Collection Practices Act. 15 USC §1692a(6); *Bush v Loanstar Mortgagee Servs., LLC* (ND Cal 2003) 286 F Supp 2d 1210. See §2.38.

When an incomplete or partial subordination between lenders creates a circuity of liens among other lienholders, the borrower cannot take advantage of the uncertainty if the proceeds from a foreclosure sale are less than the total amount of the secured debts. The court will allocate the proceeds to the lienholders in an interpleader action or

summary procedure before giving any to the borrower. *Wells Fargo Bank v Neilsen* (2009) 178 CA4th 602, ___ CR3d ___. See §§2.106, 9.84.

Evictions following foreclosure: In May 2009, the federal government enacted preemptive legislation that temporarily protects residential tenants holding possession under a month-to-month agreement or a lease from immediate eviction after the foreclosure sale by a purchaser or the foreclosing lender. See Protecting Tenants at Foreclosure Act of 2009 (12 USC §5220), discussed in §7.75A.

Payment disputes, insurance: Amendments to California CC §2954(a)(1) allow a lender to establish impound accounts to pay taxes and insurance on loans secured by single-family, owner-occupied property when the loan meets the definition of a higher-priced mortgage loan in regulations issued under the Truth in Lending Act (TILA) (15 USC §§1601-1667f) and when the loan is refinanced or modified under a governmental or nonprofit incentive program. See §8.56.

Sellers who had a business of buying property in foreclosure and giving false information about home sales transactions so that their sales to otherwise unqualified buyers could be made with the support of federal loan insurance programs were sued under the False Claims Act (31 USC §§3729-3733). *U.S. v Eghbal* (9th Cir 2008) 548 F3d 1281. See §12.85A.

Priorities: If a junior lienholder delays in asserting its subrogation rights (after paying obligations secured by senior liens) and an intervening creditor changes its position in reliance on the record of title, the court may deny equitable subrogation relief to the junior. *Land Title Ins. Corp. v Ameriquest Mortgage Co.* (Colo 2009) 207 P3d 141. See §8.79.

An incomplete or partial subordination only affects parties participating in the agreement and consequently creates a circuity of liens for other lienholders. In that situation, the borrower cannot take advantage of the lack of clarity about the relative priority of the liens. After a foreclosure the court will determine the distribution of the sales proceeds in an interpleader action. See, *e.g., Wells Fargo Bank v Neilsen* (2009) 178 CA4th 602, ___ CR3d ___. See §§2.106, 9.84.

Loan modifications and workouts: A new section in chapter 10 discusses pertinent professional liability issues for loan modification experts. Newly enacted Bus & P C §10085.6 prohibits brokers involved in residential loan modifications altogether from collecting "advance fees" or a power of attorney from clients, and newly enacted CC §2944.7 prohibits anyone (including attorneys) from collecting such fees or obtaining a power of attorney from clients. Under Bus & P C §6106.3, attorneys who violate CC §§2944.6-2944.7 are subject to disciplinary procedures. See §10.1A.

When an attorney acts as a loan broker and improvidently assists its client in becoming a party to an inappropriate loan on refinancing, the attorney could be disciplined for violating Rules of Prof Cond 3-300 (for obtaining fee from transaction that was disadvantageous to client) and be liable in tort for breach of fiduciary duty. See *Wood v Jamison* (2008) 167 CA4th 156, 83 CR3d 877, cited in §§10.1A, 12.90.

On October 30, 2009, the Federal Deposit Insurance Corporation (FDIC) published its Policy Statement on Prudent Commercial Real Estate Loan Workouts; these guidelines are summarized in §10.5.

Civil Code §2923.5 requires notice and a dialogue between a secured lender and its homeowner borrower to explore alternatives to foreclosure, which may include a possible workout, before the lender commences nonjudicial foreclosure. The lender must first contact the borrower personally or by telephone to assess the borrower's financial situation and explore options for avoiding foreclosure. See §10.8A.

In February 2009, the California legislature enacted (for a limited class of residential loans) the California Foreclosure Prevention Act as an emergency measure as ABX2 7 (2008) and SBX2 7 (2008). It imposed an additional 90-day waiting period in the nonjudicial foreclosure process. It also established guidelines for workouts and offered lenders an exemption from the 90-day delay if they set up residential loan modification programs meeting specified criteria. See §§10.8A-10.8D.

Effective May 20, 2009, 12 USC §1715u(c) was amended to include language permitting the Secretary of Housing and Urban Development to encourage loan modifications on federally insured loans, in particular, interest rate reductions for eligible delinquent mortgages or those facing imminent default. Such modifications are to be implemented through the payment of insurance benefits, the assignment of the mortgages to the Secretary, and the sale, pooling, or reassignment of the modified mortgages. See §§2.28, 10.8B.

Bankruptcy: Federal legislation is pending to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence. See §§11.1, 11.102, 11.123.

A loan servicer may have standing to prevail on a motion for relief from the automatic stay in bankruptcy and go forward with a foreclosure if the servicer is acting as an agent for the holder of the note, but the servicer must prove both agency status and that the principal is the actual holder. See, *e.g., In re Vargas* (Bankr CD Cal 2008) 396 BR 511. See §§7.15, 7.99, 7.105.

Bankruptcy courts continue to rule that a stay relief motion may be denied if filed by a party that is not the real party in interest. See, *e.g., In re Jacobson* (Bankr WD Wash 2009) 402 BR 359. See §§7.99, 7.105, 11.33.

A stay relief motion in bankruptcy court may be denied if affidavits or testimony fail to properly authenticate exhibits, such as payment records, promissory notes, and deeds of trust. *In re Lee* (Bankr CD Cal 2009) 408 BR 893. See §§7.105, 7.109, 12.37.

A bankruptcy court in *In re Winitzky* (CD Cal, May 7, 2009, No. 1:08-bk-19337) 2009 Bankr Lexis 2430, denied the debtors' efforts to follow a Chapter 7 discharge with a Chapter 13 case and a motion to remove the wholly undersecured creditor's lien from the property. The court reasoned that the filing of the Chapter 13 case could not result in a discharge, and therefore the lien could not be "stripped." See §7.88.

Bankruptcy should be considered if the borrower is marginally solvent, because the expense of a state-court lender liability action may undermine the borrower's ability to successfully reorganize in a bankruptcy. See *In re DCNC N.C. I, LLC* (Bankr ED Pa 2009) 407 BR 651. See §§7.82, 7.86, 12.113.

The Bankruptcy Code imposes a harsh rule if the debtor had two or more cases in any Chapter dismissed in the prior year (other than a case refiled under 11 USC §707(b)). See *Nelson v George Wong Pension Trust (In re Nelson)* (BAP 9th Cir 2008) 391 BR 437 (concluded that stay did not arise on debtors' third filing of petition within 1 year of the first; also dismissed adversary proceeding brought against foreclosing lender for stay violation), cited in §11.6.

For an example of how a bankruptcy court may equitably apply a loan rescission remedy in a borrower's Chapter 13 case, see *Lynch v GMAC Mortgage Corp. (In re Lynch)* (Bankr D NH 1994) 170 BR 26, cited in §§7.115, 12.69.

Bankruptcy Code §§546(b) and 362(b)(3) permit a creditor to perfect and to maintain or continue perfection of a security interest without stay relief by giving notice under state law or by giving notice in lieu of enforcement. See *In re 201 Forest St., LLC* (Bankr Mass 2009) 404 BR 6 (lender lost right to foreclose because it failed prepetition to record extension of mortgage or acknowledgment that mortgage was not satisfied as required by state law). See §11.57.

Although a contract prohibiting an insolvent debtor from assigning property is not enforceable in bankruptcy, a breach gives rise to a claim for damages but does not affect the bankruptcy trustee's power to sell the property under 11 USC §363(*l*). *DB Structured Prods., Inc. v American Home Mortgage Holdings, Inc. (In re American Home Mortgage Holdings, Inc.)* (Bankr Del 2009) 402 BR 87. See §11.66.

To avoid conflicts of interest, bankruptcy counsel should always refer debtors to independent real estate or loan brokers and other professionals on marketing real property bankruptcy sales instead of attempting to assist in this way on sales. See *Price v Lehtinen (In re Lehtinen)* (9th Cir 2009) 564 F3d 1052. See §11.72.

A party that appeals from an order authorizing a sale or lease of property must obtain a stay pending appeal or the appeal will become moot if the purchaser or lessor acted in good faith. 11 USC §363(m). *Official Comms. of Unsecured Creditors v Anderson Senior Living Prop., LLC (In re Nashville Senior Living, LLC)* (BAP 6th Cir 2009) 407 BR 222. See §§11.79, 11.150.

A transferee with knowledge of the bankruptcy case will have no defense or offset to avoidance of an unauthorized postpetition transfer under 11 USC §549(a) or to recovery under 11 USC §550(a). *Aalfs v Wirum (In re Straightline Invs.)* (9th Cir 2008) 525 F3d 870. See §11.87.

When lender and borrower orally stipulated in the bankruptcy court record that the validity of a mortgage lien would be tried in a separate court action, res judicata did not prevent an adversary proceeding on that issue. See *Calabria v CIT Consumer Grp. (In re Calabria)* (Bankr WD Pa 2009) 407 BR 671. See §§11.89, 12.150.

Some bankruptcy courts hold that until the court reviews an application and issues an order modifying the payment allocation scheme under a Chapter 13 plan, a mortgage lender may not collect reimbursable expenses (such as attorneys fees and costs) without violating the plan confirmation order. *Wilborn v Wells Fargo Bank, NS (In re Wilborn)* (Bankr SD Tex 2009) 401 BR 872. See §11.94.

On the rights of a prevailing party to recover attorney fees, see *Hoopai v Countrywide Home Loans, Inc. (In re Hoopai)* (9th Cir 2009) 581 F3d 1090 (denied postconfirmation attorney fees to creditor because debtor was prevailing party under state law on disputed main issue), cited in §11.94. The court ruled, however, that bankruptcy law governs

an oversecured creditor's entitlement to attorney fees incurred before plan confirmation and preempts state law.

The Ninth Circuit previously ruled that the liens of junior lienholders on a residence can be stripped in Chapter 13 cases if the value of the debtor's home is less than the amount owed to senior lienholders. This rule has been followed by other circuits. See, *e.g., Griffey v U.S. Bank (In re Griffey)* (BAP 10th Cir 2005) 335 BR 166; *Obeid v SunTrust Bank (In re Obeid)* (Bankr D Md, Dec. 12, 2008, No. 08-19917PM) 2008 Bankr Lexis 3395, cited in §11.126.

Preconfirmation claims omitted from the debtor's plan are not barred by res judicata if they lie against parties who are not creditors in the case. *Air Cargo, Inc., Litig. Trust v i2 Technol., Inc. (In re Air Cargo, Inc.)* (Bankr D Md 2008) 401 BR 178. See §11.131.

Loan servicer and lender liability: When lenders or loan servicers hold late payments in a suspense account and then charge multiple late charges on the same payments, this may be an unfair debt collection practice, and the borrower should be able to recover damages under CC §2954.4(b) or the Fair Debt Collection Practices Act (15 USC §1692f(1)). See §7.29.

A borrower may sue a lender for violating disclosure requirements of the federal Truth in Lending Act (TILA) (15 USC §§1601-1667f) as well as for common law fraud; both causes of action may support an action to enjoin a foreclosure. See *Phleger v Countrywide Home Loans, Inc.* (ND Cal, Mar. 3, 2009, No. C 07-01686) 2009 US Dist Lexis 17419 in §7.36, 7.115, 12.5, 12.69B.

In fraud actions brought under California tort law, the statute of limitations is tolled until the plaintiff discovers the fraud. CCP §337(3); *Alfaro v Community Hous. Improvement Sys. & Planning Ass'n* (2009) 171 CA4th 1356, 89 CR3d 659. See §12.5.

Because of their enhanced punitive damage remedies, California's elder abuse laws are increasingly being invoked in instances of alleged lender abuse directed at the elderly, particularly in cases involving reverse mortgages. See *Labrador v Seattle Mortgage Co.* (ND Cal, Oct. 29, 2008, No 08-22270 SC) 2008 US Dist Lexis 90698, cited in §§12.11, 12.91.

Negligent misrepresentation claims require proof of reasonable reliance, which may be difficult in predatory lending cases. See *Biggs v Eaglewood Mortgage, LLC* (D Md 2008) 582 F Supp 2d 707 (elderly couple who had refinanced home ten times in 28 years could not prove reasonable reliance on lender's alleged misrepresentation of adjustable-rate loan terms; court dismissed RICO, fraud, and negligent misrepresentation claims). See §§12.7, 12.85.

The law is in conflict about whether the remedy of rescission remains available after a loan that violates TILA has been paid off. Compare *Plascencia v Lending 1st Mortgage* (ND Cal 2008) 583 F Supp 2d 1090 with *Pacific Shore Funding v Lozo* (2006) 138 CA4th 1342, 1353, 42 CR3d 283. But if the borrower transfers ownership of the property, the borrower's rescission right is terminated. 15 USC §1635(f). See §§7.36, 12.63A.

If a lender wrongfully fails to accept a demand for rescission made within the 3-year period required under TILA, the borrower has an additional 1 year to bring an action to enforce the rescission. *Santos v Countrywide Home Loans* (ED Cal, Aug. 14, 2009, No. 1:09-cv-00912) 2009 US Dist Lexis 71736. The 1-year period may be subject to equitable tolling. See *Plascencia v Lending 1st Mortgage* (ND Cal 2008) 583 F Supp 2d 1090. See §12.63A.

When property is transferred to a trust, there may be rescission rights under TILA. The result depends on whether the beneficiaries are natural persons and the purpose of the trust. A trust naming an LLC as the beneficiary, even if the LLC is controlled by a natural person, may lack these rights. *Caminero v Wells Fargo Bank* (ED Va, Mar. 5, 2008, No. 1:07cv800) 2008 US Dist Lexis 17111. See §12.63B.

When a borrower demonstrates serious TILA violations, some courts may grant a preliminary injunction restraining the foreclosure sale action even if the borrower does not demonstrate the ability to make full restitution of the loan proceeds in one lump sum on an award of rescission. *Avila v Stearns Lending, Inc.* (CD Cal, Apr. 7, 2008, No. 08-0419) 2008 US Dist Lexis 31813. See §7.36.

For an example of how a bankruptcy court may equitably apply TILA's rescission remedy in a borrower's Chapter 13 case, see *Lynch v GMAC Mortgage Corp. (In re Lynch)* (Bankr D NH 1994) 170 BR 26, cited in §12.69.

When lender and borrower orally stipulated in the bankruptcy court record that the validity of a mortgage lien would be tried in a separate court action, res judicata did not prevent an adversary proceeding on that issue. See *Calabria v CIT Consumer Group (In re Calabria)* (Bankr WD Pa 2009) 407 BR 671. See §§11.89, 12.150.

Changes to TILA's Regulation Z (12 CFR pt 226), effective October 1, 2009, added four key protections for a newly defined category of "higher-priced mortgage loans" secured by a consumer's principal dwelling. See §12.73.

Federal regulations effective January 1, 2010, significantly revise disclosure requirements and forms lenders must

use under the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617). See §§12.74-12.75.

Broker liability: The California Elder Abuse Act (Welf & I C §§15600-15660) was applied in an action against an attorney who acted as a broker for an inappropriate loan in *Wood v Jamison* (2008) 167 CA4th 156, 83 CR3d 877. See §§12.11, 12.14, 12.90. See also §10.1A.

Under general principles of agency and statutory real estate law, a fiduciary relationship may exist between a real estate loan broker and the borrower, and a breach of that duty is actionable. See *Buick v World Sav. Bank* (ED Cal 2008) 565 FS2d 1152. See §12.14.

For an example of loan broker liability under Bus & P C §17200 (informally referred to as the "unfair competition law"), see *Buick v World Sav. Bank* (ED Cal 2008) 565 FS2d 1152, cited in §12.23.

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Cutoff Dates and CEB Citation

Cutoff Dates

We completed legal editing and analysis of authorities cited in this publication as of August 20, 2009, and monitored developments through November 20, 2009.

CEB Citation

Cite this publication as: California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009).

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§1.1 I. SCOPE OF BOOK

It is possible to purchase or improve real property by paying the entire price or cost in cash. It is also possible to borrow the required funds on an unsecured basis, *i.e.,* without using the property as security for the loan obligation (see §1.2). These activities do not constitute "real property financing transactions" as that phrase is generally understood, and they are not the subject of this book.

This book discusses borrowing money and using real property as security for repayment of the loan. The purpose of the loan may be to acquire the very property that is given as security for the loan (a purchase money loan), to construct improvements on the land (a construction loan), to enhance existing improvements (an improvement or a home improvement loan), to refinance an existing loan, or to secure some other obligation. Even when the purpose of the loan is unrelated to real property (*e.g.,* for a vacation), the loan is still characterized as a real property loan if real property is given as security. The basic characteristic of a real property loan is that a mortgage or deed of trust on the borrower's title to real property secures the borrower's promissory note or other debt instrument.

This chapter discusses the basics of the following items:

- Real property transactions, including their financing aspects (see §§1.2-1.9);
- Obligations, including promissory notes (see §§1.10-1.31);
- Mortgages and deeds of trust (see §§1.32-1.58); and
- Installment land sale contracts (see §§1.59-1.66).

On negotiating and drafting real property loans (including construction loans), see California Real Estate Finance Practice: Strategies and Forms (Cal CEB 2000).

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A. Unsecured Versus Secured Loans

§1.2 1. Unsecured Loans

In the simplest kind of credit transaction—the unsecured loan—a lender merely takes back a promissory note or other evidence of a debt or obligation from a borrower. If the loan does not fall within the Statute of Frauds (CC §1624), a signed note is unnecessary. The drawback of an unsecured loan, however, is that if the debtor defaults and the creditor then sues, the creditor's only relief is a money judgment that is not self-executing; *i.e.,* the judgment does not pay itself off. Whether the creditor can convert the judgment into money depends on the effectiveness of execution and other postjudgment remedies. Collection on a judgment is fruitful only if the judgment debtor has assets and only if those assets have not already been taken by or encumbered in favor of other creditors. For discussion of collection on judgments, see Debt Collection Practice in California, chaps 7-8 (2d ed Cal CEB 1999).

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§1.3 2. Secured Loans

To avoid the drawbacks of an unsecured loan (see §1.2), a lender often insists on security for its loan. "Security" means that certain assets of the borrower are set aside ("hypothecated") so that the creditor can reach and dispose of them if the debtor defaults on the underlying loan. Taking security gives the lender two significant advantages:

- The debtor may not convey these assets free from the creditor's claims on them, thus substantially reducing the risk that there will be no assets on which to levy (CC §2923); and
- Once the creditor's security interest is perfected, any later secured creditors acquire subordinate interests in the property, thus eliminating the risk that other claims will take priority (CC §2897).

In a practical sense, the result of a security interest in land is that the land itself "owes" the debt and the creditor can pursue it even when the debtor personally is otherwise judgment-proof.

A security agreement is a promise by the debtor that the creditor can reach certain assets if the debt is not paid. The security agreement does not create the obligation to pay; this is usually evidenced by a separate promissory note (see §§1.7, 1.10-1.31). The security agreement is a second document, usually accompanying a note, that gives the creditor rights to an asset if the obligation is not performed (see §§1.32-1.57). In lay terms, a note says, "I promise to pay," and a security agreement says, "If I fail to pay, you can take this property."

This book primarily concerns real property security, *i.e.,* security in the form of an interest in land that is available to the creditor on default. Personal property security is governed by Division 9 of the Commercial Code (Com C §§9101-9709) (see CC §§2914, 2944) and is outside the scope of this book except when the personal property constitutes a fixture (see §1.57) or is mixed with real property as security for a loan (see §§9.12-9.23). See Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001) for a thorough discussion of Division 9.

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§1.4 3. Nonconsensual Secured Obligation

In addition to unsecured loans and loans secured by consensual forms of security interest, such as mortgages and deeds of trust (see §1.3), there is also a broad class of security transactions that create "nonconsensual" or "involuntary" liens in real property. Examples include mechanics' liens, tax liens, and judgment liens. Although these liens can be the result of a consensual act (such as hiring a contractor or owning property in a certain jurisdiction), the debtor does not grant or convey the lien; rather, the creditor takes or imposes the lien.

The laws governing nonconsensual liens are different from those regulating mortgages and deeds of trust. Nonconsensual liens provide different advantages and disadvantages for the creditor and different protections for the encumbered property's owner. Involuntary liens are occasionally mentioned in this book but are not the book's primary focus. They are generally subject to the same rules for determining priority as are mortgages and trust deeds. For more on these other forms of lien and security interest in land, see California Mechanics' Liens and Related Construction Remedies (3d ed Cal CEB 1998); Enforcing Civil Money Judgments (Cal CEB Action Guide November 2008); Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

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§1.5 4. Advantages and Disadvantages to Lender of Secured Loan

A creditor who takes a security interest in land benefits not only by establishing a priority claim against identified real property, thus reducing the creditor's dependence on the borrower's changeable personal financial circumstances, but also by obtaining a measure of control over the land. This last point is most clearly seen when a debtor tries to sell land encumbered by a defaulted mortgage, trust deed, or other lien against it and realizes that he or she must pay off the secured obligation to provide the seller with "clear title" before the sale closes.

The disadvantage of loans secured by a deed of trust or mortgage is that the lender is denied access to many enforcement techniques and debt collection strategies (*e.g.*, wage garnishment) that may be pursued by unsecured creditors or by creditors whose loans are secured by nonconsensual liens or consensual security interests under Division 9 of the California Commercial Code. Although the mortgage or trust deed secured lender gains some powerful remedies, such as the right to foreclose on default on a priority-protected interest, it must in turn surrender—as a matter of public policy—a wide range of collection and enforcement techniques.

The consequences of straying from the permitted remedial path can be extremely harsh for the secured creditor. The trade-offs between remedies gained and remedies foregone by the real estate secured lender are not inevitable or driven by some inescapable logic. Nor do the same remedies apply in many states or even in California "chattel mortgage" practice. They are, instead, the result of policy choices made by the California legislature and courts. These choices will be a major topic of most of the other chapters in this book.

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B. Terminology

§1.6 1. "Parties"

A typical real property loan involves two parties. On one side of the loan is the "borrower," "debtor," or "obligor." Because a promissory note is usually executed, that person may also be known as a "maker" (a term commonly used in commercial note practice). On the other side is the "lender," "creditor," or "obligee," who may be the "payee" or "holder" of the note. Sometimes the terms "bank," "savings and loan association," or "lending institution" are used to describe the lender. When a deed of trust is used as the security instrument, the transaction will also involve the appointment of a "trustee" under the deed of trust. The role and status of this trustee are discussed in §§1.40-1.42 and in chaps 2-3, 8.

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§1.7 2. "Instruments"

A basic real property loan in California involves two documents. One is the "promissory note," which evidences the debt and is often secured by a "security instrument" that entitles the lender to reach some asset of the debtor if the note is not paid. In California, the security instrument for real property is most commonly a "deed of trust" (with the debtor and creditor known as the "trustor" and the "beneficiary," respectively, and a third party known as the "trustee"; see §§1.35, 1.39-1.46). The security instrument may also be a "mortgage" (with "mortgagor" and "mortgagee" as participants (see §1.34)). In either case, the creditor is said to have a security interest in the property, which is sometimes also referred to as "security" or "collateral." "Security" tends to be the term of choice in real property circles, and "collateral" is used more commonly in Uniform Commercial Code (UCC) Article 9 practice and to refer to security interests in personal property (historically, "chattels"). The terms "deed of trust," "trustor," and "beneficiary" are used interchangeably in this book with "mortgage," "mortgagor," and "mortgagee," respectively, unless the context indicates otherwise. In general, the latter terms are avoided to reduce confusion.

On Article 9, see Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

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§1.8 3. "Financing Parties"

If the financing is incidental to a sale of land, the "seller" or "vendor" may be the creditor, and the "buyer" or "purchaser" may be the debtor. If the purchaser is borrowing money from both a bank and the seller, there will be two loans and two deeds of trust, one to the bank and one to the seller or vendor. A bank almost always insists (often due to regulatory imperatives) on its holding the "senior" or "first" deed of trust and on the seller's holding the "second" or "junior" deed of trust. See §§9.42-9.87 on priorities. In this book, the senior beneficiary is usually treated as a lending institution and referred to as "it." For installment land sale contract terminology, see §1.59. On seller financing of real property purchases, see California Real Property Sales Transactions, chap 9 (4th ed Cal CEB 2007).

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§1.9 4. "Obligation"

Just as the terms "deed of trust," "mortgage," and "security instrument" are used somewhat interchangeably (because for most purposes their differences are not significant), the similarity among the terms "obligation," "debt," "note," and "purchase price" is sufficient to permit frequent substitution of these words. Nevertheless, there are times when the distinctions do matter. For example, CCP §580a refers to "obligation," §580b to "purchase price," §580d to "note," and §726 to "debt."

"Obligation" is the broadest of these terms because it is not limited to a payment or loan of money and is therefore the correct term when the deed of trust secures a contractual obligation other than payment (see §1.10). "Debt" refers to an obligation to pay money and is broader than "price" because a construction, refinancing, or improvement loan secured by real property is a debt even though it forms no part of the property's purchase price. A "note" is merely evidence of the debt, not the debt itself, which is what is secured. *Matthews v Hinton* (1965) 234 CA2d 736, 44 CR 692.

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§1.10 II. THE OBLIGATION

Most secured obligations take the form of written promises to pay money. Generally, "debt" and "note" are used interchangeably with "obligation" in this book (but see §1.9). The secured obligation need not, however, be embodied in a note or even constitute a debt. The statutory definitions of "liens" and "mortgages" as security for "performance of an act" (CC §§2872, 2920) are not limited to payment of money. See, *e.g.*, *Stub v Belmont* (1942) 20 C2d 208, 124 P2d 826 (crop servicing contract); *Congregational Church Bldg. Soc'y v Osborn* (1908) 153 C 197, 94 P 881 (promise to use property for church purposes); *Valley Vista Land Co. v Nipomo Water & Sewer Co.* (1968) 266 CA2d 331, 72 CR 181 (promise to furnish water and sewer facilities). See also *Dieckmeyer v Redevelopment Agency* (2005) 127 CA4th 248, 24 CR3d 895 (when purchaser of deed-restricted condominium gave trust deed securing note and restrictive covenant, prepayment of note left restrictive covenant in place as secured obligation). For a discussion of the legal and practical issues involved in using a deed of trust to secure nonmonetary obligations, see Andrew, *Deeds of Trust Securing "Performance" Obligations and Purchase-Deposit Refunds,* 24 Cal Real Prop J 24 (No. 4, 2006).

NOTE: Business and legal creativity is constantly expanding the number and types of obligations that a deed of trust may secure. In addition to a basic monetary obligation, trust deeds often secure other nonmonetary covenants and obligations contained in the note, the loan agreement, other loan documents, and covenants found in the trust deed itself. One increasingly common form of such additional covenant is the "equity share" or "equity participation" provision, which gives the secured creditor the right to share in some manner in any increase in the value of the encumbered property. *Dieckmeyer* provides an example of an equity share provision in the affordable housing context.

In nonmoney situations, the promisee can count on a meaningful foreclosure action only if the contract has provided for liquidated (or a more-or-less self-enforcing means of liquidating the) damages. See *Feraud v Anaheim Inv. Co.* (1934) 138 CA 227, 31 P2d 1092 (lump-sum damages provided for breach of lifetime annuity contract). Because California prohibits strict foreclosure (*i.e.*, forfeiture of the security without sale; see §3.1), there must be a sale when the security interest is foreclosed, and the promisee is entitled only to as much of the sale proceeds as are necessary to cover the loss. A sale may be almost impossible if no one knows what to bid, because bidding is unclear if the obligation lacks liquidity. See 1 Nelson & Whitman, Real Estate Finance Law §2.2 (5th ed 2007).

The Statute of Frauds (CC §1624) may require that the obligation be in writing, and CC §2922 requires a writing to create, renew, or extend a mortgage (*Secrest v Security Nat'l Mortgage Loan Trust 2002-2* (2008) 167 CA4th 544, 84 CR3d 275), but otherwise no mortgage law requires a writing. An enforceable oral promise is sufficient to support a mortgage or deed of trust. *Todd v Todd* (1912) 164 C 255, 128 P 413; *Hickox v Lowe* (1858) 10 C 197; *Dool v First Nat'l Bank* (1930) 107 CA 585, 290 P 478. There is also no requirement that the obligation be unconditional. *Congregational Church Bldg. Soc'y v Osborn, supra*; *Purser v Eagle Lake Land & Irrig. Co.* (1896) 111 C 139, 43 P 523. In the relatively rare circumstance in which a real property interest secures an oral (nonwritten) obligation, the secured creditor needs to take particular care to guard against arguments that oral modifications or forbearances have been agreed to. See *Secrest v Security Nat'l Mortgage Loan Trust, supra*.

In future-advance (see §§9.59-9.73) and line of credit (see §9.70) arrangements, if there is no present loan, the obligation to pay arises only if and when the creditor advances funds. *Moss v Odell* (1901) 134 C 464, 66 P 581; *Langerman v Puritan Dining Room Co.* (1913) 21 CA 637, 132 P 617. See also *Frank H. Buck Co. v Buck* (1912) 162 C 300, 122 P 466. Similarly, in contracts of indemnity and guaranty, the obligation to perform arises only after loss or nonperformance of the indemnity or suretyship obligation. *Fernandez v Tormey* (1898) 121 C 515, 53 P 1119 (indemnity); *Indusco Mgmt. Corp. v Robertson* (1974) 40 CA3d 456, 114 CR 47 (guaranty); *Kelley v Goldschmidt* (1920) 47 CA 38, 190 P 55 (guaranty).

For discussion of considerations in drafting the note, see California Real Estate Finance Practice: Strategies and Forms, chap 3 (Cal CEB 2000).

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§1.11 A. Relationship of Obligation to Security

An obligation can exist with or without security. With no security, the obligation is unsecured but still valid. A security interest, however, cannot exist without an underlying existing obligation. See *Henley v Hotaling* (1871) 41 C 22; *Turner v Gosden* (1932) 121 CA 20, 8 P2d 505. See also *Lee v Joseph* (1968) 267 CA2d 30, 72 CR 471. It is impossible to define security apart from its relationship to the promise or obligation that it secures. See CC §§2872, 2909, 2920.

The primacy of the obligation is such that if there are inconsistencies between the language of the note (evidence of the obligation) and the deed of trust (evidence of the security), the terms of the note will control. *Pacific Fruit Exch. v Duke* (1930) 103 CA 340, 284 P 729.

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§1.12 1. Consideration

The maxim that one cannot make a gift of a mortgage is technically incorrect. An owner of land is free to grant all or part of its property by way of gift deed. Mortgages and deeds of trust are more like conveyances than contracts and, as conveyances, do not require consideration any more than do gift deeds. See CC §1040. (Several early California Supreme Court decisions, however, slipped into this error. See, *e.g., McDonald v Randall* (1903) 139 C 246, 72 P 997; *Chaffee v Browne* (1895) 109 C 211, 41 P 1028.) It is correct to say that a valid mortgage needs a valid underlying obligation and that a valid obligation needs consideration to sustain it. A note is valid only when it is supported by consideration. Com C §3303(b); *Shipley Co. v Rosemead Co.* (1929) 100 CA 706, 280 P 1017; *Allen's Collection Agency v Lee* (1925) 73 CA 68, 238 P 169. Thus, a gift of a note and a mortgage will fail, not because the mortgage lacks consideration but because the note lacks consideration, and when the note fails as an obligation, the mortgage fails with it. *Coon v Shry* (1930) 209 C 612, 289 P 815. See also *Lee v Joseph* (1968) 267 CA2d 30, 72 CR 471; 1 Nelson & Whitman, Real Estate Finance Law §2.3 (5th ed 2007).

Many mortgages and deeds of trust are upheld when there is no real consideration (except under a strained construction), as when one person gives a deed of trust to secure the debt of another—an arrangement sometimes called a "suretyship deed of trust" (see *Garretson Inv. Co. v Arndt* (1904) 144 C 64, 77 P 770; *Carson v Reid* (1902) 137 C 253, 70 P 89; *Mead v Sanwa Bank Cal.* (1998) 61 CA4th 561, 71 CR2d 625)—or when a debtor gives a mortgage to secure an existing debt (see *Ekmann v Plumas County Bank* (1932) 215 C 671, 12 P2d 433; *Smitton v McCullough* (1920) 182 C 530, 189 P 686; *Frey v Clifford* (1872) 44 C 335).

A mortgage given without new consideration, even when the mortgagor is insolvent, does not constitute a fraudulent conveyance under the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12) or under the Bankruptcy Code. See 11 USC §548. Both statutes define "giving value" as securing an antecedent debt. See *Maddox v Robertson (In re Prejean)* (9th Cir 1993) 994 F2d 706, 709. Of course, a transfer made with "actual intent to hinder, delay, or defraud" creditors may still be avoided, regardless of "value." See 11 USC §548(a)(1)(A). Granting a security interest to secure an antecedent debt may also present a preference problem under the Bankruptcy Code if it was given within

- 3 months before the bankruptcy case began (11 USC §547(a)(1)(A)); and
- 2 years before the case for less than reasonably equivalent value began (11 USC §548(a)(1)(B)(i)).

For further discussion on the ability of debtors in possession and bankruptcy trustees to attack the validity of or avoid a mortgage or an obligation secured by a mortgage as a preference or fraudulent transfer, see §§7.109-7.112, 11.80-11.86.

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§1.13 2. Destruction

Complete destruction or loss of security, if not caused by the lender, does not affect the obligation other than to convert it from secured to unsecured. *Frost v Witter* (1901) 132 C 421, 64 P 705; *Bank of America v Graves* (1996) 51 CA4th 607, 59 CR2d 288. It is therefore possible for an unpaid beneficiary to reconvey its deed of trust to the trustor without automatically sacrificing its claim for payment. See *Sherwood v Dunbar* (1856) 6 C 53. Any such relinquishment of the security must be mutual because a beneficiary or mortgagee cannot unilaterally waive its deed of trust or mortgage in order to proceed against its trustor as an unsecured creditor (see §4.62; CCP §726; *Barbieri v Ramelli* (1890) 84 C 154, 23 P 1086; *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298; *Hartman v Smith* (1963) 219 CA2d 415, 33 CR 147), although such power does exist with regard to creditors secured by solely personal property. See Com C §9604(a)(2). Conversely, the debtor cannot unilaterally reconvey the security back to himself or herself. *Duley v Westinghouse Elec. Corp.* (1979) 97 CA3d 430, 158 CR 668.

Destruction of the obligation seriously affects survival of the security. If, for any reason, the underlying debt is extinguished, the security becomes meaningless. See *Trowbridge v Love* (1943) 58 CA2d 746, 137 P2d 890 (forgiveness of debt); *Burd v Downing* (1923) 60 CA 493, 213 P 287 (mutual rescission of lease). However, when the debt is extant but its enforcement is barred by some policy-based rule (*e.g.,* the Statute of Frauds (CC §1624) or a statute of limitations), the security may provide the creditor with a modicum of protection by acting to "cloud," thus impairing the marketability of the debtor's title, and encouraging the debtor to negotiate with the creditor to clear title.

"Destruction," as used in this context, does not mean mere physical loss of the security instrument. If the loan documents are lost or physically destroyed, the beneficiary remains secured, but the trustee or a court may require the posting of a lost instrument indemnity bond as a condition to a trustee sale (see §2.19), a judgment for foreclosure (see §§3.64-3.65), or a reconveyance (see §§8.92-8.99). See *Randolph v Harris* (1865) 28 C 561; *Huckell v Matranga* (1979) 99 CA3d 471, 160 CR 177. On lost instrument indemnity bonds, see §8.97.

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§1.14 3. Type of Obligation

The character of the obligation may seriously affect the character of the security, particularly when the obligation is a purchase money debt. Two consequences spring from the determination that a deed of trust secures a purchase money obligation:

- First, and most important, the creditor has no right to recover a deficiency judgment after foreclosure, regardless of the foreclosure method chosen (CCP §580b) (see chap 5 on anti-deficiency rules and §§5.54-5.60 for exceptions); and
- Second, purchase money security has priority over other liens on the property, subject to the recording laws (CC §2898) (see §§9.48-9.50 on priorities).

"Priority" under CC §2898 means that a purchase money lien is a senior lien on the property, even when there are outstanding judgment liens against the purchaser that immediately attach at delivery or close of escrow to any asset the purchaser acquires. *Brown v Boren* (1999) 74 CA4th 1303, 88 CR2d 758; *Majewsky v Empire Constr. Co.* (1970) 2 C3d 478, 85 CR 819; *Mercantile Collection Bureau v Roach* (1961) 195 CA2d 355, 15 CR 710; *Ludy v Zumwalt* (1927) 85 CA 119, 259 P 52. This does not mean, however, that a purchase money deed of trust has or "jumps" priority over a previously recorded mechanics' lien or mortgage against the property. *Avery v Clark* (1891) 87 C 619, 25 P 919. See also *Walley v P.M.C. Inv. Co.* (1968) 262 CA2d 218, 68 CR 711. On priorities, see §§9.42-9.87.

The priority advantage given purchase money liens is not limited to liens of sellers who finance all or part of the sale. Third party money is purchase money if it was given to enable the buyer to acquire the property. See *Van Loben Sels v Bunnell* (1898) 120 C 680, 53 P 266. In *Brock v First S. Sav. Ass'n* (1992) 8 CA4th 661, 10 CR2d 700, the court of appeal held that a seller's lien was subordinate to a simultaneously executed third party purchase money deed of trust, despite the secured lender's knowledge that the buyer was giving the seller an unsecured note for a portion of the purchase price. See further discussion of *Brock* in §9.53.

The descriptions of purchase money in CCP §580b and CC §2898 are not identical. Thus, a deed of trust may be called a "purchase money deed of trust" for priority purposes under CC §2898 but not for antideficiency purposes under CCP §580b. Code of Civil Procedure §580b excludes third party financing of nonresidential property and of dwellings that are for more than four families or that are not owner occupied, while CC §2898 does not. See *Kistler v Vasi* (1969) 71 C2d 261, 78 CR 170. Consequently, any effort to draw strict parallels between the two sections is of dubious validity.

The mere fact that an obligation is a purchase money debt creates certain quasi-security interests in a seller. Civil Code §3046 gives a seller a vendor's lien "for so much of the price as remains unpaid and unsecured otherwise than by the personal obligation of the buyer." See, *e.g., McGreevy v Constitution Life Ins. Co.* (1965) 238 CA2d 364, 47 CR 711. Thus even if a seller's purchase money note is not secured by a security instrument, the seller still has an implied-in-law vendor's lien (*i.e.,* a security interest) in the property.

TAX CONSIDERATION: For federal income tax purposes, indebtedness incurred to acquire real property is included in the buyer's basis in the property, whether or not the loan is secured. IRC §1012. Funds borrowed to improve the property may also be added to the basis. Treas Reg §§1.263(a)-1(a), 1.1016-2(a). (The cost of repairs is deducted rather than capitalized and therefore is not added to the basis. IRC §§162, 212.)

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§1.15 4. Personal Liability and "Nonrecourse" Loans

A security instrument needs an obligation to be enforceable, but it does not need an obligor, *i.e.,* one personally responsible for performing. See CC §2890; *Shelley v Byers* (1925) 73 CA 44, 238 P 177. The purchase money situation is the most common example of this rule. The effect of CCP §580b is that no one is personally liable for the debt. Although an obligation to pay still exists—because nonpayment will lead to foreclosure—only the property can be said to be liable for payment (see §§5.24, 5.31).

It is also possible to draft a nonpurchase money note as a contractually "nonrecourse" note to insulate its maker from personal responsibility for payment. When a loan is made contractually nonrecourse, it often includes certain "recourse carve-outs" (often called "bad boy" carve-outs or exceptions) that confirm that the nonrecourse provisions do not preclude personal liability in circumstances such as fraud, waste, and environmental contamination. Many of these circumstances will give rise to tort claims by the creditor against the borrower and, in some instances, against third parties. Both lender's and borrower's counsel should carefully review the scope of the recourse carve-out provisions. For a cautionary tale about the consequences for the creditor of carve-out language that is too narrow, see *Aozora Bank Ltd. v 1333 N. Cal. Blvd.* (2004) 119 CA4th 1291, 15 CR3d 340, in which the creditor prevailed on a claim for tortious bad faith waste against the borrower for its refusal to pay property taxes. Later, however, the court denied the creditor recovery of attorney fees, based in large part on the fact that its recourse carve-out for waste did not expressly mention attorney fees. The *Aozora* court, in its decision, cited expert testimony in the case to the effect that recourse carve-outs are "always expressed, and never implied" (119 CA4th at 1296), setting a high standard for drafters of recourse carve-outs.

TAX CONSIDERATION: Partners may deduct their allocable share of partnership losses only to the extent of their amount "at risk" with respect to the partnership. IRC §465. As a rule, the amount at risk does not include nonrecourse debt, but an exception exists for "qualified nonrecourse financing," which is (1) nonconvertible financing for which no one is personally liable for repayment, (2) secured by real property, and (3) borrowed from a qualified person or government agency. IRC §465(b)(6). For further discussion of the at-risk limitation, see Advising California Partnerships §8.44 (3d ed Cal CEB 1999).

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§1.16 a. "Trustor" Versus "Debtor"

The debtor under a note need not be the trustor under a deed of trust securing that note: If *A* gives a deed of trust to a lender to secure *B*'s promissory note, *A* is the trustor, but *B* is the debtor. If the note is not paid, *A* may lose its property by foreclosure, but it has no obligation to pay the note or any deficiency if the foreclosure proceeds do not discharge the entire debt. See *Garretson Inv. Co. v Arndt* (1904) 144 C 64, 77 P 770. See also *Carson v Reid* (1902) 137 C 253, 70 P 89.

If, however, *A* cosigns, endorses, or guarantees the note, *A* is personally liable on it, whether or not *A* posts collateral to secure it. *Lange v Aver* (1966) 241 CA2d 793, 50 CR 847; *Stephenson v Lawn* (1957) 155 CA2d 669, 318 P2d 132. But see *Lopez v Puzina* (1966) 239 CA2d 708, 49 CR 122 (alleged endorsement of promissory note ineffective because contained in separate instrument) (see §§9.118-9.121). If *A*, having previously guaranteed the loan, also both assumes personal liability on the note and gives a deed of trust as security, the deed of trust may either secure *A*'s own guaranty of payment or stand as direct security for *B*'s promise to pay the note, or both, depending on the wording of the provision of the deed of trust concerning the nature of the secured obligation. *Commercial Bank v Kershner* (1898) 120 C 495, 52 P 848; *Kelley v Goldschmidt* (1920) 47 CA 38, 190 P 55. On guaranty or "suretyship" issues raised when the trustor is not the debtor, see §9.91. Only a deed of trust or mortgage given to secure "the debt of another" squarely fits the definition of a guaranty or suretyship under CC §2787, which raises issues concerning the extensive (although generally waivable) protections accorded sureties and guarantors under California's suretyship statutes, CC §§2787-2856. On surety and guarantor protections, see chap 9. On guaranties generally, see California Real Estate Finance Practice: Strategies and Forms, chap 6 (Cal CEB 2000); Drafting Business Contracts: Principles, Techniques & Forms, chap 22 (Cal CEB 1994).

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§1.17 b. The "Nonassuming Grantee"

A subsequent grantee of encumbered property is not always personally liable for the debt. When a transferor conveys encumbered property, the transferee takes title subject to the existing encumbrance. Owning encumbered property, however, does not make the owner personally responsible for performing the obligation. That occurs only if the transferee also "assumes" the obligation, *i.e.,* promises the transferor that it will perform the obligation owed to the creditor. If property is transferred without any assumption agreement, an unpaid beneficiary may foreclose on the property (even though it is no longer owned by the original debtor) and obtain a deficiency judgment against the original debtor but not against the transferee. *Braun v Crew* (1920) 183 C 728, 192 P 531; *Hibernia Sav. & Loan Soc'y v Dickinson* (1914) 167 C 616, 140 P 265; *Wolfert v Guadagno* (1933) 130 CA 661, 20 P2d 360. Some courts use the term "practical liability" to refer to the peculiar predicament of persons who do not owe a debt in a strict personal, contractual, or juridical sense but who might still lose their property to foreclosure if the debt is not paid. This term nicely captures the sense that a person who can truthfully deny liability on the debt can still lose the property because of a default on that same debt. This notion can be important to issues such as entitlement to attorney fees. See, *e.g*., *Saucedo v Mercury Sav. & Loan Ass'n* (1980) 111 CA3d 309, 168 CR 552.

NOTE: A transfer of the encumbered property may violate a due-on-sale provision in the note or deed of trust, whether or not the transferee assumes the loan. A reference to a loan as "assumable" usually means that it contains no due-on-sale restriction. Without such a restriction, the trustor may freely transfer the property, with or without an assumption by the transferee. If a note or deed of trust clause does restrict transfer, an assumption of the note or deed of trust by the transferee does not affect the beneficiary's ability to accelerate the loan. On due-on-sale clauses, see §§8.8-8.23; California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000).

Once a nonassuming grantee has entered the picture, subsequent grantees share or "shelter in" that immunity, despite their attempts personally to assume the loan, because there is nothing to assume. See *Weaver v Bay* (1963) 216 CA2d 559, 31 CR 211 (discussed in §9.134); *Dail v Campbell* (1961) 191 CA2d 416, 12 CR 739, and cases cited there.

PRACTICE TIP: It is a common misconception that the grantee's assumption of the debt frees the original obligor from liability. That occurs only if the creditor expressly releases the obligor. If there is no release but the creditor has notice of the assumption, *the original obligor's liability is probably limited to that of a surety by operation of law*. *Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476.

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§1.18 B. Payment Provisions

Promissory notes always describe the mechanism of repayment. The category of loan payment arrangements is open-ended and subject to the creativity of the marketplace. Among the many varieties of such mechanisms are the following:

- **Fully amortized installment notes.** The payment mechanism generally used in residential mortgage notes is full amortization of principal and interest, *i.e.*, equal (level) payments of principal and interest on a monthly basis for 15, 20, or 30 years until the loan is entirely repaid. Because interest is always calculated on the outstanding unpaid balance, the interest component in the early years of the loan may constitute almost all of the payments, declining reciprocally with principal over the life of the loan to an insignificant share at the end. See California Real Estate Finance Practice: Strategies and Forms §1.28 (Cal CEB 2000). Installment notes commonly contain a provision accelerating the unpaid balance on default by the borrower. Thus, on default, the lender will seek the entire sum due, not merely the delinquent installments. On acceleration clauses, see §§8.2-8.7. An installment note may also contain a due-on-transfer clause that provides for acceleration if the borrower transfers or encumbers the property (see §§8.8-8.23).
- **Flat notes.** A flat (or "bullet") note obligates the borrower to pay the entire sum owed at some stated date in the future, without any installment obligations.
- **Demand notes.** A demand note is payable on the payee's demand. Although they are similar to flat notes, one peculiar and dangerous characteristic of demand notes is that, because the due date cannot be ascertained from the instrument's face, the statute of limitations begins to run from the date of execution. *Anglo-California Trust Co. v Holbrook* (1933) 218 C 531, 533, 24 P2d 169; *Tilden Lumber Co. v Perino* (1934) 2 CA2d 133, 37 P2d 466. See §3.17.
- **Interest-only notes.** An interest-only note requires the borrower to make periodic payments of interest, but it defers the obligation to pay the principal until a future date.
- **Balloon notes.** Mortgages and deeds of trust on residential property are often written for short periods of time (*e.g.,* 3, 5, or 7 years) but with a payment schedule that does not fully amortize the debt in time. A substantial final "balloon" payment will be required at the end of the term. Commonly, the borrower hopes to refinance at that time. By statute, certain balloon notes must contain an informative legend (CC §2966; Bus & P C §10241.4), and the holder must give advance notice of an impending payment. CC §§2924i, 2966.
- **Graduated payment notes.** To assist first-time home buyers, lending institutions sometimes use "graduated payment" notes that provide for smaller than average payments in the early years of the loan, compensated for by increasingly larger payments as the years pass (and as the borrowers' income presumably grows). The payments at the beginning of the loan term may actually be less than the interest that accrues during that period, leading to "negative amortization," *i.e.,* the enlargement rather than the reduction of the loan principal with each periodic payment.
- **Reverse annuity loans.** A retired senior citizen with little current income but significant accumulated wealth in the form of a paid-up home may obtain a reverse annuity loan from a lender, which will generate a monthly transfer of funds from the lender to the borrower, with the obligation to repay being deferred until sale of the property or death of the borrower.

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C. Interest Rates

§1.19 1. Fixed and Variable Rates

The interest rate of an obligation may either be fixed for an extended period (*e.g.,* 5 years) or over the life of the loan, or it may be tied to a financial index and periodically recalculated (adjustable and variable rate loans). See California Real Estate Finance Practice: Strategies and Forms §§1.76-1.77 (Cal CEB 2000). With an adjustable rate, changes in the index lead either to altered periodic payments (*e.g.,* larger or smaller monthly amounts) or to an altered duration (*e.g.,* 35 years instead of 30 years). Negative amortization can occur if the note calls for a defined payment but variable rates. If the monthly interest exceeds the required payment, the difference is added to the principal balance. Lenders who are not exempt from state usury laws and who use such devices must be careful to comply with state usury laws. See Real Estate Finance, chap 3.

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§1.20 2. Shared Appreciation Loans

Lenders may offer commercial borrowers a lower interest rate in return for a share of the profits of the borrower's venture or a share in the capital appreciation of the security over all or part of the life of the loan as a form of "contingent interest" or "equity kicker." Shared appreciation mortgages on property other than one-to-four-unit residential property are regulated by CC §§1917-1917.006. Concern that such arrangements might be held to constitute joint ventures rather than lending arrangements, or be held to violate usury laws, is largely eliminated by CC §§1917.001 and 1917.005. See, *e.g., Jones v Wells Fargo Bank* (2003) 112 CA4th 1527, 5 CR3d 835 (if lender can demonstrate that loan comes within specific exception to usury law, lender's actual intent is irrelevant).

The court in *WRI Opportunity Loans II, LLC v Cooper* (2007) 154 CA4th 525, 65 CR3d 205, provided guidance on what constitutes a shared appreciation loan under CC §1917. The court stated that shared appreciation loans involve contingent deferred interest based on appreciation or rents and profits. The statutory usury exemption applies if the return in excess of the amount allowed by the usury law is subject to risk based on appreciation, whether based on changes in land values or on the success of a project. On usury, see §1.21.

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§1.21 3. Usury

The interest rate that may be charged for a loan of money is regulated by Cal Const art XV, §1, and rates above its limits are usurious. *Pillon-Davey & Assocs. v Contra Costa Water Dist. (In re Pillon-Davey & Assocs.)* (Bankr ND Cal 1985) 52 BR 455 (excessive interest rate on agreement extending due date on promissory note held usurious). The usury laws do not apply to sellers who carry back purchase money deeds of trust and who, in effect, are charging a time-price differential for deferred payment. *Ghirardo v Antonioli* (1994) 8 C4th 791, 35 CR2d 418. See §§1.60, 9.134.

Usury laws will not protect junior lienholders who pay off the senior lienholder to avoid foreclosure, because these laws are intended to benefit only borrowers and their representatives who are directly liable on the note. *Roes v Wong* (1999) 69 CA4th 375, 81 CR2d 596. See §§2.105, 8.79. Nor do usury laws apply to real estate secured loans made or arranged by a licensed real estate broker. CC §1916.1. This exemption applied even when the broker, who was an employee of the lending entity's affiliate, failed to provide a required mortgage loan disclosure statement. *Stoneridge Parkway Partners, LLC v MW Housing Partners III, LP* (2007) 153 CA4th 1373, 64 CR3d 61.

There is a general federal preemption of state usury laws for "federally related" residential mortgage loans (12 USC §1735f-7a; 12 CFR pt 590), which include loans eligible for purchase by the Federal National Mortgage Association ("Fannie Mae"), the Government National Mortgage Association ("Ginnie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") (12 CFR §590.2(b)(5)), and loans by major lenders (12 CFR §590.2(b)(6)). For further discussion of usury, including a list of exempt lenders and loans, see California Real Estate Finance Practice: Strategies and Forms, chap 3 (Cal CEB 2000).

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4. Tax Treatment of Interest

§1.22 a. To Lender

Interest payments received by the lender constitute ordinary income. IRC §61(a)(4). This is true whether the lender collects payments regularly during the loan term or in a lump sum at a foreclosure sale (from third party bidding or from the credit bidding of accrued interest as well as unpaid principal). See §§2.113-2.115. When the loan is paid prematurely and the lender forgoes receipt of anticipated interest, only an accrual-basis taxpayer who has already included the anticipated interest payment in income (or cash-basis taxpayer subject to original-issue discount treatment; see §1.23) may deduct unreceived anticipated interest. Treas Reg §§1.166-1(e), 1.166-6(a)(2). See *Fitzhugh L. Odom,* TC Memo 1979-53. See also §§8.51-8.53.

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§1.23 b. To Borrower

Treatment of interest paid by the borrower depends on the character of the debt, which in turn may depend on the nature of the asset being financed:

- **Business property.** If the security consists of business property, the interest paid may be deducted as a business expense under IRC §163(a).
- **Investment property.** If the borrower holds the property for investment, interest is deductible to the extent of net investment income. IRC §163(d). If the property is subject to passive activity treatment, interest is deductible in accordance with IRC §469.
- **Residential property.** Home mortgage acquisition interest is deductible up to $1 million of acquisition debt (plus $100,000 of debt in a nonacquisition case as home equity interest, *i.e.,* a home equity credit line). Interest on indebtedness used to purchase a residence is not deductible as home mortgage interest unless the residence secures the debt. IRC §163(h); IRS Letter Ruling 9418001. The California rule on home mortgage interest, Rev & T C §17024.5, conforms to IRC §163(h).

Personal interest that does not qualify under any of the foregoing provisions is not deductible. IRC §163(h). On the phased elimination of qualified mortgage insurance premiums from treatment as qualified residence interest, see IRC §163(h)(3)(E), (4)(E)-(F); Treas Reg §1.163-11T (sunsetting May 4, 2012). Note that the treatment of interest may also depend on how the debt is secured. See Treas Reg §1.163-10T(o).

Points paid at the inception of the loan are deductible ratably over the life of the loan unless the taxpayer took the loan to purchase or improve the taxpayer's principal residence; in the latter instance, they are deductible in the year paid. IRC §461(g). The right to an immediate deduction does not exist when the taxpayer uses the loan to refinance an earlier loan rather than to acquire or improve property. *David A. Kelly*, TC Memo 1991-605. In certain situations, the purchaser of a residence may deduct points paid by the seller. Rev Proc 94-27, 1994-1 Cum Bull 613.

Whenever interest is set at below-market rates, deferred, or made subject to balloon treatment, the Internal Revenue Service may treat the transaction according to the original-issue discount (or imputed interest) rules. IRC §§483, 1271-1274. When the amount of nonrecourse debt greatly exceeds the property's value, interest deductions may be denied, either for the excess debt (see *Pleasant Summit Land Corp. v Commissioner* (3d Cir 1988) 863 F2d 263) or for the entire debt in an abusive situation (see *Estate of Isaacson v Commissioner* (2d Cir 1988) 860 F2d 55). Interest deductions may also be denied for nonrecourse debt that lacks economic substance. *Hildebrand v Commissioner* (9th Cir 1992) 967 F2d 350.

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§1.24 D. Transfers of Note and Deed of Trust

Mortgage transfers are common among institutional lenders, and there is an active secondary market, assisted by the federal government, for the sale and exchange of secured notes. When the lender anticipates later transfer of the note, it should be made negotiable (see §§1.28-1.30) and should meet the requirements of secondary market agencies. On secondary market requirements, see California Real Estate Finance Practice: Strategies and Forms §§1.28, 3.1, 4.2 (Cal CEB 2000).

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§1.25 1. Transferring Note and Deed of Trust Separately

The obligation and the security are commonly drafted as separate documents—typically a promissory note and a deed of trust. If the creditor transfers the note but not the deed of trust, the transferee receives a secured note; the security follows the note, legally if not physically. CC §2936; *Seidell v Tuxedo Land Co.* (1932) 216 C 165, 13 P2d 686. See *Lewis v Booth* (1935) 3 C2d 345, 44 P2d 560 (endorsement of note transferred deed of trust). If the transferee is given the deed of trust without the note accompanying it, the transferee has no meaningful rights except the possibility of legal action to compel the transferor to transfer the note as well, if such was the agreement. *Kelley v Upshaw* (1952) 39 C2d 179, 246 P2d 23; *Polhemus v Trainer* (1866) 30 C 685.

Consequently, when one transferee receives the note and another receives the deed of trust, the one holding the note prevails, regardless of who first received a transfer. *Adler v Sargent* (1895) 109 C 42, 41 P 799. Occasionally, an estoppel may modify this outcome if the transferee of the note permitted the transferor to continue to appear as its owner. *Domarad v Fisher & Burke, Inc.* (1969) 270 CA2d 543, 76 CR 529. See §§9.2-9.41 on multiple notes.

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§1.26 2. Physical Delivery Required

Transfers of mortgage paper may be made outright (sale) or by pledge (as security for a loan to the transferor). In either event, to perfect the transfer, the transferor should physically deliver the note to the transferee. Without a physical transfer, a sale of the note could be invalidated as a fraudulent conveyance (under CC §3440), and a transfer in pledge could be invalidated as unperfected (under Com C §§9313-9314). The current version of Division 9, however, provides for some circumstances in which a creditor can perfect, temporarily, a security interest in a note or other instruments and negotiable documents without filing or obtaining possession or control. The period of such temporary perfection is 20 days (under Com C §9312(e)-(h)). Sales and investments in speculative notes have often led to heavy losses for innocent investors who received impressive-looking "certificates" from their investment advisers rather than the actual notes when the schemes went into bankruptcy. See *Greiner v Wilke (In re Staff Mortgage & Inv. Corp.)* (9th Cir 1980) 625 F2d 281; *Starr v Bruce Farley Corp. (In re Bruce Farley Corp.)* (9th Cir 1980) 612 F2d 1197. But see *Bear v Coben (In re Golden Plan, Inc.)* (9th Cir 1986) 829 F2d 705 (sales not governed by Division 9 of Commercial Code). See also Bus & P C §10232.2. On Division 9, see Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

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§1.27 3. Escrow Holder's Role

Assignments of loan documents are often handled by escrow companies who generally have no duties to third parties, *i.e.,* persons who are not parties to the escrow. Absent clear evidence of fraud, an escrow holder's obligations are limited to compliance with the parties' instructions. For an authoritative decision on the role and duties of escrow holders in connection with payments on assigned notes and trust deeds, see *Summit Fin. Holdings, Ltd. v Continental Lawyers Title Co.* (2002) 27 C4th 705, 117 CR2d 541, cert denied (2002) 154 L Ed 2d, 123 S Ct 490 (escrow holder, in connection with refinancing transaction, owed no duty to disregard instructions to pay original creditor rather than assignee even though escrow holder had knowledge of assignment). For detailed discussion of *Summit*, see Bernhardt & Whitman, *Summit Financial Holdings Redux,* 25 CEB Real Prop L Rep 126 (May 2002). On the role and duties of escrow holders generally, see California Real Property Sales Transactions, chap 15 (4th ed Cal CEB 2007).

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§1.28 E. Negotiability

When a note is negotiable, its negotiation to a qualified transferee creates holder-in-due-course status in the transferee and freedom from many (but not all) personal defenses the maker might otherwise assert. See Com C §§3302, 3305; *Wilson v Steele* (1989) 211 CA3d 1053, 259 CR 851. See also California Real Estate Finance Practice: Strategies and Forms §§3.4-3.6 (Cal CEB 2000). The original lender may therefore want the note to be negotiable to make it more readily transferable. Negotiability may also leave the note subject to the 6-year statute of limitations of the Commercial Code rather than the traditional 4-year statute of limitations on written contracts in the Code of Civil Procedure. Compare Com C §3118 with CCP §337. On the 6-year statute of limitations, see §3.17.

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§1.29 1. Requirements

To be negotiable, an instrument must contain an unconditional promise to pay. Com C §3104. California courts initially took the position that a secured note was not negotiable, on the ground that CCP §726 (see §§4.1-4.11) makes the obligation to pay conditional on exhaustion of the security and entry of a valid prior deficiency judgment. *National Hardware Co. v Sherwood* (1913) 165 C 1, 130 P 881; *Kelly v Universal Oil Supply Co.* (1924) 65 CA 493, 224 P 261; *Helmer v Parsons* (1912) 18 CA 450, 123 P 356. This case law rule was abrogated by the legislature when it enacted former CC §3265, which explicitly eliminated security as an impediment to negotiability. Stats 1923, ch 98. Although former CC §3265 was repealed in 1963 when the Commercial Code was enacted, it appears that Com C §3104 continues to permit making a secured note negotiable.

Commercial Code §3106(b) provides that an otherwise unconditional promise is not made conditional by a statement to the effect that "payment is limited to resort to a particular fund or source" (which accurately describes many secured transactions). See Official Comment 1 to UCC §3-106. Incorporation of too many provisions of the security instrument into the note may impair its negotiability. See *Siebenhauer v Bank of Cal. Nat'l Ass'n* (1930) 211 C 239, 294 P 1062 (instrument on its face is negotiable; such negotiability is not destroyed by condition contained in mortgage or deed of trust securing same); *People's Bank v Porter* (1922) 58 CA 41, 208 P 200 (conditions may be imposed that would impact negotiability, but facts here rebut that implication); *Holly Hill Acres, Ltd. v Charter Bank* (Fla App 1975) 314 So2d 209; *Resolution Trust Corp. v 1601 Partners, Ltd.* (ND Tex 1992) 796 F Supp 238.

PRACTICE TIP: To preserve negotiability, simple drafting can be better than complex, and basic preprinted forms of note—of the types available from stationery stores and title companies—can be superior to elaborately drafted forms of note.

Commercial Code §3112(b) allows a negotiable instrument to have a variable interest rate. Additional requirements for negotiability are set forth by Com C §3201. Negotiation of the note may be accomplished by including a proper endorsement directly on the document or by attaching a second sheet (an "allonge") to the note.

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§1.30 2. Holder in Due Course

For a transferee of the note to gain holder-in-due-course status, Com C §3302 requires the following:

- The note must be negotiable; and
- The transferee must
- act in good faith;
- give value; and
- not have actual notice of any defense or claim by the obligor.

Under revised Com C §3106(d), inclusion in the note of a statement that a holder's rights are subject to claims of the issuer against the original payee (*e.g.,* as required by 16 CFR §433.2) does not make the note conditional. The note may still be a negotiable instrument, but the holder would not have holder-in-due-course status.

Principles of constructive notice under the recording laws do not apply to holders in due course, on the ground that the free transferability of commercial paper would be impaired if each taker had to examine the public record before purchasing negotiable paper. Com C §3302(a)(2). See also *Haulman v Crumal* (1936) 13 CA2d 612, 57 P2d 179; *Ross v Title Guar. & Trust Co.* (1934) 136 CA 393, 29 P2d 236. Thus, *e.g.,* the notice given by a lis pendens does not affect a holder in due course. *Ross v Title Guar. & Trust Co., supra*. Considerations of negotiability are sufficiently important to override inconsistent principles appropriate to real property and the real property recording system. See Com C §3302(a)(2). For contrasting interpretations of what constitutes "without notice" under former Com C §3302(1)(c) (now Com C §3302(a)(2)(F)), compare *Parkhill v Nusor (In re Nusor)* (BAP 9th Cir 1991) 123 BR 55, 58, with *Wilson v Steele* (1989) 211 CA3d 1053, 1064, 259 CR 851.

A transferee who qualifies as a holder in due course remains subject to CCP §726, although it is unknown to what extent this can be altered by a showing that the transferee was unaware that the note was secured. See *Kish v Bay Counties Title Guar. Co.* (1967) 254 CA2d 725, 62 CR 494; *Van Vleck Realty v Gaunt* (1967) 250 CA2d 81, 58 CR 246. That the mortgage was recorded may not control, because, as mentioned above, the principles of constructive notice generated by the recording laws (see CC §2934) generally do not apply to holders in due course. On the rules of priority for deeds of trust, see chap 9. It is unknown whether such a transferee takes free of CCP §580b (see §5.24) if the note fails to indicate that it represents a purchase money debt.

PRACTICE TIP: Given these uncertainties, borrower's counsel should insist that the note expressly recite that it is secured by a mortgage or deed of trust.

Federal Trade Commission regulations permit debtors to raise the same defenses against transferees that they could have raised against sellers in the consumer credit field. See 16 CFR §433.2. California courts have also limited application of the holder-in-due-course doctrine in consumer credit cases. See *Vasquez v Superior Court* (1971) 4 C3d 800, 94 CR 796; *Morgan v Reasor Corp.* (1968) 69 C2d 881, 73 CR 398; *Commercial Credit Corp. v Orange County Mach. Works* (1950) 34 C2d 766, 214 P2d 819. See §§1.24-1.26 on transfers of notes.

When a secured note is properly made negotiable, negotiability is also imparted to the security instrument. *Hayward Lumber & Inv. Co. v Naslund* (1932) 125 CA 34, 13 P2d 775. Thus, a holder in due course takes both the note and the mortgage free of hidden defenses. But see *Wilson v Steele, supra* (holder in due course is subject to illegality defense if original instrument is void and illegal pursuant to law).

For further discussion of holder-in-due-course doctrine, see §§12.37, 12.56, 12.70, 12.103. See also 1 Nelson & Whitman, Real Estate Finance Law §§5.27-5.35 (5th ed 2007).

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§1.31 F. Arbitration Clauses and Unconscionability

Two trends in the civil case law—more frequent application of the doctrine of unconscionability and a suspicion of arbitration clauses in contracts between parties of substantially discrepant bargaining power—have found expression in a case involving a "reverse mortgage." In *Flores v Transamerica HomeFirst, Inc.* (2001) 93 CA4th 846, 113 CR2d 376, the First District refused to honor the lender's attempt to enforce an arbitration clause that carved out judicial foreclosure proceedings. In so doing, the court described the clause as unconscionable and one-sided and noted that the carved-out foreclosure remedy was the only remedy the lender was likely to need. See discussion of *Flores* in 25 CEB Real Prop L Rep 42 (Jan. 2002).

On enforceability of arbitration clauses, see §§12.43-12.44. See also California Real Property Remedies and Damages, chap 14 (2d ed Cal CEB 2002).

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III. THE SECURITY INSTRUMENT

A. Historical Perspectives

§1.32 1. Real Property Conveyances

The peculiar nature of land has always required that its use as security be treated differently from chattels used for this purpose. One cannot carry real property to the nearest pawnshop or bank and leave it there until the debt is paid. Documentation replaces manual delivery, and the instruments involved must conform to the law of real property conveyancing. Thus, the earliest mortgages could not read, "I will convey my land to you if I fail to pay my debt," because that would have violated the common law prohibition against springing future interests (repealed in California by CC §767) and the rule that deeds and other conveyancing instruments may not be delivered conditionally. CC §1056. Instead, early mortgages stated, in effect, "I convey my property to you now, but if I pay my debt on time, title will revert back to me." This estate in fee simple subject to condition subsequent conformed to feudal rules for conveyancing and thus was the first generally used mortgage device in England. See 1 Nelson & Whitman, Real Estate Finance Law, chaps 1, 4 (5th ed 2007).

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§1.33 2. Equity of Redemption

Under the common law system of estates, a debtor's failure to pay the debt by its due date ("law day") meant that the condition subsequent had failed, the debtor's power of termination (or right of reentry) had ended, and the creditor's fee simple subject to condition subsequent was enlarged into a fee simple absolute. The debtor had no right to pay late and recover the land. Although the English common law courts countenanced these harsh results, the rival courts of equity looked behind the form of the transaction and recognized that, even though such a transaction might appear to be a conveyance, it could in fact be a loan. The deed had been given not to convey land but as security for a debt. If the grantee under the deed were accordingly treated as a lender rather than as a purchaser, late payment of the debt would not prejudice it (as long as interest was added for the delay), because the legitimate expectation of a lender (as opposed to an owner) would be entirely satisfied by full payment of the debt. Thus, a debtor who had failed to pay the debt on time could proceed to a court of equity and, on showing that the deed was really security for a loan, obtain the right to pay the debt late and thus "redeem" the property. This judicially created "equity of redemption" came to be read into every real property loan, leading to the further development that on default the creditor was compelled to go to court to "foreclose" the debtor's right to pay late (equity of redemption) and thereby to claim beneficial title to the mortgaged property. See *McMillan v Richards* (1858) 9 C 365. The common law equity of redemption is codified in CC §§2903-2905. See §§2.73, 3.63.

These redemption rights were given to the debtor not because of language in the mortgage but rather by the courts and the legislature, usually in contradiction of the express wording of the mortgage. The judiciary assumed that debtors were too necessitous to bargain for any rights and that the courts had to protect them. These "superior equities" are now embedded in all mortgage loans and are not waivable by any language or artifice in the mortgage documents.

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§1.34 B. Mortgage

The mortgage was originally written as a common law fee simple subject to a condition subsequent (see §1.32), but it ultimately came to be simply a document by which the debtor-borrower "mortgaged" (hypothecated) the real property to the creditor as "security" for a debt.

Unlike the common law fee simple subject to condition subsequent, the California mortgage does not give the mortgagee title to the property. A mortgage is not treated as a deed absolute. The mortgagee receives a lien on the property, *i.e.,* the right to have the property sold to satisfy the indebtedness. This is the "lien theory" of mortgages followed in California and many other states. CC §§2888, 2926; *Harp v Calahan* (1873) 46 C 222, 233; *Mack v Wetzlar* (1870) 39 C 247, 254; *Goodenow v Ewer* (1860) 16 C 461, 467; *Nagle v Macy* (1858) 9 C 426. See 1 Nelson & Whitman, Real Estate Finance Law §§1.5, 4.2 (5th ed 2007). The "lien theory" of mortgages is one of the few remaining distinctions between mortgages and deeds of trust in California, and it still has practical implications for the operation of the statute of limitations (see §1.35).

Under CC §2922, a mortgage must contain all the formalities of a grant of real property (a model mortgage form is in CC §2948). But even if the appropriate formalities are lacking, a court may nevertheless rule that an enforceable equitable mortgage exists. See *Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379.

A UCC-1 financing statement may qualify as a real property mortgage if it contains all essential information. *Lovelady v Bryson Escrow, Inc.* (1994) 27 CA4th 25, 32 CR2d 371 (leasehold mortgage). Such a statement may lack a power of sale provision, however, and the creditor may therefore have to resort to judicial foreclosure. Note also that in *Burlesci v Petersen* (1998) 68 CA4th 1062, 80 CR2d 704, no security interest was created when the borrower signed a financing statement but did not sign a security agreement containing language creating or granting a security interest.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/1 Basics of Real Property Secured Transactions/§1.35 C. Deed of Trust

§1.35 C. Deed of Trust

In California, the deed of trust has completely eclipsed the mortgage as the lending and title industries' preferred security instrument. The reasons for its rise in popularity illustrate a peculiar aspect of California mortgage law.

The general tendency of English courts of equity and American courts is to treat as a mortgage any instrument that secures a debt with real property. The instrument is thus made subject to all the rules governing mortgages. If changes in form could insulate a mortgage instrument from the rules protecting debtors, creditors would automatically compel their debtors to execute such variant instruments. Thus, the threshold question for a court examining a real property instrument is whether the document serves a mortgage function. If it does, it will be treated as a mortgage, regardless of its form. This rule has been followed in California for many forms of disguised security (or "mortgage substitute" or "hidden mortgage") (see §5.46).

Historically, however, the California Supreme Court declined to follow this approach with deeds of trust, holding that, because they did not look like mortgages, they could not be treated as mortgages. *Koch v Briggs* (1859) 14 C 256. The differences between the two instruments, although strictly formal and based on different terminology, were held to give them different effects. (A mortgage declares that the debtor "mortgages" the property; a deed of trust recites that the trustor "grants, transfers, and assigns [the property] to trustee in trust" as security for the loan.) *Koch* further held that, because the deed of trust instrument was not a mortgage, it was not subject to the debtor-protection rules governing mortgages. Given this advantage, the deed of trust rapidly became the dominant real property security instrument in California.

Seventy-four years later, the supreme court recognized its error and brought the deed of trust back within the coverage of California's mortgage policy. In *Bank of Italy Nat'l Trust & Sav. Ass'n v Bentley* (1933) 217 C 644, 20 P2d 940, the court held that a deed of trust serves the same economic function as a mortgage, should be treated as a mortgage, and is generally subject to the same set of rules that govern mortgages. Code of Civil Procedure §726 (see §§4.3-4.6, 4.61) was thus held to apply to a note secured by a deed of trust as well as to a mortgage.

The *Bank of Italy* decision did not cause lenders to return to the mortgage as the preferred security instrument. Although the decision deprived the deed of trust of almost all of its previous advantages over the mortgage, the many years of judicial analysis of the deed of trust as a security instrument were invaluable to an industry interested in certainties. Habit and simple inertia undoubtedly played a role. The deed of trust continued as the standard security document.

Subsequent decisions have continued to the present-day melding of mortgage and deed of trust law. Today it is difficult to find meaningful legal differences between them. Although the deed of trust was originally held to give the creditor a "title" rather than a "lien"—a statement still true today as a matter of legal theory—most practical consequences of that distinction have vanished. Both instruments now have the same effect, or lack of it, on the debtor's title. Compare, *e.g., People ex rel Dep't of Pub. Works v Nogarr* (1958) 164 CA2d 591, 330 P2d 858, with *Hamel v Gootkin* (1962) 202 CA2d 27, 20 CR 372. See also *Aviel v Ng* (2008) 161 CA4th 809, 813, 74 CR3d 200 (mortgages and deeds of trust are functionally and legally equivalent); for a discussion of *Aviel*, see Andrew, *A Further Thought on Aviel v Ng: Enforcement of an Automatic Lease-Subordination Provision,* 31 CEB Real Prop L Rep 155 (Sept. 2008); Bernhardt, *When First Might Be Worst,* 31 CEB Real Prop L Rep 75 (May 2008).

There remains today only the early holding that the power of sale in a deed of trust is not outlawed by time, although the same power in a mortgage—such a mortgage creates a lien—is subject to the statute of limitations. CC §2911; *Travelli v Bowman* (1907) 150 C 587, 89 P 347; *Sipe v McKenna* (1948) 88 CA2d 1001, 200 P2d 61. This rule is sometimes loosely expressed as "a trust deed never outlaws." The legislature narrowed this distinction in the Marketable Record Title Act (CC §§880.020-887.090), which imposed time limits on the enforceability of all real property security instruments (CC §882.020). The distinction remains between mortgages and deeds of trust in terms of time limitations (see §§3.16-3.20, 7.28-7.33); however, it is safe to assume that the courts will ultimately eliminate even this distinction as unreasonable and unnecessary when an appropriate opportunity arises.

Mechanically, the deed of trust adds a third party—an independent trustee—whose sole significant function is to

conduct a foreclosure sale (trustee sale) on demand. See chap 2. See also California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000). The "trustee" of a deed of trust is not a trustee as known under the law of trusts or bankruptcy and is best viewed as playing a purely ministerial and mechanical role (see §2.1). That role is limited to, in essence, reconveying the deed of trust at the beneficiary's request if the debt is repaid or nonjudicially foreclosing the deed of trust at the beneficiary's request if a default occurs (see chap 2). The trustee plays little if any role in foreclosure litigation (see chap 3). See *Monterey S.P. Partnership v W.L. Bangham, Inc.* (1989) 49 C3d 454, 261 CR 587 (beneficiaries cannot be served through service on trustee).

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1. Forms of Deeds of Trust

§1.36 a. Title Company Forms

There is a suggested statutory model form for mortgages (in CC §2948) but not for deeds of trust. Most noninstitutional lenders use the printed deed of trust forms supplied by title companies. Both long- and short-form printed deeds of trust are available from title companies. The long form prints all the typical provisions, and the entire form is recorded. The short form incorporates by reference a recorded template or fictitious deed of trust, which contains many of the standardized provisions in the long-form deed of trust. Use of such fictitious deeds of trust is authorized by CC §2952. Although these provisions are reprinted on the reverse side of the short-form deed of trust, they are not recorded (in order to save recording fees). The substantive provisions of both forms are usually identical. It is of course easier to modify and augment the long-form provisions when that is desired.

PRACTICE TIP: Using the long form—with the provisions in the body of the form above the signature line, rather than in small print on the back of the form—makes it more difficult for a party to later claim ignorance of the provisions. Using the long form also eliminates the risk of defective incorporation by reference.

Counsel should feel free to propose modifying the terms of a deed of trust if doing so improves the client's situation. There is no requirement that the deed of trust be on a printed form or that the title company acting as trustee necessarily agree to the changes. Most of the provisions (*e.g.,* right to insurance or condemnation proceeds, interest on sums advanced by a beneficiary to protect the security) affect only the trustor and beneficiary and do not concern the trustee. Attorneys who frequently represent trustors or beneficiaries may wish to add their own predrafted riders to the printed form to serve as a starting point for negotiations.

On drafting deeds of trust, see California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000).

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§1.37 b. Institutional Lender Forms

Institutional lenders usually use their own forms, computer-generated forms, or uniform conforming instruments approved by the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). For discussion of various agencies' requirements in the secondary mortgage market, see California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000). Uniformity of provisions is necessary if individual deeds of trust are to be sold in the secondary mortgage market or bundled into large pools for sale to Wall Street investors, often as part of a process that has come to be known as "securitization" (to give the originating lenders further infusions of cash for loans to new borrowers). On securitization, see Real Estate Finance, chap 10. On lender liability in securitized lending situations, see chap 12.

Institutional deeds of trust also contain special provisions for loans to be insured by the Federal Housing Administration or guaranteed by the Veterans Administration. The discussion in this book is generally confined to the common title company form deeds of trust.

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§1.38 2. Formal Requirements

Mortgages and deeds of trust must each comply with the formalities necessary for grants of real property. The mortgage is specifically required to do so by CC §2922. In fact, the deed of trust is technically a grant of real property. See *Hahn v Hahn* (1954) 123 CA2d 97, 266 P2d 519. Thus, the instrument must be in the form of a writing that adequately identifies the parties and the property (CC §1091; *Dool v First Nat'l Bank* (1929) 207 C 347, 278 P 233; *Watkins v Bryant* (1891) 91 C 492, 504, 27 P 775), and it must be properly signed and delivered (CC §1091; *Le Mesnager v Hamilton* (1894) 101 C 532, 35 P 1054). Although acknowledgment is not required, the instrument cannot be recorded without it. CC §2952; *Bank of Ukiah v Petaluma Sav. Bank* (1893) 100 C 590, 35 P 170; *Williams v Nieto* (1929) 98 CA 615, 277 P 513. Requirements for establishing the identity of the parties whose signatures are acknowledged in the instrument are in CC §1185.

For a lien to attach to the property, an obligation underlying the mortgage or deed of trust must exist (see §§1.10-1.13). The obligation, however, may merely be to repay any future obligations that may arise. *Moss v Odell* (1901) 134 C 464, 66 P 581. See §9.63. The trustor's failure to execute or deliver the deed of trust as agreed may nevertheless give the intended beneficiary an equitable lien or equitable mortgage on the property. See *Pellerin v Stuhley (In re Destro)* (9th Cir 1982) 675 F2d 1037.

As a rule, parties desiring to conceal the fact that their transaction involves a secured loan intentionally omit all language that discloses its true purpose. These omissions may ensure that the transaction will not qualify as a legal mortgage, but the transaction may still be enforceable as an equitable mortgage, thus forcing one party to go through a foreclosure action to collect regardless of the terms of the contract. Options to repurchase, sale and leasebacks, covenants not to convey or encumber, and negative pledges all have been held, at various times, to constitute mortgage arrangements despite their carefully drafted language to the contrary. See §§4.33, 5.51; 1 Nelson & Whitman, Real Estate Finance Law, chap 3 (5th ed 2007).

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3. Parties

§1.39 a. Trustor

A deed of trust must identify the trustor, whose signature is necessary to the instrument's effectiveness. *Le Mesnager v Hamilton* (1894) 101 C 532, 35 P 1054; *Welch v Security-First Nat'l Bank* (1943) 61 CA2d 632, 143 P2d 770. The trustor need not be the debtor; a mortgage or deed of trust can be given to secure the debt of another. *Everly Enters. v Altman* (1960) 54 C2d 761, 8 CR 455; *Garretson Inv. Co. v Arndt* (1904) 144 C 64, 77 P 770; *Exchequer Acceptance Corp. v Alexander* (1969) 271 CA2d 1, 76 CR 328. See §§1.15-1.16. Because the security instrument encumbers an interest in real property, the trustor must own the interest to be encumbered.

The ownership requirement is qualified by the doctrine of after-acquired title. Thus, a mortgage is valid even when the mortgagor does not acquire title to the security until a later time. See CC §2930. A deed of trust recorded before the trustor acquires record title may be outside the chain of title and hence ineffective to give constructive notice to subsequent purchasers or encumbrancers. *Far W. Sav. & Loan Ass'n v McLaughlin* (1988) 201 CA3d 67, 246 CR 872 (see §9.45).

Both tenants in common and joint tenants may mortgage their fractional interests (see §§1.48-1.49), but spouses who hold title as community property must both execute instruments affecting title, thus rendering fractional transfers impossible (see §1.50).

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§1.40 b. Trustee

The trustee under a deed of trust is not a true trustee and is not subject to the general rules governing trusts. *Lupertino v Carbahal* (1973) 35 CA3d 742, 747, 111 CR 112. The function of such a trustee is to reconvey the property to the trustor if the loan is repaid or to foreclose nonjudicially, at the beneficiary's election, if a default occurs. *Monterey S.P. Partnership v W.L. Bangham, Inc.* (1989) 49 C3d 454, 261 CR 587. See §§1.35-1.38. The trustee has been referred to as a common agent rather than as a true trustee, but even this label is misleading because of the following:

- The trustee is not required to obtain the trustor's consent as a precondition to selling the trustor's interest on foreclosure (*Jones v Sierra Verdugo Water Co.* (1923) 63 CA 254, 218 P 454); and
- The trust deed trustee has almost none of the discretion typically enjoyed even by special agents (*I.E. Assocs. v Safeco Title Ins. Co.* (1985) 39 C3d 281, 288, 216 CR 438).

The nature of trust deed trustees and their activities is described in *Pro Value Props., Inc. v Quality Loan Serv. Corp.* (2009) 170 CA4th 579, 88 CR3d 381. In *Pro Value*, the court characterized the trustee as a ministerial statutory actor, and its actions in conducting a trustee sale as the ministerial implementation of statutory procedures. In determining the proper interest rate to be paid on funds to be refunded to the putative buyer at what turned out to be a void trustee sale, the court rejected the contention that any contract had been formed between the trustee and the successful buyer at the trustee sale.

Because the trustee has no other real functions, title company deeds of trust often name title companies as trustees even though they have not expressly consented to the appointment or even been given notice of it. See *Huntoon v Southern Trust & Commerce Bank* (1930) 107 CA 121, 290 P 86. A trustee who does not wish to reconvey on demand or conduct a nonjudicial foreclosure may have the beneficiary select a substitute trustee (see §§1.41, 2.21-2.26, 8.97).

PRACTICE TIP: Unless the attorney is familiar with foreclosure procedures, it is preferable to permit an experienced foreclosure company or a title company's foreclosure specialists to handle the mechanics of a trustee sale (see §2.4).

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§1.41 (1) Substitution of Trustee

The beneficiary may choose to substitute its own attorney or another nominee as trustee if the beneficiary does not want to pay the charges that title companies or other trustees exact for foreclosure or if the trustee declines to foreclose when requested to do so (see §2.21). Likewise, a beneficiary may choose to substitute the trustee for the purpose of executing a deed of reconveyance. Procedures for substitution are set forth in CC §2934a. One may be able to follow alternative procedures set forth in the deed of trust. See *U.S. Hertz, Inc. v Niobrara Farms* (1974) 41 CA3d 68, 116 CR 44. On substitution of trustees, see California Title Insurance Practice, chap 15 (2d ed Cal CEB 1997).

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§1.42 (2) Involvement in Litigation

In any action affecting the interest of a trustor or a beneficiary under a deed of trust, service of process on the trustee does not constitute service of process on either of those parties and does not impose any obligation on the trustee to notify them of the action. CC §2937.7. See *Monterey S.P. Partnership v W.L. Bangham, Inc.* (1989) 49 C3d 454, 261 CR 587 (mechanics' lien foreclosure). See also §1.35.

Under CC §2924*l*, a trustee who is named in an action solely as a trustee—and not because of any wrongful acts—may file a declaration of nonmonetary status. Absent any objection, the trustee need not participate further and is not subject to any liability. See chap 3.

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c. Beneficiary

§1.43 (1) Must Be Obligee

The beneficiary must be an obligee of the secured obligation (usually the payee of a note) because otherwise the deed of trust in its favor has no purpose. *Watkins v Bryant* (1891) 91 C 492, 27 P 775; *Nagle v Macy* (1858) 9 C 426. See §§1.10-1.21 on the need for an obligation. The deed of trust is merely an incident of the obligation and has no existence apart from it. *Goodfellow v Goodfellow* (1933) 219 C 548, 27 P2d 898; *Adler v Sargent* (1895) 109 C 42, 41 P 799; *Turner v Gosden* (1932) 121 CA 20, 8 P2d 505. The holder of the note, however, can enforce the deed of trust whether or not named as beneficiary or mortgagee. CC §2936. See §1.25.

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§1.44 (2) Relationship to Trustee

A beneficiary is not prohibited from also serving as trustee under the deed of trust it holds (*More v Calkins* (1892) 95 C 435, 30 P 583) or having one of its employees do so (*Witter v Bank of Milpitas* (1928) 204 C 570, 576, 269 P 614). This is not commonly done, however, because rights, duties, or knowledge in one capacity may be imputed to the other. See chap 2. It is not unusual, however, to see deeds of trust in which the party named trustee is an "auxiliary" of the beneficiary, typically a wholly or commonly owned entity-subsidiary within a holding company framework.

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§1.45 (3) Relationship to Trustor

If the beneficiary and trustor are too closely connected, a court may conclude either that no actual obligation underlies the deed of trust or that the obligation has merged into the underlying fee interest. See *Spacek v Thomen (In re Universal Farming Indus.)* (9th Cir 1989) 873 F2d 1334; *Wilson v McLaughlin* (1937) 20 CA2d 608, 67 P2d 710. But see *Anglo-Californian Bank, Ltd. v Field* (1908) 154 C 513, 98 P 267 (merger does not occur if there is intervening lien on property and no evidence of express intention to extinguish first mortgage). If the beneficiary is also named as beneficiary of other deeds of trust on the same real property, similar merger risks arise. See *Anglo-Californian Bank, Ltd. v Field, supra; Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549; *Investcal Realty Corp. v Edgar H. Mueller Constr. Co.* (1966) 247 CA2d 190, 55 CR 475.

PRACTICE TIP: Because of some courts' readiness to find mergers in multi-loan situations (see *Simon v Superior Court* (1992) 4 CA4th 63, 5 CR2d 428; *Union Bank v Wendland, supra;* see also §§5.12, 9.61-9.67), a lender holding two deeds of trust on the same property may gain a small margin of safety by having different trustees serve under the two instruments. The relationship between the two loans and the beneficiaries, however, will be more significant than the identity of the trustees. *Marion Drive, LLC v Saladino* (2006) 136 CA4th 1432, 39 CR3d 695, provides a useful example of the successful use of a "separate ownership" structure to avoid an undesirable merger.

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§1.46 (4) Multiple Beneficiaries and Trustees

Multiple parties may be named as beneficiaries, either because they hold separate notes secured by common property or because they hold individual participation interests in a single secured note (see §§2.34, 3.23). All parties must foreclose together to ensure a prorata distribution of the proceeds. *Phelan v Olney* (1856) 6 C 478. On multiple parties, see chap 9.

Any one beneficiary may elect to foreclose (following a default) without obtaining the consent of the others. See *Perkins v Chad Dev. Corp.* (1979) 95 CA3d 645, 157 CR 201. See also *Bliss v Security-First Nat'l Bank* (1947) 81 CA2d 50, 183 P2d 312. Civil Code §2941.9, however, permits multiple beneficiaries to agree to be governed by majority vote of the beneficial interests on issues such as default and foreclosure. On foreclosure by multiple beneficiaries, see California Title Insurance Practice, chap 15 (2d ed Cal CEB 1997).

Trustees can probably also rely on nonstatutory authorizations of majority action in loan syndications or participations. See Lott, Makel & Evans, *Multiple Lender Transactions: Current Issues,* 112 Banking LJ 846, 871 (1995).

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§1.47 4. Security

The deed of trust should contain a legal description of the property or, alternatively, adequate reference to a prior recorded instrument containing such a description. *Wemple v Yosemite Gold Mining Co.* (1906) 4 CA 78, 87 P 280. An inadequate or incorrect description of the property may invalidate the instrument or disqualify it from giving constructive notice. *Balistreri v Nevada Livestock Prod. Credit Ass'n* (1989) 214 CA3d 635, 262 CR 862 (mutual mistake); *Sepulveda v Apablasa* (1938) 25 CA2d 381, 77 P2d 526; *Saterstrom v Glick Bros. Sash, Door & Mill Co.* (1931) 118 CA 379, 5 P2d 21.

Any interest in real property capable of being transferred may be mortgaged. CC 2947. Thus, less than the full fee may be mortgaged. When the security consists of a nonfee interest, the deed of trust should describe with particularity both the property and the nature of the interest or estate encumbered. Some of the more common lesser interests given as security are discussed in §§1.51-1.54.

Foreclosure of a security interest encumbering less than the fee, *e.g.*, a ground lease, will affect only that lesser interest and will leave ownership of the fee interest unimpaired. This result, however, can create legal issues between the fee owner and the new owner of the lesser interest that was encumbered and foreclosed. *Miscione v Barton Dev. Co.* (1997) 52 CA4th 1320, 61 CR2d 280 (general rule that foreclosure of deed of trust extinguishes subordinate lease does not apply when tenant contractually agreed to attorn to lender after foreclosure and be bound by lease).

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a. Fractional Interests

§1.48 (1) Tenancies in Common

One tenant in common may subject its individual interest to a deed of trust, leaving the interest of the other tenant in common unencumbered. *Haster v Blair* (1940) 41 CA2d 896, 107 P2d 933. If only one co-owner executes a deed of trust, then only that owner's interest is encumbered unless it was authorized to act on behalf of the other co-owner(s). Because of the risks and disadvantages of co-ownership following foreclosure, most lenders do not favor deeds of trust on cotenancy property. When all co-owners execute the deed of trust, however, it constitutes an encumbrance on the entire fee, whether it secures the obligation of all or only some of the owners. *Caito v United Cal. Bank* (1978) 20 C3d 694, 144 CR 751.

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§1.49 (2) Joint Tenancies

The rules for joint tenancies are similar to those for tenancies in common (see §1.48). One joint tenant may encumber its fractional interest without the signature, consent, or knowledge of the others. *Schoenfeld v Norberg* (1970) 11 CA3d 755, 90 CR 47; *Clark v Carter* (1968) 265 CA2d 291, 70 CR 923. See §1.39. In some states, execution of a mortgage by one joint tenant severs the joint tenancy. California courts have not followed this rule. *Clark v Carter, supra; People ex rel Dep't of Pub. Works v Nogarr* (1958) 164 CA2d 591, 330 P2d 858. Although CC §683.2(a)(1) provides that the joint tenancy be severed when a joint tenant executes and delivers a deed conveying legal title to another "whether or not pursuant to an agreement that requires the third person to reconvey legal title to the joint tenant," it is unlikely that the legislature intended to alter the existing rule by enacting this section. See Bernhardt, *Secretly Severing Joint Tenancies,* 19 CEB Real Prop L Rep 125 (May 1996).

Under existing case law, the beneficiary takes a lien on the joint-tenancy interest. *Hamel v Gootkin* (1962) 202 CA2d 27, 20 CR 372; *People ex rel Dep't of Pub. Works v Nogarr, supra*. A foreclosure sale will effect a severance, however, and the purchaser at the sale becomes a tenant in common with the remaining joint tenant. But if either joint tenant dies before foreclosure, the result is different. Because the joint tenancy remains in effect despite the mortgage, the principles of survivorship regulate the consequences of a death. Thus, if the nonmortgaging joint tenant dies first, the other joint tenant succeeds to the entire estate and the mortgage previously executed expands to cover the entire estate. See CC §2930; *Sherman v McCarthy* (1881) 57 C 507; *Parry v Kelley* (1877) 52 C 334. If the mortgaging joint tenant dies first, the mortgage is lost along with the estate and the surviving joint tenant takes the property free of the mortgage. See *Schoenfeld v Norberg, supra; Clark v Carter, supra; Hamel v Gootkin, supra; People ex rel Dep't of Pub. Works v Nogarr, supra*. On property held by spouses in joint tenancy, see §1.50.

When a junior lien exists on a fractional interest in property and the entire fee is sold to satisfy a senior lien, any surplus is divided between the junior and the holders of the other fractional interest. *Caito v United Cal. Bank* (1978) 20 C3d 694, 144 CR 751. See Bernhardt, *A Comment on Caito v United California Bank,* 1 CEB Real Prop L Rep 65 (July 1978).

PRACTICE TIP: Accounts between co-owners are frequently out of balance, with one owner advancing funds in the expectation of later being reimbursed by the other. These reimbursement rights rarely appear in the public records and may, therefore, be held to be subordinate to the recorded claims of a third party lender, regardless of which came first. Co-owners in such situations should see that their reimbursement rights do not suffer from nonrecordation by executing and recording mutual secured agreements for reimbursement. See Bernhardt, *A Comment on Caito v United California Bank,* 1 CEB Real Prop L Rep 65 (July 1978); Bernhardt, *Secretly Severing Joint Tenancies,* 19 CEB Real Prop L Rep 125 (May 1996).

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§1.50 (3) Community Property

Under Fam C §1102(a), both spouses must join in executing any conveyance or encumbrance on community property. Thus, a creditor who holds a deed of trust on community property that contains only one signature has no enforceable security interest, even if it purports to secure the debt of that spouse only. *Droeger v Friedman, Sloan & Ross* (1991) 54 C3d 26, 46, 283 CR 584. (In response to *Droeger,* the legislature in 1993 enacted Fam C §2033(a), which permits a spouse to encumber his or her interest in community property to secure payment of attorney fees in a marital dissolution action.)

When a nonconsenting spouse invalidates in its entirety a deed of trust on community property executed solely by the other spouse, the effect is to leave the creditor unsecured, but a subsequent recorded judgment for the debt in the nonconsenting spouse's favor will operate as a lien against both spouses' interests in the community property because such property is liable for the debts of either spouse. Fam C §910. See *Lezine v Security Pac. Fin. Servs.* (1996) 14 C4th 56, 58 CR2d 76. See Bernhardt, *Trading Mortgages for Judgments Against Community Property,* 20 CEB Real Prop L Rep 103 (Apr. 1997).

When community property appears of record to be held in joint tenancy or tenancy in common, however, the signature of one spouse may be effective to encumber half of the property. *Kane v Huntley Fin.* (1983) 146 CA3d 1092, 194 CR 880. See *Security Pac. Fin. Corp. v Nelson* (*In re Nelson)* (9th Cir 1985) 761 F2d 1320 (wife bound by husband's forgery of her signature when he believed he had her consent and she accepted benefits of transaction). See also §§1.48-1.49.

Although California law requires both spouses to sign a deed of trust encumbering community property, under the Equal Credit Opportunity Act (ECOA) (15 USC §§1691-1691f) and Regulation B (12 CFR pt 202), a commercial creditor may not require the signature of the applicant's spouse or other person (other than a joint applicant) on the credit instrument if the applicant meets a creditor's standards of creditworthiness. 12 CFR §202.7(d)(1). Nor can the creditor demand that the applicant's spouse be the additional party if only one is properly required. 12 CFR §202.7(d)(5). But see *Ramsdell v Bowles* (1st Cir 1995) 64 F3d 5, 9 (when borrower not creditworthy, lender can require spouse to co-sign loan); *Riggs Nat'l Bank v Linch* (4th Cir 1994) 36 F3d 370, 374. If the borrower is relying on a spouse's income to establish creditworthiness, however, the creditor may demand the spouse's signature, even in a community property state. *U.S. v ITT Consumer Fin. Corp.* (9th Cir 1987) 816 F2d 487. These rules apply to both consumer and commercial credit. 12 CFR pt 202, Supp I, ¶1(a)-1. See Lustigman & Serfaty, *The Equal Credit Opportunity Act as a Defense Against Payment: How Lenders Can Strike Back,* 111 Banking LJ 444 (1994).

NOTE: Third party creditors of a married couple lack standing to challenge the validity of a mortgage executed by only one spouse. *Clar v Cacciola* (1987) 193 CA3d 1032, 238 CR 726.

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b. Estates Less Than Fee Simple

§1.51 (1) Life Estates or Terms of Years

A life estate or a term of years may be mortgaged. *McLeod v Barnum* (1901) 131 C 605, 63 P 924; *Commercial Bank v Pritchard* (1899) 126 C 600, 59 P 130; *San Francisco Breweries v Schurtz* (1894) 104 C 420, 38 P 92. In response to an earlier court of appeal decision that a leasehold estate was a chattel interest rather than real property (*Taylor v Bouissiere* (1987) 195 CA3d 1197, 241 CR 253), CCP §§580b, 580d, and 726 now apply explicitly to "real property or an estate for years," as do many other related statutes: CC §§1213-1214 (recording), 2898 (purchase money priority), 2920 (mortgage definition), 2924b (notices of default and sale), 2924c (reinstatement), 2924.3 (mortgage collection agents), 2931a-2931b (state liens), and 2954.10 (due-on-sale accelerations).

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§1.52 (2) Leasehold Mortgages

Leasehold mortgages are common financing arrangements in modern commercial transactions. If the tenant defaults, the leasehold interest is sold at a foreclosure sale and the purchaser becomes the new tenant. The landlord's reversionary interest is unaffected by the sale. Sometimes a landlord will subordinate the reversion to the mortgage instrument, in which case the foreclosure will result in sale of the entire fee, not just the leasehold. See *Mead v Sanwa Bank Cal.* (1998) 61 CA4th 561, 71 CR2d 625 (landlord who "subordinates" to construction loan by executing deed of trust on reversion to secure loan to tenant may have surety rights). But see *Matthews v Hinton* (1965) 234 CA2d 736, 44 CR 692 (landlord signed deed of trust as trustor with tenants making landlord's reversionary interest primarily liable). When the same party subsequently acquires both the leasehold and the reversion, the existence of a mortgage on the leasehold will prevent a merger of the two estates. *6424 Corp. v Commercial Exch. Prop., Ltd.* (1985) 171 CA3d 1221, 217 CR 803. See *Lovelady v Bryson Escrow, Inc.* (1994) 27 CA4th 25, 32 CR2d 371 (use of a UCC-1 financing statement as leasehold mortgage).

A leasehold mortgagee will lose its security if the landlord terminates the tenant's lease. See *Glendale Fed. Bank v Hadden* (1999) 73 CA4th 1150, 87 CR2d 102 (leasehold mortgagee has no independent right to unlawful detainer notice, is not indispensable party to action, and cannot assert right to later reinstate tenancy after judgment); see also discussion of *Glendale* in 22 CEB Real Prop L Rep 216 (Oct. 1999).

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§1.53 (3) Reversions

It is also possible for a landlord to mortgage only its retained reversionary interest in the property. This automatically occurs when a mortgage is executed after the property is already subject to a lease. Nevertheless, the tenant may, and commonly does, agree to subordinate the leasehold to the mortgage; otherwise, the tenant's lease may give the mortgagee the power to demand such a subordination. *Enos v Cook* (1884) 65 C 175, 3 P 632. See §§6.95-6.96. If only the reversion is mortgaged, a foreclosure sale will convey only the reversion and the purchaser will become the new landlord of the existing tenant. If the leasehold is or has been subordinated to the mortgage, the foreclosure sale may terminate the leasehold and dispose of the entire fee. *McDermott v Burke* (1860) 16 C 580. See *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 270 CR 183. But compare *Dover* with *Miscione v Barton Dev. Co.* (1997) 52 CA4th 1320, 61 CR2d 280. On subordination, nondisturbance, and attornment provisions in leases, see Office Leasing: Drafting and Negotiating the Lease, chap 28 (Cal CEB 1996); Retail Leasing: Drafting and Negotiating the Lease, chap 44 (Cal CEB 2007). See also Bernhardt, *When First Might Be Worst,* 31 CEB Real Prop L Rep 75 (May 2008).

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§1.54 (4) Seller and Buyer Interests

The seller and the buyer under an installment land sale contract (see §§1.59-1.66) may each separately mortgage its respective interest. Each interest fits within the statutory requirement for transferability. CC §2947. See *Tripler v MacDonald Lumber Co.* (1916) 173 C 144, 159 P 591. The rights under an option to purchase real property and the right to redeem property from a tax sale may also be mortgaged.

When an installment land contract has been completely performed, or an option exercised, the doctrine of after-acquired title enlarges the mortgage to include the newly acquired interest. CC §2930. In a foreclosure on one of these lesser interests, the purchaser at the foreclosure sale acquires no greater rights than the trustor had, and the purchased rights are no smaller. Thus, the purchaser may complete performance under the land sale contract, exercise the option (*Chapman v Great W. Gypsum Co.* (1932) 216 C 420, 14 P2d 758), or redeem the property from the tax sale.

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c. Property Already Encumbered

§1.55 (1) Monetary Liens

Property subject to a mortgage or deed of trust or other monetary lien remains fully alienable and thus can be further encumbered. When a deed of trust is executed on property that is already subject to an existing deed of trust, the new beneficiary merely acquires a junior lien on the property (see §§9.44-9.47). There is no legal limit to the number of mortgages or deeds of trust that may be imposed on property, although each junior creditor, to be fully secured, will need to calculate whether the property has sufficient value to reliably satisfy all prior liens as well as its own and whether the creditor has sufficient resources to prevent a senior foreclosure by either reinstating the loan or redeeming the property. See *Streiff v Darlington* (1937) 9 C2d 42, 68 P2d 728; *Wardlow v Middleton* (1909) 156 C 585, 105 P 738. See also §§2.52, 2.73, 2.83, 2.99, 2.103-2.104, 9.58.

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§1.56 (2) Nonmonetary Interests

Prior easements, covenants, and equitable servitudes are encumbrances on property that usually do not impair its alienability or its mortgageability. If property subject to an easement or similar burden is foreclosed, the purchaser at the sale will obtain the encumbered title. *Kreichbaum v Melton* (1874) 49 C 50; *Cook v De La Guerra* (1864) 24 C 237. If the mortgage or deed of trust has priority over such an interest, foreclosure will terminate it. *Sain v Silvestre* (1978) 78 CA3d 461, 144 CR 478, overruled on other grounds in *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 129, 158 CR 1. See §2.44 on notice of default to easement holders. On easements generally, see California Easements and Boundaries: Law and Litigation (Cal CEB 2008).

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§1.57 d. Personal Property; Fixtures

When personal property is affixed to the land, it becomes part of the real property under the doctrine of fixtures. CC §§658, 660. As such, it is subject to any subsequently executed real property mortgage or deed of trust and also is subject to previously executed mortgages or deeds of trust under the doctrine of after-acquired title. CC §2930; *Commercial Bank v Pritchard* (1899) 126 C 600, 59 P 130; *Hill v Gwin* (1875) 51 C 47. Thus, a typical residential mortgage covers not only the land but also the house and its built-in appliances.

A real property mortgage or deed of trust in and of itself does not encumber personal property that is not affixed to the land. *McLeod v Barnum* (1901) 131 C 605, 63 P 924. A beneficiary who seizes or sells such personal property may be liable for conversion. *Strutt v Ontario Sav. & Loan Ass'n* (1972) 28 CA3d 866, 105 CR 395. A creditor who wants a security interest in personal property as well as real property should execute a security agreement and file that agreement in accordance with the Commercial Code. Com C §§9201, 9203; *Freedland v Greco* (1955) 45 C2d 462, 289 P2d 463. On issues that arise when the collateral consists of both real and personal property ("mixed collateral"), see §§9.12-9.23; on taking and perfecting a security interest in personal property under the Commercial Code, see California Real Estate Finance Practice: Strategies and Forms, chap 7 (Cal CEB 2000).

A lease of equipment or personal property may create a security interest under certain circumstances, dependent on the facts of each case. See Com C §1203.

On fixture filings, see UCC §9-313. A deed of trust may be effective as a financing statement filed as a fixture filing. Com C §9502. See Secured Transactions in California Commercial Law Practice §3.99 (2d ed Cal CEB 2001); Real Estate Finance §7.23. On priority of fixture claims as against real estate encumbrances, see §9.51.

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§1.58 D. Convertible Mortgages

A convertible mortgage gives the lender an option to buy the encumbered property at some future time. When the option is exercised, the note is canceled and the deed of trust is reconveyed as part of the purchase price. This arrangement permits the borrower to keep the property for the short term (retaining the early tax and ownership benefits and risks) and enables the lender later to acquire a valuable mature property in an increasingly competitive market. An option granted to a beneficiary under a deed of trust to acquire encumbered (nonresidential) real property is valid as long as its exercise does not depend on a default by the borrower. CC §2906. A right to exercise the option that depends on default by the borrower is considered an impermissible "clog" of the equity of redemption and therefore invalid. See Nellis, *Convertible Mortgages: A Brief Review of the Legal and Drafting Issues,* 8 CEB Real Prop L Rep 1 (Jan. 1985). Civil Code §2906 does not apply if the option is on property that is not real property collateral, such as a remainder interest in real property. *Wachovia Bank v Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1060, 52 CR3d 168.

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§1.59 E. Installment Land Contracts

An alternative to the deed of trust in California is the installment land contract. As a device that was once perceived as circumventing the effect of a due-on-sale clause in a deed of trust encumbering the vendor's interest (see §§8.12-8.13), it acquired considerable popularity during the 1970s. The land contract was also widely used as an inexpensive and expedient financing vehicle until a series of court decisions eliminated almost all of the legal or financial advantages it had over a conventional promissory note secured by a deed of trust. See *Petersen v Hartell* (1985) 40 C3d 102, 219 CR 170. Therefore, §§1.60-1.66 give only a brief summary of installment land contracts. For further discussion, see California Real Property Remedies and Damages, chap 4 (2d ed Cal CEB 2002); California Real Property Sales Transactions §§9.14-9.17 (4th ed Cal CEB 2007).

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§1.60 1. Documentation

In an installment land contract transaction, a single document is used instead of the separate note and security instrument used in conventional financing arrangements. The contract, which both parties execute, provides that the vendor will convey title to the vendee only when the price is paid in full, and the vendee agrees to pay the price to the vendor in installments over time. The vendor retains title until the vendee pays the price in full. The vendor needs no other security interest in the property, and thus no deed of trust or mortgage is used. Because the contract embodies the vendee's promise to pay the purchase price, there is also no need for the vendee to execute a promissory note to the vendor. Instead of interest, the vendor pays a time-price differential. See *Ghirardo v Antonioli* (1994) 8 C4th 791, 35 CR2d 418; *Boerner v Colwell Co.* (1978) 21 C3d 37, 145 CR 380. Thus the installment land contract in form, if not in purpose, operates like a conditional sales contract extended over a prolonged period (greater than 1 year). CC §2985.

TAX CONSIDERATION: Gain and loss are treated identically, regardless of whether the financing is conventional or by installment land contract. IRC §453.

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§1.61 2. Vendor's Remedies

Early cases gave the California installment land contract vendor a package of remedies on the vendee's breach that was in many ways superior to the remedies available to a lender under a mortgage or deed of trust. See, *e.g., Longmaid v Coulter* (1898) 123 C 208, 55 P 791; *Glock v Howard & Wilson Colony Co.* (1898) 123 C 1, 55 P 713. Relief included benefit-of-the-bargain damages, forfeiture of the vendee's past payments, specific performance, rescission, quiet title, and liquidated damages.

Starting in 1949, the courts began significantly eroding the vendor's formerly favored position. Code of Civil Procedure §580b was read to include land contracts within its bar against deficiency judgments (because of the reference to contracts in the text) (see §5.45), thus prohibiting a vendor from recovering unpaid back installments owed by the vendee. *Venable v Harmon* (1965) 233 CA2d 297, 43 CR 490. This logic also bars an action to recover future installments (*i.e.,* to recover the price), although such actions had previously been authorized in *Longmaid v Coulter, supra*. Compare this §580b bar against deficiency judgments with the mortgagee's right to monetary relief under CCP §726 (see §4.32).

An installment land contract may contain a power of sale provision, making it entirely similar to a conventional deed of trust for collection purposes. These provisions were legislatively ratified by CC §2920(b) and now are subject to the same statutory regulation of trustee sales (see CC §§2924-2924h) that apply to deed of trust sales.

A vendor may not bring an unlawful detainer action against a defaulting purchaser who refuses to leave, because the unlawful detainer statute does not cover this situation. CCP §1161. The vendor must instead bring an action for ejectment, which is considerably slower. *Francis v West Va. Oil Co.* (1917) 174 C 168, 162 P 394.

On vendor's remedies for vendee's breach, see California Real Property Remedies and Damages, chap 4 (2d ed Cal CEB 2002).

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§1.62 a. Reinstatement

In *Barkis v Scott* (1949) 34 C2d 116, 208 P2d 367, the supreme court permitted defaulting vendees to resist the vendor's attempt to quiet title and allowed them to reinstate their breached contract even though it had provided that time was of the essence. The *Barkis* court limited its decision to nonwillfully defaulting vendees, but this limitation was dropped in *MacFadden v Walker* (1971) 5 C3d 809, 97 CR 537, in which the court allowed a willfully defaulting vendee to reinstate her installment land contract, holding that reinstatement as a remedy was discretionary with the trial court. That discretion was eliminated in *Petersen v Hartell* (1985) 40 C3d 102, 219 CR 170, in which the court held that a willfully defaulting vendee has an absolute right to redeem the property if the vendee paid a substantial portion of the purchase price before the default. The relief was limited to redemption (payment of the entire price) rather than reinstatement (payment of missed installments), but it is unlikely that this distinction has any better chance of survival when the proper case arises than did the previous distinctions. Compare the vendee's reinstatement right with the statutory right to reinstate mortgages and deeds of trust under CC §2924c (see §§2.51-2.52).

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§1.63 b. Restitution

A defaulting vendee is not limited to being able to reinstate the contract; it may also seek to recover, as restitution, any amounts paid to the vendor in excess of the vendor's actual damages. *Freedman v Rector, Wardens & Vestrymen of St. Matthias Parish* (1951) 37 C2d 16, 230 P2d 629. These damages are held to be nonexistent if the vendor subsequently resells the property for a higher price. Conversely, a resale at a loss does not fix the vendor's damages at that amount, because the statutory measure is the difference between the contract price and the market value on the date of the breach, not the difference between the contract price and the resale price on the date of resale. *Royer v Carter* (1951) 37 C2d 544, 233 P2d 539. The consequential damages and interest to the seller's benefit-of-the-bargain damages provision in CC §3307 reduce the amount of restitution the vendor may have to pay.

The vendor may choose to rescind and recover rental-value rather than difference-value damages. See *Honey v Henry's Franchise Leasing Corp.* (1966) 64 C2d 801, 52 CR 18; *Kudokas v Balkus* (1972) 26 CA3d 744, 103 CR 318. But this option applies only in the context of calculating the restitution to be paid to the vendee.

By contrast, a mortgagee or beneficiary need not return any funds to the debtor unless there is a surplus after a foreclosure sale. *Smith v Allen* (1968) 68 C2d 93, 65 CR 153. For an unpublished decision acknowledging the general availability of restitution and redemption despite willful breach of an installment land contract but denying the vendee both reinstatement and restitution after the vendor privately sold the property (not at trustee sale), see *Hartley v Graham* (Aug. 22, 2003, B157725; not certified for publication) 2003 Cal App Unpub Lexis 8011, 2003 WL 21995460. Interestingly and somewhat surprisingly, the *Hartley* court justified this denial of restitution and redemption by holding that "symmetry and logic" dictated that the vendor's nonforeclosure sale be treated as if it had been a trustee sale under power of sale, given the vendee's invocation of antideficiency protection under CCP §580b.

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§1.64 c. Protecting Title

The judicial and statutory protections for installment vendees primarily benefit them when they default. For nondefaulting vendees, the risk remains that the vendor (who still has title) may fail to perform. The vendor may jeopardize the purchaser's expectant title by failing to protect it against liens or by failing to keep it or even to acquire it. See, *e.g., Luette v Bank of Italy Nat'l Trust & Sav. Ass'n* (9th Cir 1930) 42 F2d 9. Absent an anticipatory repudiation, the vendee may be unable to seek any relief until the final payment is due if the installment land contract was drafted so that the vendor has no obligation to obtain or deliver good title until the price is fully paid. *Lloyd v Locke-Paddon Land Co.* (1935) 5 CA2d 211, 42 P2d 367. But see *Prentice v Erskine* (1913) 164 C 446, 129 P 585 (court permitted vendee to rescind when vendor failed to provide perfect title). Conversely, a trustor or mortgagor holds the title to the property and therefore has no comparable fears concerning the vendor's performance (see §§1.34-1.35). Installment vendees have some limited protection under CC §§2985-2985.6, which impose certain obligations on vendors under installment land contracts but have little effect on third party claims to the title.

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§1.65 d. Damages

The vendee's statutory measure of damages against a defaulting vendor is the difference between the price and the value of the property at the time of the breach, together with certain out-of-pocket expenses, consequential damages, and interest. CC §3306. See generally California Real Property Remedies and Damages, chap 4 (2d ed Cal CEB 2002). The vendee also has a "purchaser's lien" or "vendee's lien" on the property for sums paid to the vendor. CC §3050.

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§1.66 3. Liquidated Damages

There is heavy statutory regulation of liquidated damages in real estate transactions; see CC §§1675-1680. Installment land contracts, however, are specifically carved out of these provisions. CC §1681. Liquidated damage provisions in installment contracts are apparently subject to the more relaxed general standard of presumptive validity of CC §1671 (rather than the former standard of presumptive invalidity, which is now confined to residential leases and retail installment contracts). See §§8.25-8.28. See also California Real Property Sales Transactions §4.142 (4th ed Cal CEB 2007); California Real Property Remedies and Damages, chap 4 (2d ed Cal CEB 2002).

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Trustee Sales

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/ I. CHOOSING THE REMEDY/§2.1 A. Role of Trustee Sale Compared With Other Remedies

I. CHOOSING THE REMEDY

§2.1 A. Role of Trustee Sale Compared With Other Remedies

Having real property security for a loan becomes meaningful to the creditor if the loan goes into default. An unsecured creditor must go to court to obtain first a money judgment and then a writ of execution on the judgment in the hopes of converting the judgment into money. Not only is this pursuit of a judgment and writ of execution a relatively ambitious judicial process, but also, even after the default and commencement of the litigation—and until either a recordable judgment or a writ of attachment is obtained—the ordinary unsecured money creditor has no assurance that the debtor will have nonexempt assets (or sufficient equity in those assets) to make collection on the judgment a realistic prospect.

A validly secured creditor, in contrast, is priority-protected even before default, at least with regard to those assets it evaluated before the creation of the debt relationship. A secured creditor with a power of sale clause in its deed of trust or mortgage may, instead, simply use the security to effect payment without the need for judicial intervention. Possessing this type of security not only entitles the creditor to pursue the debtor's asset (*i.e.,* the one given as security) without a preceding judgment and writ but also assures the creditor that the asset remains available for disposition in order to recover on the debt.

The process by which the lender uses the debtor's property to satisfy its debt is known as "foreclosure" or "foreclosure and sale." On completion, the debtor's rights in the property are terminated (foreclosed), the property is sold to the highest bidder at an auction, the buyer owns the property free and clear of the claims of the former debtor and creditor, the creditor receives as much of the sales proceeds as are needed to satisfy the debt, and any surplus proceeds pass to other foreclosed interests in their order of priority.

In California, foreclosure sales often occur as private, *i.e.,* nonjudicial, sales, not preceded by any judicial action. Such "trustee sales" (or "private sales" or "extrajudicial sales") are conducted under authorizing language in the security instrument (a "power of sale" clause; see §§2.14-2.17) and are regulated by CC §§2924-2924*l*. The power of private sale (also called "trustee sale") is a primary advantage of taking a trust deed or mortgage with power of sale to secure an obligation. For this reason, trustee sales are addressed extensively in this book.

The trustee sale is not the only method by which the creditor can enforce an obligation secured by a mortgage or deed of trust. The secured creditor may also pursue judicial foreclosure (see §2.2; chap 3) or use a passive collection strategy (see §2.3).

NOTE: Trustee sale, judicial foreclosure, and passive collection strategy are the three basic enforcement methods available under California law. However, the debtor's filing of a bankruptcy proceeding may open up other possibilities for a sale of security free and clear of liens under 11 USC §§363 and 1104. This scenario can involve fewer protections for the debtor than state law procedures and should be considered carefully before a debtor files a bankruptcy. See *Clear Channel Outdoor, Inc. v Knupfer (In re PW, LLC)* (BAP 9th Cir 2008) 391 BR 25 (secured creditor failed to show compliance with 11 USC §363(f) for free and clear sale); *Coppola v Superior Court* (1989) 211 CA3d 848, 873, 259 CR 811 (sale of debtor's real property "free and clear of liens" under Bankruptcy Code could not be equated with either nonjudicial or judicial foreclosure sale under California law). This issue is discussed in greater detail in §§2.109, 11.72-11.76.

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§2.2 1. Judicial Foreclosure

Judicial foreclosure is the second well-recognized method of enforcement, and its benefits and disadvantages are typically contrasted with those of a trustee sale. Unlike a trustee sale, judicial foreclosure (see chap 3) requires the filing of a civil action and therefore is usually less expedient than a trustee sale. However, the judicial foreclosure process has some important advantages for the creditor. The most prominent advantage is that it permits the creditor, in certain circumstances, to preserve a claim for a deficiency judgment, *i.e.,* a money judgment against the borrower for the portion of the obligation not satisfied from the sale of the security at foreclosure. By legislative design in California, both trustee sales and judicial foreclosures have a rough parity of contrasting procedures, outcomes, and benefits to the debtor and secured creditor. On distinct advantages and disadvantages of trustee sale compared with judicial foreclosure, see §§2.10, 3.4-3.11.

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§2.3 2. Passive Collection Strategy

A third creditor strategy—less widely discussed in the case law but no less important in any practical discussion of the power inherent in taking real property security—is what might be called the "passive" or "blocking right" collection strategy. This strategy is based on the fact that a validly created and recorded mortgage or deed of trust encumbers and "clouds" the owner's title as a matter of public record. An owner of the encumbered property who wishes to convey or further encumber title free and clear of the existing encumbrance must take the initiative to clear title by paying off existing secured obligations and obtaining the recordation of a deed of reconveyance, eliminating the existing deed of trust as an encumbrance of record. More secured creditors are paid off because of the owner's desire to clear title than as the result of judicial and nonjudicial foreclosures. A payoff to clear title typically involves no dispute and often no default; therefore, there is relatively little controversy about or published case law on this important method of collection. Controversies can nevertheless arise when the creditor and debtor disagree about the valid payoff amount (redemption price; see §§3.93-3.95) or when the creditor has included a provision in the loan documents (often called a "prepayment," "lock in," or "yield maintenance" provision; see §§8.36-8.53) that limits the debtor's right to pay off the obligation. Passive collection strategies can be crucial to creditors whose ability to foreclose is impaired by a bankruptcy or the lack of a power of sale clause.

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B. Attorney's Role

§2.4 1. Representing Beneficiary-Lender

An attorney's first involvement in a secured loan situation often occurs when the holder of the note reports that the loan is delinquent and seeks advice on how to proceed. After exhausting the common informal collection methods (*e.g.,* telephone calls, letters), the attorney must explain a foreclosure sale and its attendant consequences to the client and, perhaps, assist the client in carrying out the sale.

If the client chooses to proceed with a trustee sale, the attorney will usually advise the client to select an institutional trustee (*e.g.,* an experienced foreclosure company) to handle the sale. This will probably require a formal substitution of the trustee named in the deed of trust. See §§2.21-2.26, 2.33. The attorney may then assist by doing the following:

- Explaining the foreclosure proceedings to the client;
- Monitoring those proceedings on the client's behalf;
- Providing counsel in making strategic decisions;
- Advising on areas of potential liability (see chap 12);
- Stating the potential for a borrower bankruptcy (see chaps 7, 11);
- Helping the client furnish the necessary information and documents to the trustee; and
- Standing ready to resist an attempt to stop or set aside the foreclosure (see chap 7).

The client may wish to engage a foreclosure expert to ensure that (1) the sale procedures are carried out correctly so that the sale is not vulnerable to attack and (2) title conveyed to the purchaser is marketable. See, *e.g., Heritage Oaks Partners v First Am. Title Ins. Co.* (2007) 155 CA4th 339, 66 CR3d 510, cited in §§2.26, 2.98.

NOTE: Until January 1, 2013, on secured loans for owner-occupied residential property made between January 1, 2003, and December 31, 2007, special meet-and-confer requirements apply. The beneficiary or trustee must first contact the homeowner to assess his or her financial situation and explore options to avoid foreclosure. Then the beneficiary or trustee must wait 30 days after the contact before commencing foreclosure. See CC §2923.5, effective September 8, 2008, discussed in §2.49. See also §§2.37-2.38, 2.63, 2.65, 2.68.

Counsel may wish to remind the creditor of its obligations to notify certain junior secured creditors of delinquencies (see §2.6). The failure to give the notice after a valid request exposes the senior creditor to liability for any monetary damage sustained by the requesting junior from the date the notice should have been given to the earlier of (1) the date the notice is actually given or (2) the recordation date of the notice of default under CC §2924 (see §§2.41, 2.50). CC §2924e(d). If the trustee sale is initiated within the first 4 months after the default, the creditor should forward the names of the requesting juniors to the foreclosing trustee. As a rule, the creditor should also purchase a foreclosure or trustee sale guaranty with an adequate liability amount from a title insurance company (see §2.34).

The creditor's attorney should give close attention to trustee substitution documents (see §§2.21-2.26) and the client's bidding strategy at the auction (see §§2.80-2.87). Other than bidding advice, attorneys are seldom involved in the details of conducting the trustee sale, because it is usually more efficient to let the trustee handle them. Accordingly, this chapter does not specifically instruct the attorney on how to conduct a trustee sale procedurally. The chapter is intended to impart sufficient information to enable the attorney to work with or critically evaluate the work of the trustee and inform the client about the general procedures of a foreclosure sale. Beginning with §2.33, this chapter summarizes, step by step, the trustee sale procedures.

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2. Representing Junior Secured Creditors

§2.5 a. Reinstatement Rights

An attorney may be asked to advise the holder of a junior priority security interest facing foreclosure by a senior secured creditor. Depending on the economics and the nature of the junior interest (*e.g.,* whether the junior loan is recourse or purchase money), counsel may be called on to render advice about (1) how to obtain notice of a foreclosure sale (see §2.6), (2) efforts to stop or set aside the senior foreclosure (see §7.35), (3) bidding at the senior's foreclosure sale (see §§2.76-2.87), or (4) the junior lender's rights of redemption and reinstatement (see §§2.51-2.61, 2.72-2.73, 2.102-2.104, 6.63). If the junior loan is recourse and not purchase money, the best, if counterintuitive, advice may sometimes be to allow the senior sale to proceed and then to pursue recovery on the "sold-out" junior debt by the remedies available to unsecured creditors (see chaps 4-5).

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§2.6 b. Right to Notice of Default or Delinquency

Junior lienholders may record requests that they be served with notices of default on any senior deed of trust or mortgage (see §§2.41, 2.131). CC §2924b(a). Even without recordation of such request for notice, secured creditors holding a recorded interest that is subordinate by virtue of order of recordation or subordination are entitled to be mailed a copy of the notice of default within 1 month of its recordation. CC §2924b(c)(1), (c)(2)(B). The junior need not mail the request for notice to the beneficiary as long as the notice is recorded. Absent recordation, there is no duty to give notice to such parties. *First Sec. Bank, N.A. v Chase Manhattan Mortgage Corp.* (June 4, 2004, E033880; not certified for publication) 2004 WL 1234104. Recordation of the request is *not* considered to be notice to the beneficiary that the requester has or claims any interest in the property. CC §2924b(g). The beneficiary or trustee (*i.e.,* the person who records notice of default) must mail a copy to each requester. CC §2924b(b). If the requester wishes to notify the beneficiary of such a claim, those facts should be stated in a separate certified or registered letter.

To be protected against optional future advances made by the senior lienholder, a junior lienholder must give independent notice of its interest to the senior (see §§9.64, 9.69). If the trustor files a bankruptcy petition (see §11.1), a junior lienholder must file with the court a request for special notice so that it will receive notices of stay relief motions filed by senior lienholders and other bankruptcy proceedings that may affect the junior's rights (see §11.63).

WARNING: One who acquires an interest in property against which a notice of default *has already been recorded* must contact the trustee or beneficiary directly to obtain information on the future course of that foreclosure. Mere recordation of a deed of trust or mortgage or recordation of a request for notice of default will not accomplish that purpose.

Independently of the notice of default, a junior may obtain a notice of delinquency in certain situations. A beneficiary of a senior lien that either (1) encumbers one to four residential units or (2) was given to secure an original obligation not exceeding $300,000, must, on receipt of written request from a junior lienholder accompanied by the trustor's written consent and the payment of $40, notify the lienholder of delinquencies of 4 months or more on the senior obligation. The request for notice expires after 5 years, but it may be renewed on payment of a $15 fee within 6 months before the request expires. CC §2924e(b). The rights and obligations of the various parties under §2924e inure to the benefit of their successors and assigns. CC §2924e(b). On liability for failure to give notice, see §2.4. The junior is also required to notify the senior when the junior obligation has been satisfied (CC §2924e(g)), but no penalty is specified for noncompliance.

PRACTICE TIP: When a title search discloses the existence of a deed of trust on property in which the client has or may take an interest, the attorney should advise the client to (1) record a request for notice of default and (2) mail a request for notice of delinquency to the lender, if applicable. Doing so will ensure that the client is notified of any default and accelerate receipt, by 20 days, of the notice otherwise required under CC §2924b.

On a common interest development association's right to request copy of trustee's deed following sale, see §2.41.

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3. Representing Trustor-Borrower

§2.7 a. Trustee Sale Process; Remedies

An attorney may be contacted by a trustor who has committed or been accused of a default. The attorney should advise the debtor on conduct of the sale and possible avenues for protecting the debtor's interests. The foreclosure process is not inexorable and affords many opportunities for attorneys to protect vital interests of their debtor clients (see chaps 4-10).

Debtor strategies may range from early and cordial workout discussions, emphasizing the benefits of a negotiated solution to the lender, to vigorous litigation strategies. See §§2.9A-2.9B. These strategies may focus on the loan relationship, challenges to the claim that the loan is in default, the foreclosure process, or legal limitations on debtor liability. Details aside, however, all realistic debtor strategies do the following:

- Acknowledge that the lender has rights secured by the property;
- Review in detail the default and other disputes (see chaps 6, 8);
- Explore loan workout opportunities (see chap 10);
- Examine areas of potential lender liability (see chaps 7, 12);
- Hold the creditor to the narrow remedial choices available to secured lenders (see chaps 2-6, 9); and
- Find long-term solutions to the problems that caused the default.

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§2.8 b. Home Equity (Distress) Sales

A residential property owner is particularly vulnerable when a loan secured by the residence is in default. The Home Equity Sales Contract Act (HESCA) (CC §§1695-1695.17) regulates "home equity sales contracts," *i.e.,* sales of one-to-four-unit owner-occupied residences against which there is an outstanding notice of default. CC §1695.1(b). Under CC §1695.13, it is unlawful for anyone to take "unconscionable advantage" of an owner whose residential property is in foreclosure. The law applies only if the owner of the foreclosed property resides in it at the time the violation of §1695.13 occurs. *In re Phelps* (2001) 93 CA4th 451, 113 CR2d 217. The exception from HESCA's requirements in CC §1695.1(a)(4) for a transfer of property at a sale authorized by statute should be narrowly construed and does not apply to the sale by a Chapter 13 bankruptcy debtor, even if approved by the bankruptcy trustee and allowed by the bankruptcy court. *Spencer v Marshall* (2008) 168 CA4th 783, 85 CR3d 752. The provisions of HESCA apply to all persons, regardless of whether they have a real estate license. *Spencer v Marshall, supra*.

A 4-year statute of limitations applies to criminal prosecution of violations of the Act. *People v Shetty* (2009) 174 CA4th 1488, 95 CR3d 355. A general release with a CC §1542 waiver in an unlawful detainer case brought by a buyer against the former owner is ineffective to prevent rescission of a contract of sale that fails to comply with the Act. *Hoffman v Lloyd (In re Lloyd)* (Bankr ND Cal 2007) 369 BR 549, aff'd (9th Cir 2009) 572 F3d 999.

For further discussion, see California Real Property Remedies and Damages, chap 4 (2d ed Cal CEB 2002).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.9 c. Mortgage Foreclosure Consultants

§2.9 c. Mortgage Foreclosure Consultants

The borrower's attorney should be aware of CC §§2945-2945.11, regulating mortgage foreclosure consultants. In CC §2945(a), the legislature declared that "homeowners whose residences are in foreclosure are subject to fraud, deception, harassment, and unfair dealing by foreclosure consultants," who are defined in CC §2945.1(a) as persons who represent that they, for compensation, will perform services that in any manner will do any of the following:

- Stop or postpone the foreclosure sale;
- Obtain a forbearance from a beneficiary or mortgagee;
- Assist the owner in exercising CC §2924c reinstatement rights;
- Obtain an extension of the loan reinstatement period;
- Obtain a waiver of an acceleration clause contained in loan documents on a loan secured by a deed of trust or mortgage on a residence in foreclosure;
- Assist the owner to obtain a loan or advance of funds;
- Avoid or ameliorate the impairment of the owner's credit resulting from the recordation of a notice of default or the conduct of a foreclosure sale;
- Save the owner's residence from foreclosure; or
- Assist the owner in obtaining the surplus funds (remaining proceeds) from the foreclosure sale of the owner's residence.

NOTE: Civil Code §2945.45 imposes registration requirements on foreclosure consultants. Any person not excluded from the definition of a foreclosure consultant in CC §2945.1(b) may not perform any of the described services without registering with the Department of Justice (CC §2945.45(a)(1)) and maintaining a $100,000 surety bond (CC §2945.45(a)(2)). Violation of the registration requirements may be punished by a fine of between $1000 and $25,000, imprisonment, or both. CC §2945.45(d).

Among other duties, foreclosure consultants must provide the owner with a written contract for services to be rendered by the consultant and specific notices, including a notice of cancellation rights and a notice that the owner is entitled under the law to be paid automatically the balance of surplus funds (*i.e.,* excess proceeds) after a foreclosure without the assistance of a foreclosure consultant. CC §§2945.2-2945.3.

The contract must be written in the language principally used by the consultant to describe his or her services or to negotiate the contract. CC §2945.3(c). In addition, under CC §2945.3(c), the foreclosure consultant must, before the owner signs the contract, provide the owner with a copy of the completed contract in any other language used in any communication between the foreclosure consultant and the owner, as well as in any language designated in CC §1632(b) and requested by the owner. Furthermore, even if the foreclosure consultant describes his or her services or negotiates the contract principally in English, the consultant must inform the owner both orally and in writing, before the owner signs the contract, that the owner has the right to request a copy of the completed contract in a language designated in CC §1632(b).

The foreclosure consultant is responsible for damages resulting from violations of the contract and notice requirements and from the illegal acts or misrepresentations made by a representative. CC §§2945.4-2945.7, 2945.9. See, *e.g., Onofrio v Rice* (1997) 55 CA4th 413, 64 CR2d 74 (owner awarded rescission, treble damages, and attorney fees). For a criminal law case interpreting CC §§2945-2945.11, see *In re Phelps* (2001) 93 CA4th 451, 113 CR2d 217. These statutes apply only if the complaining owner of the foreclosed property resides in it at the time the foreclosure consultant does an act that would violate the law. 93 CA4th at 453 n3.

PRACTICE TIP: Although serious abuses by purported foreclosure consultants and home equity purchasers undoubtedly occur, it is important not to read CC §§1695-1695.17 and 2945-2945.11 so broadly as to thwart the efforts of those who seek to develop business models that will provide alternatives to homeowners facing loss of their homes through foreclosure. Although foreclosure auctions are open and competitive events in concept and

theory, many practitioners find that foreclosure auctions do not result in vigorous bidding or in final bids that approach the value of the foreclosure property by an ordinary fair market value definition. This can cause serious forfeiture of equity on the part of the foreclosed owner and uncompensated losses on the part of the holders of junior liens and other interests that are "wiped out" in a senior foreclosure sale. This leaves the possibility of creative business solutions to the problem of anemic foreclosure bidding. This may involve new techniques for exposing the property to broad markets, such as through "e-auction" formats (a trend already well underway for the resale of foreclosed property) or through various sale, option, and leaseback arrangements that may give the owner a better alternative than a sale of the home on the auction block without the benefit of ordinary market mechanisms like contingencies, inspection rights, and time.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.9A d. Enjoining or Attacking Trustee Sale

§2.9A d. Enjoining or Attacking Trustee Sale

There is no automatic judicial review or supervision of a trustee sale. Judicial review primarily occurs if the trustor or another interested party brings an action in state court to either enjoin the sale or set aside a completed sale. See *Smith v Allen* (1968) 68 C2d 93, 65 CR 153; *Meadows v Bakersfield Sav. & Loan Ass'n* (1967) 250 CA2d 749, 59 CR 34; *Py v Pleitner* (1945) 70 CA2d 576, 161 P2d 393. When the trustor remains on the premises after the sale, the trustor may also get judicial review in the foreclosure purchaser's action to recover possession. See CCP §1161a; *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826. See also *MCA, Inc. v Universal Diversified Enters. Corp.* (1972) 27 CA3d 170, 103 CR 522. For further discussion, see §§7.22-7.77.

WARNING: Before launching an effort to enjoin or set aside a trustee sale, borrower's counsel should review the loan documents to determine if they contain a prevailing party attorney fee clause. If so, counsel must caution the client that an unsuccessful challenge to the sale could leave the client exposed to a large attorney fee award, which will not be limited by CC §2924c(c)-(d) or §2924d(b) and for which the antideficiency laws might not provide protection. See *Passanisi v Merit-McBride Realtors, Inc.* (1987) 190 CA3d 1496, 236 CR 59. On attorney fees in lending liability cases filed under federal law, see §12.102.

One of the most effective ways for a debtor to halt a foreclosure, at least temporarily, is to file a bankruptcy petition in federal court because it automatically stays most collection activities by the debtor's creditors, including secured creditors who are in the process of foreclosing. For further discussion, see §§7.85-7.125.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.9B e. Lender Liability; Loan Rescission

§2.9B e. Lender Liability; Loan Rescission

Aggrieved borrowers sometimes sue their lenders for violating lending law or for lender behavior they believe was harmful to their interests, even when that behavior was permitted by the loan documents. Remedies for predatory lending can be based on either the common law or statutory and regulatory protections and include damages, rescission of the loan, and in some situations statutory attorney fees. See chap 12. See also §§7.78-7.84.

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C. Trustee Sale and Judicial Foreclosure

§2.10 1. Advantages and Disadvantages to Creditor of Trustee Sale

Under the right circumstances, a creditor will prefer a trustee sale to judicial foreclosure (see chap 3) for many of the following reasons:

- Avoids court proceedings;
- Discourages borrower from consulting an attorney;
- Allows faster pace and is less expensive;
- Avoids borrower's postsale redemption rights;
- Results in potentially higher foreclosure sale price;
- Provides better (*i.e.,* more marketable) title sooner;
- Allows optional piecemeal sales for multiple security; and
- Provides for longer statute of limitations period.

A trustee sale bypasses the courts altogether, which means that the matter can usually be handled with significantly less time and expense than judicial foreclosure (see §3.9). Trustee fees are often less than attorney fees, and the entire process can often be completed within about 4 months after the notice of default is issued. Although the Internal Revenue Service has certain statutory postsale redemption rights (see §2.31), a trustee sale is not subject to borrowers' postsale redemption rights under CCP §§729.010-729.090 (see §§3.90-3.101), except in the case of a nonjudicial foreclosure by the association of a common interest development to collect on a debt for delinquent assessments (CC §1367.4(c)(4)). A real property asset auctioned off at a trustee sale therefore will typically command a higher price from third parties than a parcel sold at judicial foreclosure and thus subject to postsale redemption rights. This gives the creditor a better chance of recovering all that it is owed.

A further advantage, if multiple security is used for a single note, is that (if the deed of trust so provides; see §2.75) extrajudicial foreclosures may be conducted in separate, piecemeal fashion, with the order of sales at the creditor's discretion (see *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29; *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 257, 120 P2d 869; see also §§9.4-9.10). Judicial foreclosure, by contrast, requires consolidating all components of the security into a single action (see CCP §726 on one-action rule). (On order of sale after judgment when multiple parcels are involved, see §§3.14, 3.77; on multiple creditor foreclosure, see chap 9.) Finally, for a deed of trust, nonjudicial foreclosure under a power of sale provision is not subject to the 4-year statute of limitations regulating actions on notes (see CCP §337; CC §2911). *Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090. See *Faxon v All Persons* (1913) 166 C 707, 137 P 919. It is instead subject to the much longer periods afforded under the Marketable Record Title Act (CC §§880.020-887.090). *Slintak v Buckeye Retirement Co.* (2006) 139 CA4th 575, 43 CR3d 131; *Nicolopulos v Superior Court* (2003) 106 CA4th 304, 130 CR2d 626. See §§1.35, 3.20, 7.34.

The major disadvantage of nonjudicial foreclosure is that the creditor is precluded by statute from seeking a deficiency judgment after the sale. CCP §580d (see §§3.1, 3.4, 3.86-3.89, 5.3, 5.8). When fully recourse and non-purchase money security is involved (see §§5.24-5.25), the bar to a deficiency judgment may be a significant disincentive to the creditor's electing to complete a trustee sale. But if the debtor is likely to declare bankruptcy and have the debt discharged in any event, this disincentive loses much of its sting.

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§2.11 2. Reasons to Use Judicial Foreclosure

Sometimes a creditor has no practical choice other than to complete a judicial foreclosure even though a trustee sale would be preferable. This is unavoidable when the security instrument lacks a power of sale (a typical problem when a hidden security device has been used) (see §§2.14-2.17, 4.33). In addition, if the obligation is unliquidated or if other issues remain unsettled between the creditor and the debtor (such as whether or not a default has truly occurred) or among various creditors of the same debtor, judicial resolution of these matters may be necessary (see §§3.6-3.7). In that event, having the sale conducted under judicial supervision at the same time that the collateral disputes are resolved may be the best course. See *Scott v Security Title Ins. & Guar. Co.* (1937) 9 C2d 606, 72 P2d 143; *Hamilton v Carpenter* (1942) 52 CA2d 447, 126 P2d 395.

It would be theoretically possible in these situations to seek resolution of the issue through declaratory relief and to complete a nonjudicial foreclosure after that resolution became final. But this would involve significant delay, and it would run a small but not insignificant risk of triggering "one-action" problems under CCP §726. It is possible under CCP §§726(b) and 729.010 for the creditor to waive any claim for a deficiency at the time the decree of judicial foreclosure is entered and thus avoid leaving the debtor with postsale redemption rights. This means in practice that the creditor can pursue a form of "judicial foreclosure lite," which will result in the same array of basic outcomes (no deficiency, no postsale redemption) as does a trustee sale.

For additional discussion about deciding between trustee sale and judicial foreclosure, see §§3.4-3.11.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.12 D. Receivership Pending Foreclosure

§2.12 D. Receivership Pending Foreclosure

Whether the creditor decides to foreclose judicially or by a trustee sale, counsel should examine and discuss with the beneficiary the possibility of having a receiver appointed if the property is producing income (*i.e.,* the debtor is renting or leasing the property to a tenant). See chap 6. On receiver's holding rents and profits, see §§2.61, 2.82, 2.107. On economics of having receiver appointed, see §6.36.

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§2.13 E. Election of Remedies

By commencing trustee sale proceedings, a creditor is not bound to complete them and may later drop the process at any time for any reason including a decision to switch to a judicial foreclosure strategy. *Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090; *Commercial Centre Realty Co. v Superior Court* (1936) 7 C2d 121, 59 P2d 978. The decision is strictly within the discretion of the creditor, who is not considered to have made an irrevocable election of remedy until the trustee sale is conducted. *Carpenter v Title Ins. & Trust Co.* (1945) 71 CA2d 593, 163 P2d 73.

Similarly, a creditor may elect to initiate but then abandon a judicial foreclosure action in favor of a trustee sale (without violating the one-action rule under CCP §726) as long as no judgment (or, arguably, no interim coercive relief) was obtained in the action. *McDonald v Smoke Creek Live Stock Co.* (1930) 209 C 231, 286 P 693. See *Vlahovich v Cruz* (1989) 213 CA3d 317, 261 CR 565. Two bankruptcy cases have held that the entry of a default does not constitute an election of remedies as long as no judgment is taken on the default. See *Madigan v Potrans Int'l, Inc. (In re Madigan)* (BAP 9th Cir 1991) 122 BR 103 (action on debt); *Tidrick v General Bank (In re Tidrick)* (Bankr CD Cal 1989) 105 BR 584 (action for foreclosure on deed of trust). *Madigan* and *Tidrick* were distinguished on other grounds in *Shin v Superior Court* (1994) 26 CA4th 542, 31 CR2d 587. The Third Appellate District, in a similar vein, held that a secured creditor did not incur a sanction under CCP §726 when it filed an improper cause of action on the debt but later dismissed that claim and replaced it with a judicial foreclosure count before entry of judgment. *Kirkpatrick v Westamerica Bank* (1998) 65 CA4th 982, 76 CR2d 876 (see §§3.6, 3.11, 4.15-4.16, 4.18, 4.26).

Creditors often initiate both judicial and nonjudicial procedures simultaneously, a process sometimes called "dual tracking." By filing an action that includes a cause of action and a prayer for the appointment of a receiver (see §§6.37, 6.99) and contemporaneously pursuing a trustee sale, the lender may be able to preserve its opportunity to receive both the rents and a salable title. See *Turner v Superior Court* (1977) 72 CA3d 804, 140 CR 475. Another more basic reason for dual tracking is to preserve the option of obtaining a deficiency judgment in the judicial action (see §§3.1, 3.4) until the debtor's financial condition is better understood or the lender's objectives are more clearly formulated. See §§3.4-3.7.

TACTICS: Although courts have repeatedly approved "dual tracking" (*i.e.,* pursuing trustee sale and judicial foreclosure simultaneously), they have not yet decided whether the secured lender may recover the full amount of fees and costs incurred in the overlapping foreclosure processes. Debtor's counsel could consider challenging such arguably duplicative fees, especially if no convincing justification is made for dual tracking other than the creditor's desire to keep its options open. This challenge could be based on the duty to mitigate damages, the duty of good faith and fair dealing, and the absence of express statutory authority for recovery of such duplicative fees and costs. See §2.59 and the Practice Tip at the end of that section on debtor's use of CC §2924c(d) to avoid paying dual fees.

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F. Power of Sale Clause

§2.14 1. Prerequisite to Sale

No security instrument can be foreclosed extrajudicially unless it expressly authorizes such a procedure in a power of sale clause. *Huene v Cribb* (1908) 9 CA 141, 98 P 78. A mortgage or deed of trust without such a clause is still a valid security instrument despite that omission, but it must be foreclosed judicially. *Fogarty v Sawyer* (1861) 17 C 589; *Huene v Cribb, supra*. Similarly, arrangements that constitute hidden security devices do not usually have a power of sale clause, often because such a clause would reveal the secured transaction nature of the document, and must therefore be foreclosed judicially (see §3.44). A power of sale clause creates an independent contractual right, given to the creditor by the debtor, to dispose of the security on default without resort to the judicial system. *McDonald v Smoke Creek Live Stock Co.* (1930) 209 C 231, 286 P 693; *Fogarty v Sawyer, supra*.

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§2.15 2. Language of Power of Sale Clause

No particular form or language is required for a power of sale clause. Most conventional (title company) and commercial deed of trust forms merely state in the granting clause (usually the first or second paragraph) that the trustor grants the property to the trustee "with power of sale" (see sample deed of trust clause in California Real Estate Finance Practice: Strategies and Forms §4.64 (Cal CEB 2000)). Courts liberally interpret such language to sufficiently constitute a power of sale clause. *Fogarty v Sawyer* (1861) 17 C 589, 591. The detailed provisions of these deed of trust forms on the mechanics of sale do little more than encapsulate many of the provisions already in CC §§2924-2924*l*. Many of these statutory provisions automatically become a part of the contractual power of sale (*Curti v Pacific Mortgage Guar. Co.* (9th Cir 1936) 87 F2d 42) and probably cannot be altered, at least to the debtor's detriment, by contrary language in the security instrument. CC §2953. See §7.62. The deed of trust may contain notice provisions more favorable to the debtor, and the creditor is bound by such provisions. *Fogarty,* 17 C at 592. More liberal notice provisions may be required, *e.g.,* if the instruments are to be sold on the secondary mortgage market. See Real Estate Finance §4.65.

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§2.16 3. Instruments That Include Power of Sale Clause

Any real property security instrument may include a power of sale clause. Civil Code §2932 specifically authorizes inclusion of power of sale clauses in mortgages, but the parties to real property transactions included them in mortgages long before that statute was enacted. *Fogarty v Sawyer* (1861) 17 C 589. Deeds of trust have customarily contained power of sale clauses as a contractual remedy, although there has never been any statutory authority for this common practice. See *Koch v Briggs* (1859) 14 C 256, 263. The power of sale is automatically transferred along with any assignment of the deed of trust. *Strike v Trans-West Discount Corp.* (1979) 92 CA3d 735, 155 CR 132. Deeds absolute may also contain such clauses (*Felton v Le Breton* (1891) 92 C 457, 28 P 490), although the presence of such language (see §3.44) is a broad hint that would be inconsistent with the usual desire on the part of one side of the transaction to mask the fact that the instrument is intended to create a security interest.

A power of sale clause may be included in installment land sale contracts. CC §2920(b). See §1.61. This statute, which provides that CC §§2924-2924h apply to installment land contracts with a power of sale, removes earlier doubts about their enforceability in land contracts and should overcome the previous reluctance by title companies to insure titles that result from their enforcement in the installment land contract context. See California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000).

Finally, a power of sale may exist in its own right, embodied in an independent document. In that event, the mere creation of the remedy by the parties implies that a security interest was intended and conveyed, making the document a mortgage. *Pfeiffer v Hesse* (1930) 107 CA 616, 290 P 501.

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§2.17 4. Cumulative Remedy

As long as the security instrument does not make sale under the power of sale the creditor's exclusive remedy, a power of sale clause merely adds a cumulative remedy to the existing remedy of judicial foreclosure. CCP §725a; *Fighiera v Radis* (1919) 180 C 660, 182 P 418; *Godfrey v Monroe* (1894) 101 C 224, 35 P 761; *Cormerais v Genella* (1863) 22 C 116. A creditor may therefore ignore the power of sale and instead judicially foreclose the security instrument. *Commercial Centre Realty Co. v Superior Court* (1936) 7 C2d 121, 59 P2d 978; *Loretz v Cal-Coast Dev. Corp.* (1967) 249 CA2d 176, 57 CR 188.

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G. Constitutionality of Trustee Sales

§2.18 1. Nonjudicial Foreclosure Not Protected State Action

The California Supreme Court upheld the constitutionality of trustee sales in *Garfinkle v Superior Court* (1978) 21 C3d 268, 146 CR 208, ruling that a private foreclosure sale does not constitute state action and is therefore not subject to the due process clauses of the federal and state constitutions (US Const amend XIV, §1; Cal Const art I, §7(a)). The *Garfinkle* court reasoned the following:

- The power of sale arises from contract rather than from statute;
- Although statutes extensively regulate trustee sales, they are designed to restrict creditor behavior and do not encourage the procedure;
- The ministerial role of the county recorder does not constitute significant involvement by government officials in the process; and
- There is no delegation of judicial power to private parties.

The supreme court reached its conclusion with respect to application of both the federal and state constitutions. Because it can speak authoritatively only on state law, the remote possibility remains that the federal courts will reach a different conclusion on the Fifth and Fourteenth Amendment issues. The California trustee sale has been held not to constitute state action for federal constitutional purposes by the federal district court for the Northern District of California (*Lawson v Smith* (ND Cal 1975) 402 F Supp 851), and several federal courts of appeals have reached the same conclusion concerning similar nonjudicial foreclosure and power of sale protocols in other states (see *Charmicor, Inc. v Deaner* (9th Cir 1978) 572 F2d 694 (Nevada power of sale not state action even though created by statute, not contract); *Northrip v Federal Nat'l Mortgage Ass'n* (6th Cir 1975) 527 F2d 23 (Michigan power of sale statute); *Bryant v Jefferson Fed. Sav. & Loan Ass'n* (DC Cir 1974) 509 F2d 511 (Washington, D.C., statute)).

Because trustee sales have largely been construed as constituting private conduct rather than state action, judicial review of such sales must proceed along common law and statutory, rather than constitutional, grounds. But see *Bank of America v Giant Inland Empire R.V. Ctr., Inc.* (2000) 78 CA4th 1267, 93 CR2d 626, applying due process considerations under the Fourteenth Amendment to invalidate a county property tax sale. For discussion of challenges to trustee sales, see chaps 7-8.

The use of an anti-SLAPP motion shed some additional light on the publicly regulated but still essentially private nature of trustee sales. In *Garretson v Post* (2007) 156 CA4th 1508, 68 CR3d 230, a borrower claimed to have been wrongfully required to pay a sum in reinstatement in a trustee sale context. The secured lender moved to strike the wrongful foreclosure claim under the provisions of CCP §425.16, the anti-SLAPP statute. The court held that, although statutorily regulated, trustee sale proceedings are nonetheless a purely private, contractual process and not part of an official governmental process involving the rights to free speech or to petition governmental authorities.

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§2.19 2. Impact of Personal Property Due Process Cases

Early decisions of the United States Supreme Court upheld power of sale foreclosures (see *Scott v Paisley* (1926) 271 US 632, 70 L Ed 1123, 46 S Ct 591; *Bell Silver & Copper Mining Co. v First Nat'l Bank* (1895) 156 US 470, 39 L Ed 497, 15 S Ct 440). In more recent cases, however, the Supreme Court has invoked the due process clause of the United States Constitution to invalidate state procedures that sanction the seizure or sale of a debtor's personal property without a prior hearing. See *Sniadach v Family Fin. Corp.* (1969) 395 US 337, 23 L Ed 2d 349, 89 S Ct 1820 (prejudgment wage garnishment). See also *Connecticut v Doehr* (1991) 501 US 1, 115 L Ed 2d 1, 111 S Ct 2105 (ex parte prejudgment attachment of real property); *Fuentes v Shevin* (1972) 407 US 67, 32 L Ed 2d 556, 92 S Ct 1983 (summary seizure of debtor's property under replevin statute). But see *Mitchell v W.T. Grant Co.* (1974) 416 US 600, 40 L Ed 2d 406, 94 S Ct 1895, in which the court upheld a statute that did not require preseizure notice or a hearing to recover personal property after default on a retail installment sale contract.

The *Sniadach* line of decisions should not provide a basis for invalidating a trustee sale if the high court agrees that no state action is involved. The Supreme Court's decision in *BFP v Resolution Trust Corp.* (1994) 511 US 531, 128 L Ed 2d 556, 114 S Ct 1757, which held that noncollusive trustee sales are insulated from bankruptcy avoidance powers (see chap 11), suggests that the high court is well disposed toward nonjudicial foreclosure in general and is unlikely to disrupt the California tradition of trustee sales on constitutional grounds.

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§2.20 3. Compliance With CC §2924b Does Not Violate Due Process

The California Supreme Court has held that compliance by the trustee with the notice formalities required by CC §2924b is sufficient to validate a trustee sale even though no actual notice was given to the trustor. *I.E. Assocs. v Safeco Title Ins. Co.* (1985) 39 C3d 281, 216 CR 438. In *Garfinkle v Superior Court* (1978) 21 C3d 268, 146 CR 208 (see §2.18), the court specifically refrained from expressing an opinion on the validity of the provision in CC §2924 that recitals in a trustee's deed that proper notice was given are conclusive in favor of a bona fide purchaser for value. 21 C3d at 279 n16. See §§2.46, 2.50, 2.134, 7.63 on deed recitals.

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II. SPECIAL PROBLEMS IN TRUSTEE SALES

§2.21 A. Substitution of Trustee

The deed of trust names the trustee (see §§1.31, 1.36-1.42). Private lenders often use form deeds of trust supplied by title companies, which identify the title company as trustee. Because many title companies no longer handle foreclosures, the beneficiary may need to substitute a foreclosure company, another title company, or a private person or entity to serve as the foreclosing trustee and to conduct the sale. On selecting the foreclosing trustee, see §2.33. See also California Title Insurance Practice §§15.15-15.17 (2d ed Cal CEB 1997).

Deeds of trust almost always contain a provision for changing or "substituting" the trustee. The substitution provision typically vests the power to appoint a new trustee in the beneficiary alone. Occasionally, however, the deed of trust will require, awkwardly and unnecessarily, that the trustor and the beneficiary act jointly to substitute in a new trustee. In rare instances, the deed of trust will require that, in addition to the consent of the beneficiary (and, sometimes, the trustor), the original trustee must convey title to the substituted trustee.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.22 1. Substitution Procedures

§2.22 1. Substitution Procedures

Civil Code §2934a provides a procedure for substitution of trustees. Although CC §2934a(a)(1) provides that the statutory procedure controls despite any contrary provision in a deed of trust executed on or after January 1, 1968, the procedures apparently need not be followed if alternative provisions in the deed of trust are followed. See *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859; *U.S. Hertz, Inc. v Niobrara Farms* (1974) 41 CA3d 68, 84, 116 CR 44. In any event, CC §2934a applies only when the deed of trust confers on the trustee "no other duties" than those incidental to exercise of the power of sale. If more duties are conferred, the instrument will likely control.

Under CC §2934a(a)(1), a substitution of trustees may be effected by recordation of, in the county in which the property is located, a substitution executed and acknowledged by all the beneficiaries under the deed of trust or their successors in interest. The substitution must contain (1) the date on which the deed of trust was recorded, (2) the name of the trustor, (3) the book and page or instrument number where the deed of trust is recorded, and (4) the name of the new trustee. CC §2934a(a)(4).

PRACTICE TIP: Creditor's counsel should review the deed of trust (including the substitution clause) before the trustee sale proceedings commence. Beneficiaries should not delay the process of substituting the trustee, because a late substitution may jeopardize foreclosure rights or delay the trustee sale process (see §2.62; see also §2.33).

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§2.23 2. Effect of Substitution on Validity of Notices

Provisions requiring service of a copy of the substitution on all persons entitled to receive notice of default are in CC §2934a(b)-(c). Effective January 1, 2005, these were amended to (1) allow the substituted trustee to act before recordation of the substitution (CC §2934a(d)) and (2) modify the required timing for service of the substitution so that recipients of notices of default or sale are aware of the substitution (CC §2934a(b), (c)). See Stats 2004, ch 177, §5; Senate Judiciary Committee Analysis of SB 1277 (Apr. 13, 2004). If the substitution is executed (but not recorded) before or concurrently with the recordation of the notice of default, then a copy of the substitution must be mailed before or concurrently with the recordation of the notice of default. CC §2934a(b). If the substitution is effected after the notice of default has been recorded but before the recordation of the notice of sale, a copy of the substitution must be mailed before or concurrently with the recordation of the notice of sale. CC §2934a(c). In either event, the substituted trustee is authorized to act as the trustee under the mortgage or deed of trust from the date the substitution is executed. CC §2934a(d). Once recorded, the substitution constitutes conclusive evidence of the substituted trustee's authority to exercise the power of sale, *i.e.,* conduct the trustee sale. See CC §2934a(d).

On notice of sale required after substitution of trustee, see §2.62.

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§2.24 3. Substitution Under Multiple Deeds of Trust

Provisions for substituting trustees under multiple deeds of trust recorded in the same county are found in CC §2934a(a)(4). Alternatively, under CC §2934a(a)(1), if the deed of trust secures multiple notes in favor of multiple beneficiaries or if it secures a single note in which the beneficiaries have undivided interests "equivalent to a series transaction," the trustee substitution may be executed by a 50-percent-plus majority of deed of trust beneficiaries. In that event, the substitution must be made in compliance with the procedure specified in CC §2934a(a)(2)-(3). The procedure is similar to that of a "Majority Action Affidavit," described in CC §2941.9(d), but without the prior written agreement by all beneficiaries or inclusion of the authorization in the deed of trust required by CC §2941.9(b)-(c) (see §1.46).

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§2.25 4. Effect of Substitution on Trustee's Authority

A party who is not the trustee of record will not have the authority to conduct the foreclosure or deliver a valid trustee's deed. See *Pro Value Props., Inc. v Quality Loan Serv. Corp.* (2009) 170 CA4th 579, 88 CR3d 381. See also §§2.64, 2.98. In fact, one appellate court held entirely void a purported sale by a former trustee who had been substituted out as trustee of record before foreclosure. See *Dimock v Emerald Props., LLC* (2000) 81 CA4th 868, 97 CR2d 255. However, another court used "reformation" to validate a foreclosure sale under CC §2934a when the former trustee mistakenly conducted the sale after a new trustee had been substituted. See *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859.

PRACTICE TIP: Some institutional lenders regularly substitute themselves in as trustee to perform such tasks as execution and recordation of deeds of partial reconveyance. Lenders must take care not to rely on the former (substituted out) trustee to conduct a later foreclosure unless that trustee is formally substituted back in as trustee.

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§2.26 5. Trustee Liability

A trustee's primary responsibility is to the lender and the borrower. For example, a trustee under a deed of trust owes a duty to conduct the sale fairly and openly and to secure the best possible price for the benefit of the borrower. CC §2924g; *Nomellini Constr. Co. v Modesto Sav. & Loan Ass'n* (1969) 275 CA2d 114, 79 CR 717; *Hill v Gibraltar Sav. & Loan Ass'n* (1967) 254 CA2d 241, 62 CR 188. A trustee may also incur liability to third parties, such as prospective bidders, when it engages in deceptive acts to thwart the competitive bidding process. *Block v Tobin* (1975) 45 CA3d 214, 119 CR 288.

When a former trustee or an improperly substituted trustee mistakenly conducts a foreclosure sale and conveys title to the highest bidder, numerous parties, including subsequent purchasers, may suffer losses, including costs and attorney fees incurred in attacking or defending the sale. See, *e.g., Heritage Oaks Partners v First Am. Title Ins. Co.* (2007) 155 CA4th 339, 66 CR3d 510. Although the courts in these circumstances may either invalidate the sale (see, *e.g., Pro Value Props., Inc. v Quality Loan Serv. Corp.* (2009) 170 CA4th 579, 88 CR3d 381; *Dimock v Emerald Props., LLC* (2000) 81 CA4th 868, 97 CR2d 255) or validate it by applying equitable relief (see, *e.g., Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859), a damages action by a subsequent purchaser of the property will not lie against the trustee, who has a limited role as the common agent of the borrower and the lender. See, *e.g., Heritage Oaks Partners v First Am. Title Ins. Co., supra,* in which a subsequent purchaser sued to recover damages sustained in the ensuing postsale lawsuits, asserting causes of action for negligence and equitable subrogation against the former trustee, which had conducted the sale when it was no longer trustee of record. The court, relying on *I.E. Assocs. v Safeco Title Ins. Co.* (1985) 39 C3d 281, 216 CR 438 (see §§2.20, 2.46), construed the role of the trustee narrowly, ruled that the trustee owed no duty to the purchaser, and refused to allow the purchaser to recover any damages. This insulation of the trustee from the claims of bidders and other nonparties to the deed of trust or mortgage, however, should not be taken as necessarily holding the trustee immune from potential liability to its principals (the trustor and beneficiary) and others when the trustee negligently, deceitfully, or unlawfully performs the narrow and ministerial tasks required of the trustee under a deed of trust.

A trustee's actions in a nonjudicial foreclosure (*i.e.,* the mailing, publication, and delivery of statutory notices) and the execution of statutory nonjudicial foreclosure procedures are privileged communications under the qualified, common-interest privilege of CC §47(c)(1). Accordingly, the trustee's recordation of a notice of default on instruction by the lender is not actionable in tort unless the trustee acted with malice. *Kachlon v Markowitz* (2008) 168 CA4th 316, 85 CR3d 532 (rejecting claims by borrower against trustee for slander of title and negligence, but allowing claims against lender for equitable relief, tort damages, and attorney fees).

For further discussion of trustee, lender, and other party liability arising from trustee sales, see §§2.74-2.80, 12.138-12.154.

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B. Federally Insured or Guaranteed Loans

§2.27 1. Private Lender Foreclosures

If the loan is insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA), the beneficiary must notify the appropriate agency before initiating foreclosure proceedings. See, *e.g.,* 38 USC §3732(a)(1) (VA). Each agency also requires that certain procedures be followed with respect to the sale and subsequent related events in order for the secured creditor to recover from the agency on the insured loan or the guaranty should the sale proceeds be insufficient to satisfy the debt. See 12 USC §§1707-1715z-22a (FHA); 38 USC §§3701-3736 (VA).

PRACTICE TIP: The beneficiary should contact the agency involved before starting foreclosure in order to ascertain the required procedures. Attorneys should advise debtors with VA-guaranteed loans that the VA has the right to recover a deficiency from a defaulting buyer, despite state law barring a deficiency, if the VA acquires the property from the lender after the foreclosure sale and suffers a loss on resale. See §5.63.

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§2.28 2. Federal Agency Foreclosures

FHA-insured loans assigned to the Department of Housing and Urban Development (see 12 USC §1715u(c)) may be foreclosed under the Multifamily Mortgage Foreclosure Act of 1981 (12 USC §§3701-3717 (see *Geneva Ltd. Partners v Kemp* (ND Cal 1990) 779 F Supp 1237)) or under the Single Family Mortgage Foreclosure Act of 1994 (12 USC §§3751-3768).

Foreclosures under the two acts are similar but not identical to state trustee sale proceedings. Both federal acts provide for a combined notice of default and sale (12 USC §§3706, 3757), which is to be sent to the current owner, to any prior borrowers still liable on the loan, and to other lienholders. The notice, effective on the date sent by registered mail, can precede the sale by as few as 21 days and, in the case of notice to other lienholders of multifamily property, by as few as 10 days. 12 USC §§3708, 3758. The FHA justifies these short notice periods because of its usual lengthy (up to 36 months) preforeclosure forbearance period. 60 Fed Reg 57485 (1995).

Separate regulations for single-family nonjudicial foreclosure, adopted in 1995 (former 24 CFR pt 29, 60 Fed Reg 57483 (1995)), were amended in 1996 and made part of consolidated regulations applicable to multifamily and single-family mortgages. 24 CFR pt 27. The Federal Register includes two appendixes, not appearing in the Code of Federal Regulations, which combine the statutory and the regulatory procedures for multifamily mortgage foreclosures (App A, 61 Fed Reg 48552 (1996)) and for single-family mortgage foreclosures (App B, 61 Fed Reg 48557 (1996)).

Effective May 20, 2009, in response to the high number of foreclosures nationally, 12 USC §1715u(c) was amended to permit the Secretary of Housing and Urban Development to encourage loan modifications on federally insured loans, in particular interest rate reductions, for eligible delinquent mortgages or those facing imminent default. Such modifications are to be implemented through the payment of insurance benefits, the assignment of the mortgages to the Secretary, and the sale, pooling, or reassignment of the modified mortgages to the mortgagees. Pub L 111-22, §203, 123 Stat 1646 (Helping Families Save Their Homes Act of 2009).

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§2.29 C. FDIC Interests Protected by Federal Law

In 1992, the Federal Deposit Insurance Corporation (FDIC) issued its Statement of Policy concerning foreclosure consent and redemption rights. 57 Fed Reg 29491 (1992). Under 12 USC §1825(b)(2), enacted as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (12 USC §§1811-1835a), the FDIC's consent is required before a lender may foreclose on property in which the FDIC has an interest. The FDIC has granted consent to foreclosure of liens that are consensual (Statement ¶4.a.ii), but if the FDIC's interest is of record, lienholders with involuntary liens must obtain the FDIC's consent before foreclosing (Statement ¶4.a.iii). The FDIC does not waive any rights under state foreclosure law (Statement ¶4.a.iv).

When a senior lienholder forecloses on property in which the federal government (other than the Internal Revenue Service; see §2.31) claims a mortgage or other lien, 28 USC §2410(c) gives the federal government 1 year to redeem the property. In any event, the FDIC will not assert any right to redeem under 28 USC §2410(c) within 1 year after foreclosure of a prior lien (Statement ¶5).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.30 D. Servicemembers Civil Relief Act

§2.30 D. Servicemembers Civil Relief Act

The Servicemembers Civil Relief Act (50 USC App §§501-596) provides that foreclosure of a lien on real property for nonpayment of any amount due and secured by a mortgage or deed of trust is invalid if made while the debtor is in military service, or within 9 months thereafter, except on court order or if made under a written agreement as provided in 50 USC App §517. 50 USC App §533(a), (c). This provision applies only if the obligation was incurred before the debtor entered military service. 50 USC App §533(a)(1).

NOTE: The 2008 amendment to 50 USC App §533(c), which changed the time period during which foreclosure may not occur, ends on December 12, 2010. Effective January 1, 2011, the time period returns to 90 days after the trustor's military service.

The Act supersedes the former Soldiers' and Sailors' Civil Relief Act of 1940. It applies to all military servicemembers and their dependents, whether they entered military service before or after signing a loan or mortgage agreement. When the Act applies, it effectively precludes foreclosure by trustee sale without court intervention. Consequently, before conducting the foreclosure sale, trustees customarily require assurance that the trustor is not a member of the armed forces. The beneficiary usually provides this assurance by executing an affidavit on a form supplied by the trustee. If the beneficiary has no direct knowledge of the trustor's military status, it may be necessary to obtain certificates from the personnel branches of each of the armed forces stating that the trustor is not in the military service.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.31 E. Federal Tax Liens

§2.31 E. Federal Tax Liens

Federal tax liens recorded more than 30 days before the date of the trustee sale are not extinguished by the sale unless the Internal Revenue Service (IRS) was given notice at least 25 days before the date of the sale. IRC §7425(b). Notice must be made in writing, by personal service, or by registered or certified mail. See Treas Reg §301.7425-3 for the notice requirements. California law provides that (1) a notice of sale complying with IRC §7425 must be given to the IRS if a notice of federal tax lien has been recorded against the property and (2) failure to give notice is sufficient cause for the purchasing bidder or the trustee to rescind the trustee sale and cancel the trustee's deed if the foreclosing lender consents. CC §2924b(c)(4). See §§2.50, 2.65. If notice was given and the lien is extinguished, the United States then has a 120-day period following the trustee sale within which to redeem the property. IRC §7425(d). See *Little v U.S.* (9th Cir 1986) 794 F2d 484. See also *Ellis v U.S.* (MD NC 2005) 2005-2 USTC ¶50,518, 96 AFTR2d (RIA) 5535 (120-day period runs from date sale completed, not date trustee's deed recorded). Even if the IRS lien is recorded only against the interest in the property owned by a joint tenant, the IRS may redeem the entire real property sold at the foreclosure sale. IRC §7425(d). See *Vardanega v Internal Revenue Serv.* (9th Cir 1999) 170 F3d 1184.

PRACTICE TIP: A lender can sometimes negotiate with the IRS for a waiver of its 120-day redemption right if it can convince the IRS, with the help of an appraisal, that the debtor has no equity in the property.

The IRS currently redeems properties on a fairly regular basis, although it did so less frequently in years past. The existence of the IRS lien effectively restrains the foreclosure-sale purchaser from reselling the property during this special 120-day redemption period. Title companies generally except such IRS liens from coverage, making the encumbered title effectively unmarketable. Litigation often arises when a title insurer is forced to pay under its policy, having failed to find and except an IRS lien because it was recorded under a different name from that appearing on other documents regarding the property. See, *e.g., First Am. Title Ins. Co. v U.S.* (9th Cir 1988) 848 F2d 969; *U.S. v Polk* (9th Cir 1987) 822 F2d 871. See also *Olympic Fed. Sav. & Loan Ass'n v Regan* (9th Cir 1981) 648 F2d 1218. A trustee who conducts a foreclosure sale without discovering the IRS lien and giving the IRS notice of the sale is not liable to subsequent purchasers or their title insurers. *Diediker v Peelle Fin. Corp.* (1997) 60 CA4th 288, 70 CR2d 442.

NOTE: To comply with the IRS notice requirements, after expiration of the notice of default, trustees customarily schedule the sale date at least 31 days in advance, rather than the minimum 20 days required by CC §2924f, and also order a "date down" of the trustee sale guaranty from the title company. The timing must be such that the record is searched as of 31 days before the sale date, thus revealing whether any federal tax liens were filed more than 30 days before the sale date. The minimum period of 3 months plus 20 days (see §2.62) is effectively increased to 3 months plus 31 days. On effect of postponements on IRS notice requirements, see §2.95.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.32 F. Property Tax Postponement

§2.32 F. Property Tax Postponement

If the State of California has a lien on the property for postponed property taxes under the Senior Citizens and Disabled Citizens Property Tax Postponement Law (Rev & T C §§20581-20622), the State Controller must be given notice of any trustee sale under a lien having priority over the state's lien. Govt C §16187(b). If the notice of lien for postponed property taxes is recorded after the notice of default was recorded but at least 30 days before the date of the sale, the Controller must be given notice of the sale at least 25 days before the sale. Govt C §16187(b).

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III. NOTICE OF DEFAULT

A. First Steps

§2.33 1. Selecting Foreclosing Trustee

Although no law prohibits the same person or legal entity from acting both as beneficiary and trustee (see §1.40), the practice is rarely employed. Although a trustee has little discretion and is, in essence, implementing a detailed statutory formula for private foreclosure, the trustee still has the duty to act fairly toward both sides and to conduct a competitive and open sale. Given that the beneficiary is likely to be a bidder, a party acting in a dual role as trustee and beneficiary may have difficulty avoiding the appearance of impropriety and conflict of interest in the sale process. Most institutional lenders have subsidiaries that can act as foreclosure trustees to shield the parent lender from liability. On trustee substitution procedures and effect of substitution, see §§2.21-2.26.

PRACTICE TIP: In selecting a trustee to handle the trustee sale, the beneficiary and its counsel should consider the insurability of the title to be conveyed to the successful bidder at the sale. The beneficiary should select a foreclosure trustee that is or is closely affiliated with or underwritten by a title insurance company and whose sale will have maximum credibility with a potential future title insurer. For further discussion, see California Title Insurance Practice §§15.15-15.17 (2d ed Cal CEB 1997).

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§2.34 2. Gathering Necessary Information; Multiple Beneficiaries

The foreclosure law portion of the Civil Code prescribes certain notices to the borrower and others before a trustee sale may be conducted. CC §§2924, 2924b-2924c (notice of default) and 2924b, 2924f (notice of sale). In addition, the deed of trust may contain provisions adding further notice requirements (see §2.39). A trustee may rely on information given to it in good faith by the beneficiary regarding the nature and the amount of the default and will not be liable for any good faith error resulting from reliance on that information. CC §2924. See *Kachlon v Markowitz* (2008) 168 CA4th 316, 85 CR3d 532 (rejecting assertion by borrower that immunity conferred on trustee for good faith error limits scope of trustee's qualified privilege under CC §47(c); see §2.26).

A trustee sale guaranty is nearly always purchased from a title company at the inception of trustee sale proceedings. The guaranty lists all junior creditors and others who have requested or are entitled to notice of default and sale. See California Title Insurance Practice §§9.6-9.8 (2d ed Cal CEB 1997). Although the cost of a guaranty may tempt the beneficiary to order the issuance and recordation of a notice of default before the guaranty is obtained (in the hope that the notice will encourage payment of the delinquent amount), lack of such a guaranty may leave the trustee unaware that the trustor has filed a bankruptcy petition, making the recordation of the notice of default a violation of the automatic stay (see §§7.90-7.108).

Although the trustee may have problems when multiple beneficiaries disagree about the foreclosure, it is probably safe to act on the instructions of any one beneficiary as long as the others have not given contrary orders. *Bliss v Security-First Nat'l Bank* (1947) 81 CA2d 50, 183 P2d 312. See discussion of CC §2941.9 in §1.46. The right to protect the common estate from injury enables any cobeneficiary of a deed of trust to make an independent election to initiate a trustee sale when the trustor is in default. *Perkins v Chad Dev. Corp.* (1979) 95 CA3d 645, 157 CR 201. On decision-making procedure for multiple beneficiaries of deed of trust, see §1.46. On multiple notes, see §§9.26-9.41.

Trustees nearly always require manual delivery to them of the original note and deed of trust when asked to initiate a foreclosure, although they are not legally always required to do so. *California Trust Co. v Smead Inv. Co.* (1935) 6 CA2d 432, 44 P2d 624. The deed of trust itself often requires the same documents for the trustee's protection. If the original papers cannot be located, the title company may require the beneficiary to furnish a lost instrument indemnity bond. See *Huckell v Matranga* (1979) 99 CA3d 471, 160 CR 177. See Title Ins §15.14. Because the promissory note is a negotiable instrument (Com C §§3104, 3301-3302, 3305; see §§1.28-1.30), the trustee has no assurance that it has not been transferred if the beneficiary cannot produce it. See *Randolph v Harris* (1865) 28 C 561.

NOTE: Despite the business practices of professional trustees and title insurance companies, federal courts have ruled that, because California law allows a nonjudicial foreclosure to be brought by the trustee under a deed of trust without requiring proof of the original note, a creditor need not prove that it is a holder in due course in possession of the note in order to foreclose. See, *e.g., Bouyer v Countrywide Bank* (ND Cal, June 25, 2009, No. C 08-5583) 2009 US Dist Lexis 53940 (possession of original note is not prerequisite to trustee sale); *Sicairos v NDEX W., LLC* (SD Cal, Feb. 13, 2009, No. 08cv2014) 2009 US Dist Lexis 11223 (noting that CC §2924(a)(1) does not expressly require party commencing nonjudicial foreclosure to physically possess or produce promissory note to borrower).

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§2.35 3. Foreclosing on Property in Probate

For purposes of notices of default and sale, the personal representative of the estate of a deceased trustor is entitled to *trustor* notice under CC §2924b(b) (including the last known physical address requirement), not *successor-in-interest* notice under CC §2924b(c). See *Estate of Yates v West End Fin. Corp.* (1994) 25 CA4th 511, 32 CR2d 53, cited in §2.43. For probate procedures in judicial foreclosures, see §§3.37-3.38. On general probate procedures, see California Decedent Estate Practice (2d ed Cal CEB 2009).

A beneficiary is not required to file a creditor's claim in probate as a condition to a nonjudicial foreclosure. *Cosentino v Coastal Constr. Co.* (1994) 30 CA4th 1712, 36 CR2d 444. Probate Code §9391 provides that a lienholder may "commence an action" to enforce the lien without filing a claim if the complaint waives all recourse against other property of the estate. But *Cosentino* held that a nonjudicial foreclosure is not governed by §9391, because it is not an "action." 30 CA4th at 1715. A similar conclusion was reached under a predecessor section (CCP §1500) in *More v Calkins* (1892) 95 C 435, 30 P 583. *Cosentino* also notes that, under CCP §580d, a creditor relinquishes all recourse following a nonjudicial foreclosure sale. 30 CA4th at 1716. For further discussion of effect of §580d, see §§5.4-5.9.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.36 4. Foreclosure by Homeowners' Association

§2.36 4. Foreclosure by Homeowners' Association

Most common interest communities organized under California law allow their homeowners' associations to file liens against their members' property for delinquent assessments. Special notice and alternative dispute resolution requirements must be met before the association proceeds with a trustee sale or judicial foreclosure. See CC §§1367-1367.5. See Advising California Common Interest Communities, chap 5 (Cal CEB 2003).

On priorities between assessment liens held by homeowners' associations and other liens, such as mortgage liens held by lenders, see Common Interest Communities, chap 5. On a common interest community's right to request a copy of the trustee's deed following a foreclosure sale on another's lien, see §2.41.

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§2.37 B. Preparing Notice of Default

The foreclosing trustee or its agent usually prepares, records, and serves the notice of default. See CC §§2924, 2924b(b); *Jones v Sierra Verdugo Water Co.* (1923) 63 CA 254, 218 P 454. If the trustee fails to record the notice, the substituted trustee, the beneficiary, or any person holding the note or any of their authorized agents may do so. CC §§2924, 2924b(b)(4); *Birkhofer v Krumm* (1938) 27 CA2d 513, 81 P2d 609. If the trustee disagrees with the beneficiary about the propriety of the sale, either the trustee should resign or the beneficiary should seriously evaluate the trustee's objections (which may serve as early warning of problems) or substitute a more compliant trustee (see §2.21).

The notice of default is usually prepared whenever there is an event of default. See §§12.141-12.142. On event of default provisions, see California Real Estate Finance Practice: Strategies and Forms, chaps 3-4 (Cal CEB 2000). Most often missed payments trigger the notice of default. A typical deed of trust, however, contains many covenants other than the requirement to pay principal and interest, such as property maintenance, payment of property taxes, and property insurance. Before foreclosing on such defaults, the lender must usually give a notice to cure before the notice of default. See, *e.g.,* Real Estate Finance §4.84, paragraph 19.2.

Also, most notes and deeds of trust contain a due-on-transfer clause. See §§8.8-8.24. This provision allows the lender (or holder of the note) to accelerate the loan if the underlying real property is sold, transferred, or exchanged. However, depending on how the provision is drafted (see §8.19), a breach may not give the lender the right to immediately record a notice of default. Instead, the lender might be required first to provide the trustor with a notice of its intent to accelerate the loan based on the specified violation. See *Miller v Cote* (1982) 127 CA3d 888, 179 CR 753. In most instances, the trustor will be unable to cure the breach by paying off the loan balance in full, and the lender may then proceed with the notice of default.

NOTE: Effective September 8, 2008, to January 1, 2013, for California owner-occupied residences securing loans made between January 1, 2003, and December 31, 2007, the trustee, beneficiary, or authorized agent must wait 30 days after contacting the borrower (or 30 days after satisfying due diligence efforts to contact the borrower) before undertaking recordation of the notice of default. The purpose of the contact is to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure. The beneficiary or its agent must (1) advise the borrower that he or she has the right to request a meeting within 14 days and (2) provide the borrower with the toll-free telephone number made available by the United States Department of Housing and Urban Development to find a certified housing counseling agency. See CC §2923.5(a)-(b). For further discussion, see §§2.38, 2.49, 2.63, 2.65, 2.68.

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1. Contents of Notice

§2.38 a. Civil Code Requirements

Under CC §2924, the notice of default must do the following:

- Contain the notices prescribed by CC §2924c(b)(1), stating the amount due, the reinstatement period, and statutory warnings (CC §2924(a)(1)(D));
- Name the trustor(s) (CC §2924(a)(1)(A));
- Give either (1) the instrument number or the book and page number of the originally recorded deed of trust or mortgage or (2) a description of the secured property (CC §2924(a)(1)(A));
- Declare that a breach of the obligation has occurred and specify the nature of each breach actually known to the beneficiary (see §2.40) (CC §2924(a)(1)(B)-(C)); and
- State the beneficiary's election to sell the property to satisfy that obligation and any other obligation secured by the deed of trust or mortgage in default (CC §2924(a)(1)(C)).

The notice need not include the names of parties other than the original trustor or mortgagor. *Rogers v Evans* (1934) 137 CA 538, 31 P2d 233. No special language is required to describe the breach; a general description (*e.g.,* "failure to pay January installment") is adequate. See *Engelbertson v Loan & Bldg. Ass'n* (1936) 6 C2d 477, 58 P2d 647; *Middlebrook-Anderson Co. v Southwest Sav. & Loan Ass'n* (1971) 18 CA3d 1023, 96 CR 338. But see *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 98 CR 735. Similarly, for installment obligations, general language may be sufficient to show an intent to accelerate. *Engelbertson v Loan & Bldg. Ass'n, supra*.

NOTE: Effective September 8, 2008, to January 1, 2013, for owner-occupied residences securing loans made between January 1, 2003, and December 31, 2007, the notice of default must include a declaration from the beneficiary or its agent stating that it contacted the borrower as mandated by CC §2923.5(a), that it tried with due diligence to contact the borrower, or that no contact was required under CC §2923.5(h). See CC §2923.5(b). See also Note in §2.37 and form in §2.130. If a notice of default had already been recorded and served before the effective date in §2923.5, then the notice of sale (see §2.63) must include a declaration about contacting the borrower. CC §2923.5(c). See exceptions and summary of related requirements in §2.49.

A material defect in the notice, such as gross misstatement of the amount in default, voids the sale, and the trustee may refuse to convey the trustee's deed. *Angell v Superior Court* (1999) 73 CA4th 691, 86 CR2d 657. In carrying out its statutory duties under the foreclosure law, a trustee is entitled to rely on information provided to it in good faith by the beneficiary, and the trustee incurs no liability for good faith errors resulting from such reliance. CC §2924(b).

PRACTICE TIP: The type size and precise wording of portions of the notice are dictated by statute. Given this, the foreclosing trustee should use a tried and tested form of notice of default, adding transaction-specific information. A completely original notice of default should be proofread painstakingly because the malpractice exposure may be high if the debtor or other interested party successfully challenges the validity of the notice. See form in §2.130.

Debt collection agencies that prepare and serve notices of default under CC §2924 must comply with the federal Fair Debt Collection Practices Act (FDCPA) (15 USC §§1692-1692p). 15 USC §1692a(6); *Bush v Loanstar Mortgagee Servs., LLC* (ND Cal 2003) 286 F Supp 2d 1210. In *Bush,* the court found that the debt collector that sent the notice of default had accurately described the debt. Thus, there was no liability.

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§2.39 b. Contractual Requirements

Some loan or security agreements contain additional notice requirements. For example, the uniform deed of trust approved for use in California by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) imposes different duties on a beneficiary and should be read carefully to ensure that the additional requirements are met. In pre-1985 loans salable to the FNMA and the FHLMC, the California FNMA or FHLMC deed of trust permitted the borrower to reinstate up until 5 days before the sale. Jensen, *Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure,* 7 Real Prop, Prob & Tr J 397, 428 (1972). Beginning in 1985, CC §2924c(e) extended the reinstatement period from the recordation date of the notice of default until 5 business days before the sale for all California deeds of trust, thus eliminating the contract-statute discrepancy.

An earlier version of the FNMA or FHLMC deed of trust required written notice at least 30 days before acceleration and, apparently, 30 days before recordation of the statutory notice of default. The notice had to state that the borrower had the right to "bring a court action to assert the non-existence of a default or any other defense of Borrower to acceleration and sale." This information is not included in the Important Notice language of CC §2924c (see form in §2.130). This procedure was adopted because of concerns about constitutionality, particularly because foreclosure by the FHLMC might constitute state action. See Randolph, *The FNMA/FHLMC Uniform Home Improvement Loan Instruments: A Commentary and Critique,* 16 Real Prop, Prob & Tr J 546 (1981).

PRACTICE TIP: As a practical matter, by the time a lender turns over a loan to counsel to institute foreclosure proceedings, the lender often has already sent the debtor a series of demand letters and default warnings. Unless counsel can confirm that those letters strictly complied with all contractual notice and cure requirements, counsel should send an additional final notice complying with the applicable notice provisions before instituting the trustee sale.

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§2.40 2. Unknown or Omitted Defaults

Civil Code §2924 requires that the notice of default set forth only "the nature of each breach actually known to the beneficiary" (CC §2924(a)(1)(D)) and rebuttably presumes that the beneficiary actually knew of all unpaid loan payments owed to it (CC §2924(e)). The section provides that omission of an "actually known" default does not invalidate the notice of sale or preclude the beneficiary from later asserting a claim to the omitted default, which may be identified in a second, separate notice of default. CC §2924(e). Because unknown defaults on "recurring" obligations must be cured even when not listed in the notice of default (see §2.58), there is no requirement for the notice to make a pro forma listing of all possible defaults on other obligations (as was previously practiced.) See *Anderson v Heart Fed. Sav. & Loan Ass'n* (1989) 208 CA3d 202, 256 CR 180; *Little v Harbor Pac. Mortgage Investors* (1985) 175 CA3d 717, 721 n6, 221 CR 59.

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§2.41 3. Responding to Requests for Notice; CC §2924b(a)

Anyone desiring a copy of a notice of default or notice of sale may, at any time before the recordation of a notice of default, record a request for a copy of the notice of default and of the sale (see §§2.6, 2.43-2.44). CC §2924b(a). See form in §2.131. The foreclosing trustee must inquire whether anyone has recorded such a request for notice. The trustee sale guaranty (see §2.34) will provide this information to the trustee.

In addition, a common interest development association, with respect to the separate interests it governs, may record a request that following a sale, a beneficiary, trustee, or other person authorized to record a notice of default mail to the association a copy of a trustee's deed concerning any member. The request must (CC §2924b(f)) do the following:

- Include a legal description or the assessor's parcel number of the separate interest;
- Include the name and address of the association;
- Include a statement that the requestor is a homeowners' association; and
- Be recorded *before* the notice of default is filed.

The beneficiary, trustee, or other authorized person must mail the requested information to the association within 15 business days after the deed is recorded. CC §2924b(f). On priorities between common interest development association assessment liens and other liens, such as voluntary purchase money liens, see Advising California Common Interest Communities, chap 5 (Cal CEB 2003).

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C. Recording, Mailing, and Publishing Notice

§2.42 1. Recording Notice of Default

Under CC §2924, the trustee or beneficiary must record the notice of default but need not acknowledge it. *U.S. Hertz, Inc. v Niobrara Farms* (1974) 41 CA3d 68, 116 CR 44.

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2. Serving Notice of Default

§2.43 a. Persons Required to Be Served; Methods

Civil Code §2924b sets forth mailing, publication, and delivery requirements of the notice of default that must be satisfied by the mortgagee, trustee, or other person authorized to record the notice, such as "an agent for the mortgagee or beneficiary, an agent of the named trustee, any person designated in an executed substitution of trustee [see §2.21], or an agent of that substituted trustee." See CC §2924b(b)(4). A copy of the notice, including the recordation date, must be sent by registered or certified mail within 10 business days of the actual recordation to any persons who have recorded requests for notice (see §§2.6, 2.33, 2.131) and to the trustor at its last known physical, as opposed to electronic, address. CC §2924b(b). Under CC §2924b(h) (referring to CC §9), business days include Saturdays.

PRACTICE TIP: It is prudent to allow an extra day or two when calculating these requirements to ensure against any possible challenge to the validity of the notice and the trustee sale.

In addition, the notice must be sent by first-class mail to the trustor or mortgagor, to all persons who have recorded requests for notice, and to all persons specified in CC §2924b(c) at the same physical address used for the certified or registered mail as specified in CC §2924b(b) or (c), and an affidavit of the mailing must be executed and retained. CC §2924b(e). A separate notice must be given 1 month later to the trustor for secured loans governed by the Unruh Act (CC §§1801-1812.20). CC §2924f(c)(3). See §§2.48, 2.97, 2.132.

If the secured property is in probate, the administrator or executor of the estate "essentially becomes the trustor," which entitles the estate to receive a CC §2924b(b) notice at its last known physical address. *Estate of Yates v West End Fin. Corp.* (1994) 25 CA4th 511, 521, 32 CR2d 53. See §2.35. The buyer in an installment land sale contract is also a party entitled to notice. *Perry v O'Donnell* (9th Cir 1984) 749 F2d 1346. See §§1.59-1.66. A copy of the notice must also be mailed, within 1 month, to anyone holding an interest of record in the property who would be affected by the foreclosure, including successor owners, contract purchasers, junior lienholders, tenants, and various assignees. CC §2924b(c). On giving notice to taxing entities having liens on the property, see §2.31.

Government Code §27321.5(b) requires that, to be recordable, a deed of trust must contain a trustor's request for notice of default. (Note that the failure to include, or any error in including, any such request does not affect the validity or priority of the deed of trust or the notice otherwise imparted by recordation.) Under CC §2924b(d), if a deed of trust or mortgage does not contain such a request, or if the request does not contain a mailing address for the trustor or mortgagor, and if no separate request has been recorded, the trustee has three alternatives for service:

- Publish the notice of default once a week for at least 4 weeks in a newspaper of general circulation;
- Personally serve the notice on the trustor; or
- Post the notice on the property and mail it to the trustor's last known address.

This requirement seems superfluous in light of the other mandatory mailing requirements of CC §2924b, but it should nevertheless be followed.

On a common interest development association's right to request copy of trustee's deed following sale, see §2.41.

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§2.44 b. Persons Not Required to Be Served

There are some gaps in the statutory notice requirements, *e.g.,* notice of default apparently need not be mailed to guarantors, endorsers, or former owners of the property (other than the original trustor) who may have assumed the obligation, all of whom might be liable for a money judgment on the debt despite CCP §580d (see §§9.88-9.136). These parties should therefore record a request for notice to protect their interests (see §§2.6, 2.41, 2.131).

PRACTICE TIP: If lender's counsel is aware of guarantors or sureties, it is important to provide them with copies of all notices even if they have waived all applicable surety defenses. See §§9.89-9.112.

The court in *Perez v 222 Sutter St. Partners* (1990) 222 CA3d 938, 272 CR 119, held that, because holders of easements are not specifically enumerated in the foreclosure statutes, the trustee was not required to give them notice under CC §2924b. Dominant tenants, therefore, should also record requests for notice of default if they wish to preserve their easements. The rule is different in judicial foreclosure actions, in which all interested parties must be named and served. See *Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 77 CR2d 581, discussed in chap 3.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.45 c. Address Changes

§2.45 c. Address Changes

Because a trustee or a beneficiary has no duty to locate a trustor who has moved and left no forwarding information or change of address (see §2.46), any party, including the trustor, who is entitled to receive notice but whose address has changed should inform the beneficiary by recordation of a request for notice of default under CC §2924b(a) for each new address (see form in §2.131).

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§2.46 d. Last Known Address; Due Diligence

Under CC §2924b(b)(3), the trustor's "last known address" is the last business or residence address actually known by the trustee, beneficiary, or other person authorized to record the notice of default. The beneficiary must inform the trustee if it actually knows the trustor's last address, but the trustee is not liable for failing to send any notice to the last address unless the trustee has actual knowledge of it. As of January 1, 2006, notices must be sent to the last known "physical" address of the trustor or other interested parties. An address is deemed to be "actually known" if it is contained in the original mortgage or deed of trust or in any subsequent *written* notification of a change of *physical* address. This seems consistent with *Estate of Yates v West End Fin. Corp.* (1994) 25 CA4th 511, 521, 32 CR2d 53, in which the court held that a public administrator was entitled to CC §2924b(b) trustor notice, with its last known address requirement, because the trustee sale guaranty revealed that the trustor was dead. E-mail addresses and other forms of electronic addresses are specifically excluded from the definition of "physical address" in §2924b(b)(3). The courts have yet to decide if ordinary correspondence between the lender or trustee and the borrower that simply contains a new address for the borrower (without expressly pointing out that a change has occurred) is equivalent to a written notification of a change of physical address.

Before the amendments effective January 1, 2006, the courts had narrowly construed the notice requirement. For example, the supreme court ruled that the trustee need follow only the express statutory notice requirements. *I.E. Assocs. v Safeco Title Ins. Co.* (1985) 39 C3d 281, 216 CR 438. Courts of appeal ruled that the trustee had no duty to locate a trustor who had changed address without informing the trustee. *Lupertino v Carbahal* (1973) 35 CA3d 742, 111 CR 112; *McClatchey v Rudd* (1966) 239 CA2d 605, 48 CR 783. However, if the trustee or beneficiary had communicated with the trustor at the new address, the trustee was assumed to be aware of it. *Lupertino v Carbahal, supra* (this aspect of the *Lupertino* decision is questionable in light of the *Safeco* decision and the amendments effective January 1, 2006).

Although the supreme court in *Garfinkle v Superior Court* (1978) 21 C3d 268, 279 n16, 146 CR 208, had hinted at a duty to locate the trustor, it subsequently held that the trustee need merely comply with the statutory requirements and has no additional duty to attempt to give the trustor actual notice. See *I.E. Assocs. v Safeco Title Ins. Co., supra*. In practice, institutional lenders often find it difficult to coordinate the "last known address" requirement with their normal operations because the trustor (who may also be a depositor or a borrower or guarantor on other loans) may communicate by any of various means with any number of the lender's employees, and the lender may find it difficult to assemble all the information when it engages a foreclosing trustee. The amendments to CC §2924b(b)(3), operative January 1, 2006, provide some clarification by defining "actual knowledge" of an address as receipt of "written" notification of a "physical" (rather than electronic) address.

On effect of inadequate notice, see §2.50.

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§2.47 3. Default Notice Is Privileged

Under CC §2924, the "mailing, publication, and delivery of notices required" by §2924 and the performance of other statutory duties under CC §§2920-2944.5 are privileged communications under CC §47. But CC §2924 does not indicate whether a notice or other protected act should be considered absolutely privileged under CC §47(b) as a "judicial proceeding" or an "official proceeding authorized by law" or a "communication, without malice," to an interested person and therefore qualifiedly privileged under CC §47(c). Compare *Garretson v Post* (2007) 156 CA4th 1508, 68 CR3d 230 (applying absolute privilege), with *Kachlon v Markowitz* (2008) 168 CA4th 316, 85 CR3d 532 (applying qualified privilege in action for slander of title against foreclosing trustee). For discussion of slander of title actions generally, see California Real Property Remedies and Damages, chap 9 (2d ed Cal CEB 2002) and California Title Insurance Practice §11.49 (2d ed Cal CEB 1997). Civil Code §2924 provides the trust deed trustee with some insulation against liability for acts taken in good faith pursuant to the statutory scheme and in good faith reliance on information provided by the trust deed beneficiary. CC §2924(b).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.48 D. Special Notice for Unruh Act Deeds of Trust

§2.48 D. Special Notice for Unruh Act Deeds of Trust

An additional notice must be given when a foreclosure involves a mortgage or deed of trust containing a power of sale that (1) is secured by real property containing a single-family, owner-occupied residence and (2) secures an obligation in a contract for goods or services under the Unruh Act (CC §§1801-1812.20). CC §2924f(c)(1). This situation arises infrequently because CC §1804.3(b) prohibits real property security in many Unruh Act transactions.

If the default of an obligation secured by such an instrument has not been cured within 30 days after recordation of the notice of default (see §2.42), the trustee or beneficiary must mail the Unruh Act notice to the trustor or mortgagor at its last known address. CC §2924f(c)(3). See form in §2.132. The Unruh Act notice should be sent by registered or certified mail to provide proof that the notice was given. On trustee sale procedures peculiar to contracts regulated by Unruh Act, see §2.97.

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§2.49 E. Special Notice and Meet-and-Confer Requirements in Residential Nonjudicial Foreclosures

Concerned about the increase in foreclosures due to the proliferation of unsustainable residential mortgage loans, the California legislature enacted urgency legislation on July 8, 2008, effective on enactment through the end of 2012. Stats 2008, ch 69, §§1-10 (SB 1137), amended by Stats 2009, ch 43 (SB 306). (Some parts of the legislation did not become operative until 60 days after the effective date. See Stats 2008, ch 69, §10. But all provisions are scheduled to sunset by January 1, 2013, unless extended.)

Civil Code §2923.5, effective September 8, 2008, requires notice and, when possible, a dialogue between a secured lender and its homeowner borrower to explore alternatives to foreclosure before the lender commences a nonjudicial foreclosure process by sending a notice of default. This section applies only to owner-occupied residential property with no more than four dwelling units securing loans made between January 1, 2003, and December 31, 2007. It precludes the filing of a notice of default until 30 days after the lender has contacted the borrower or 30 days after the lender has satisfied specified "due diligence" requirements in attempting to contact the borrower. This section further specifies a declaration concerning contact and due diligence in the notice of default or notice of sale. See §§2.37-2.38, 2.63.

Under CC §2923.5(h), subdivisions (a), (c), and (g) do not apply if any of the following has occurred:

(1) The borrower surrendered the property by either a letter confirming the surrender or delivery of the keys to the property to the trustee, beneficiary, or an authorized agent.

(2) The borrower has entered into a contract "with an organization, person, or entity whose primary business is advising people who have decided to leave their homes on how to extend the foreclosure process and avoid their contractual obligations to mortgagees or beneficiaries."

(3) The borrower has filed a petition for relief in the bankruptcy court, "and the bankruptcy court has not entered an order closing or dismissing the bankruptcy case, or granting relief from a stay of foreclosure."

While not mandating any specific forms of loan workout, CC §2923.6(a) attempts to encourage loan restructuring by declaring in effect that (1) loan modifications and workouts with borrowers are in the best interests of all beneficiary members of a loan pool (or all investors in a pooling and servicing agreement) when anticipated recovery under the modification or workout plan is greater than the anticipated recovery through foreclosure and (2) loan servicers may act accordingly and in the general interest of the pool or investors without breaching their duties as loan servicers. Under CC §2923.6(b), the legislature declared its intent that the beneficiary or its authorized agent "offer the borrower a loan modification or workout plan if such a modification or plan is consistent with its contractual or other authority." This section applies to all California secured loans. See §10.8. On loan workouts, including strategies for residential workouts and commercial workout forms, see chap 10. On lender liability in workout process, see chap 10; §§12.128-12.137.

Civil Code §2924.8, effective September 8, 2008, requires the posting and first-class mailing of an additional notice when posting and mailing the notice of sale for residential property if the billing address for the note is different from the property address. The additional notice is designed to communicate the urgency and gravity of the foreclosure to residential tenants. See §§2.63, 2.65, 2.68, 2.133.

In an effort to reduce the "foreclosure blight" that has attended the mortgage crisis, CC §2929.3 requires those who acquire residential property at foreclosure to maintain the physical exterior and to remedy property conditions that threaten public health and safety on pain of substantial civil fines. Unless a 90-day notice applies (see 12 USC §5220, cited in §7.75A), landlords must provide tenants and subtenants of foreclosed residential property 60 days' written notice to quit before filing an eviction action. CCP §1161b. See California Eviction Defense Manual, chaps 7, 20 (2d ed Cal CEB 1993).

For further discussion of SB 1137, see §§7.38-7.39, 7.62, 10.7-10.8.

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§2.50 F. Effect of Failure to Serve Notice of Default

The trustee's failure to notify a party who is entitled to notice may void the sale. See, *e.g., Estate of Yates v West End Fin. Corp.* (1994) 25 CA4th 511, 32 CR2d 53. Recitals of regularity (see §§2.134, 7.61-7.63) in the trustee's deed may overcome this defect if the buyer at the trustee sale is a bona fide purchaser and the party omitted from service of notice is someone other than the trustor. See *Little v CFS Serv. Corp.* (1987) 188 CA3d 1354, 1359 n1, 233 CR 923. See also *Garfinkle v Superior Court* (1978) 21 C3d 268, 146 CR 208. Lack of formal notice should not invalidate the sale if the requesting party nevertheless receives actual notice. *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826.

When no notice of default is given to a party who is entitled to it and who holds a significant interest in the property, the omission may be analogous to a failure to effect service of process on an equivalent party in a judicial foreclosure proceeding. See *Garfinkle v Superior Court, supra,* also cited in §§2.20, 2.46. Thus, failure to give notice to a trustor probably voids the sale entirely (*Goodenow v Ewer* (1860) 16 C 461), but failure to notify a requesting junior might result in a sale that either leaves the junior lien intact or creates a liability in damages to the junior (*Carpentier v Brenham* (1870) 40 C 221). The trustee incurs no liability for failing to send a notice of default or sale to the trustor's latest physical address unless the trustee has actual knowledge of the address. CC §2924b(b)(3). See §2.46. For special rules on consequences of not giving notice of sale to taxing authorities holding liens on the property, see §2.31.

To ensure that all entitled parties have notice, most trustees ask the beneficiary to authorize the purchase of a trustee sale guaranty (TSG) from a title company, which lists all parties entitled to receive the notice (see §2.34; California Title Insurance Practice §§9.6-9.8 (2d ed Cal CEB 1997)). If a TSG is obtained, careful attention should be given to the information contained in it. At least one California court has held that information contained in the TSG expands the universe of those entitled to receive notice under CC §2924b(b)-(c). See *Estate of Yates v West End Fin. Corp.* (1994) 25 CA4th 511, 521, 32 CR2d 53. This treatment of TSGs as a source of notice and information is in considerable tension with the theory, not yet fully accepted, that TSGs are merely a specialized form of title insurance policy and therefore, strictly speaking, pure indemnity contracts rather than sources of information. See Title Ins §§9.6-9.8.

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IV. LOAN REINSTATEMENT RIGHTS

§2.51 A. "Reinstatement" Defined

Civil Code §2924 provides that at least 3 months must pass after the filing of the notice of default before the creditor may take the next step toward a foreclosure sale. This 3-month period is not merely a moratorium that gives the trustor 3 extra months of possession; it is also a grace period during which the trustor may cure the default by belated performance, if the default is curable. (The practice of calling this 3-month period the "reinstatement period" arose when reinstatement was permitted only during these 3 months. Although the reinstatement opportunity has been extended by statute to a date 5 days before the sale (see §2.53), the old terminology for this 3-month period has persisted.)

Most secured notes are installment notes containing an acceleration clause (see §8.2). The entire debt may be declared due because of the missed payment. During the reinstatement period, by virtue of CC §2924c, the trustor may reinstate any installment obligation accelerated by the beneficiary due to a default by (1) paying the missed installments and allowable costs and (2) curing other defaults as required under the deed of trust and permitted by statute (see §§2.57-2.61). Reinstatement is thus different from redemption in that it does not require that the entire loan be paid off and merely restores the loan to its original installment status. See *Magnus v Morrison* (1949) 93 CA2d 1, 208 P2d 407. The debtor's statutory reinstatement right is therefore an essential shield against the contractual sword of acceleration.

WARNING: Not all defaults are curable or subject to reinstatement. Reinstatement is nothing more than a reversal of the loan's acceleration and for this reason could accurately be called "de-acceleration." If the loan is fully due without the need for acceleration, then reinstatement is not a possibility. For example, a sale of the property in violation of a due-on-transfer clause (see §§8.8-8.19) probably cannot be cured. Also, if the loan is in default for failure to pay a balance due at maturity (*e.g.,* a "balloon" payment), there is no right of reinstatement. In such cases, complete redemption is the only available alternative (see §2.73).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.52 B. Persons Entitled to Reinstate Loan

§2.52 B. Persons Entitled to Reinstate Loan

Under CC §2924c(a)(1), reinstatement is a remedy available to the following:

- The trustor;
- The trustor's successors; and
- Anyone holding a subordinate lien or encumbrance of record on the property (see discussion of junior reinstatement strategies in §§2.5, 2.102-2.104, 6.63, 8.79).

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C. Time Period for Reinstatement

§2.53 1. Up to 5 Business Days Before Sale

Under CC §2924c(e), entitled persons (see §2.52) may reinstate the debt until 5 business days before the date of sale set forth in the notice of sale. Under §2924c(e) and CC §9, business days include Saturdays. Therefore, between the giving of the notice of default and the actual sale, such persons have a total of 105 days in which to reinstate the debt, depending on how quickly the notice of sale is given (see §2.62). On extending reinstatement period, see Practice Tip directed to borrower in §2.59; see also §§2.54-2.56, 2.89.

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2. Extension or Revival of Reinstatement Period

§2.54 a. Sale Postponed

If the sale is postponed to a date more than 5 business days beyond the scheduled sale date, the reinstatement period is automatically extended, but there is no right to reinstatement during the final 5 days before the renoticed sale. CC §2924c(e).

EXAMPLE: A sale may be serially postponed for successive periods of less than 5 days in order to avoid reviving expired reinstatement rights. *Hicks v E.T. Legg & Assocs.* (2001) 89 CA4th 496, 108 CR2d 10. In *Hicks*, the sale was postponed 25 times for successive periods of 5 days or less over a 4-month period.

If the sale does not occur on the date stated in the initially recorded notice of sale and a subsequent recorded notice of sale is required to be given, the right of reinstatement is revived as of the date of recordation of the subsequent notice and continues from that date until 5 business days before the new sale date. On need for subsequent notice of sale, see §§2.91-2.94.

Precise calculation of the expiration of the reinstatement period has yet to be determined by case law and can cause dilemmas for trustees, *e.g.,* when reinstatement is offered on the fifth business day before the sale. Dicta in *Hicks* suggests that the final day to reinstate is actually the sixth business day. 89 CA4th at 507.

On postponement of trustee sale generally, see §§2.88-2.96. On effect of postponement on reinstatement right, see §2.89.

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§2.55 b. Sale Enjoined or Challenged

Courts are likely to suspend or extend the reinstatement period well past the sale date when the trustor has filed an action challenging the validity of the foreclosure sale. See chap 7. In *Bisno v Sax* (1959) 175 CA2d 714, 346 P2d 814, the trustors filed an action to enjoin the sale after the statutory period (the former reinstatement period before the 1985 amendments to CC §2924c that extended the period to 5 days before the date of sale) and cured their existing defaults while the injunction was in effect and the case was awaiting trial (7 months later). This late reinstatement was held to be sufficient reason to set aside the sale as improper. In *Hunt v Smyth* (1972) 25 CA3d 807, 101 CR 4, the trustors sought an injunction on the 77th day of the notice period, but it was not until more than 2 years later that an appellate court ruled against them and then gave them their remaining 13 days to reinstate. Trustors who have precipitately enjoined foreclosure sales, however, may have exposed themselves to significant damage liability. See *Surety Sav. & Loan Ass'n v National Auto. & Cas. Ins. Co.* (1970) 8 CA3d 752, 87 CR 572, further discussed in §§7.55, 10.64.

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§2.56 c. Extension by Agreement

The period during which reinstatement may occur can also be extended by contract made between the borrower and the secured creditor. *Bank of America, N.A. v La Jolla Group II* (2005) 129 CA4th 706, 28 CR3d 825 (trustee had no power to conduct trustee sale or to provide good title to third party bidder at putative sale following trustor's and beneficiary's agreement to cure default and reinstate loan). On rights of successful third party bidder, see *Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413 (trustee sale held valid when trustor did not comply with terms of repayment agreement, bona fide purchaser had no knowledge of agreement, and no fraud or imposition occurred), discussed in §§7.60, 7.63, 7.65-7.66.

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§2.57 D. Reinstatement Procedure; Payments

Reinstatement is effected under CC §2924c(a) by (1) tendering to the beneficiary the amount stated in the notice of default plus reasonable costs and expenses under CC §2924c(c) and trustee or attorney fees under CC §2924c(d) (see §2.59) and (2) offering to cure additional defaults such as recurring obligations (see §2.58) and defaults occurring or discovered after the notice of default (see §2.40). Under CC §2924c(a)(2), if a trustor reinstates, the beneficiary is required to have the trustee record a rescission of the notice of default.

If reinstatement is tendered under CC §1500, the amount tendered should be deposited into a bank account in the trustee's or beneficiary's name. *Hicks v E.T. Legg & Assocs.* (2001) 89 CA4th 496, 108 CR2d 10. On the use of CC §1500, see Warning in §7.25 and Practice Tip in §7.41.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.58 1. Recurring Obligations

§2.58 1. Recurring Obligations

Under CC §2924c(a)(1), a trustor endeavoring to reinstate is required to cure all delinquent "recurring obligations" as well as the specific defaults listed on the notice of default. These include defaults on the secured obligation, senior liens, property taxes, or hazard insurance that occur after the notice of default. The reinstatement requirement is disclosed to the trustor in the Important Notice (introductory) provisions of the notice of default. See CC §2924c(b)(1) and form notice in §2.130.

When the beneficiary has advanced these sums, reinstatement requires reimbursement by the trustor. If no one has cured delinquencies on the recurring obligations, CC §2924c(a)(1) requires the trustor to pay the obligation and furnish the beneficiary written evidence of payment in order to reinstate.

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§2.59 2. Reinstatement of Trustee's and Attorney Expenses

The beneficiary may also require that the trustor pay the trustee's properly incurred expenses, including the costs of recordation, mailing, publishing, and posting notices required by CC §§2924-2924j, the costs of postponement under CC §2924g (not to exceed $50 per postponement), and the fee for a trustee sale guaranty or, in a judicial foreclosure, a litigation guaranty. CC §2924c(c). See §§2.34, 3.21 on trustee sale and litigation guaranties.

In addition, trustee or attorney fees may be charged in an amount determined by the unpaid principal balance, as follows (CC §§2924c(d), 2924d(a)):

Unpaid Principal	Base Fee Before Mailing Notice of Sale	Base Fee After Mailing Notice of Sale	Plus Cumulative Percentage of Unpaid Principal*
$150,000 or less	$300	$425	0.5% of the amount exceeding $50,000 up to $150,000
More than $150,000 to $500,000	$250	$360	0.25% of the amount exceeding $150,000 up to $500,000
More than $500,000	$250	$360	0.125% of the amount exceeding $500,000

*Percentages in column 4 are cumulative and double after mailing of notice of sale. CC §§2924c(d), 2924d(a).

See also *Sweatt v Foreclosure Co.* (1985) 166 CA3d 273, 212 CR 350. The statutory limitations may not apply to attorney fees that the beneficiary may be entitled to recover under the deed of trust. *Buck v Barb* (1983) 147 CA3d 920, 195 CR 461 (see §§3.53, 8.84). For example, the beneficiary may incur attorney fees to obtain relief from a bankruptcy automatic stay or to litigate issues in bankruptcy court (see §§7.87, 11.94).

PRACTICE TIP: Lender: If the contractual provisions of the note or deed of trust permit, the lender should add to the delinquent amount any attorney fees actually incurred in its collection efforts and demand payment for them. The nominal sums allowed by statute are usually insufficient to make the lender whole.

PRACTICE TIP: Borrower: Civil Code §2924c(d) is one of the few provisions in the nonjudicial foreclosure law (CC §§2924-2924*l*) that mentions judicial foreclosure. It may provide the borrower with two arguments if the creditor is "dual tracking" (*i.e.,* concurrently pursuing both nonjudicial and judicial foreclosure). The language that refers to "[t]rustee's or attorney's fees" in the disjunctive may support the argument that the creditor cannot recover both. It also provides for payment of limited attorney or trustee fees to reinstate the debt more than 5 days before the trustee sale or "otherwise at any time prior to the decree of foreclosure." This provision may support a debtor's claim of right to pay the fees after the 5-day limit if both a trustee sale and judicial foreclosure are pending, thus creating a disadvantage, from the lender's perspective, to the practice of dual tracking. Even more aggressively, the debtor may argue that this language extends the reinstatement period past the 5-day limit in dual tracking cases because it is uncertain whether the lender will opt for a trustee sale or judicial foreclosure during that period.

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§2.60 3. Rejection of Tendered Reinstatement

If the proper reinstatement amount is tendered, it is improper for the trustee or beneficiary to reject it and proceed with the foreclosure sale. *Munger v Moore* (1970) 11 CA3d 1, 89 CR 323. The trustor must, however, unambiguously and unconditionally tender the entire amount due; the beneficiary is not obligated to go through its receipts and total up various partial payments to ascertain whether the proper amount was tendered. *Gaffney v Downey Sav. & Loan Ass'n* (1988) 200 CA3d 1154, 246 CR 421. Rejection of a proper tender of reinstatement does not cancel the debt, but it does destroy the right to foreclose based on the asserted default (*Magnus v Morrison* (1949) 93 CA2d 1, 208 P2d 407), and a proper tender of the full redemption amount (the total debt) probably works a redemption under CC §2905. Conversely, when the creditor voluntarily accepts an untimely reinstatement, this too may obviate the power to conduct a valid foreclosure sale. *Gaines v Washington Mut.* (Nov. 21, 2003, H024589; not certified for publication) 2003 WL 22790810. For further discussion, see chaps 7-8.

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§2.61 4. Rents and Profits; Partial Payments

When the beneficiary exercises its rights under a rents-and-profits clause in the deed of trust by collecting the rents during the default period or having a receiver appointed to collect the rents, the collected funds may be sufficient to effect an inadvertent reinstatement of the loan, which may entitle the trustor to have the receivership terminated. CC §2938(e). See §6.45. Many institutional deeds of trust, however, specifically provide that collection of rents does not cure the default. See *e.g.,* California Real Estate Finance Practice: Strategies and Forms §4.73 (Cal CEB 2000). Whether such a provision is valid is an open question.

Partial payments made during the reinstatement period do not effect a reinstatement or extend the reinstatement period. *Sellman v Crosby* (1937) 20 CA2d 562, 67 P2d 706.

EXAMPLE: A trustor who owes $200 every month and who misses January's payment must tender the full $400 in February (plus costs and trustee or attorney fees) or $600 in March or $800 in April to reinstate. A tender of $100 in February or $700 in April will do nothing to postpone or defeat the sale.

Creditors' attorneys usually advise their clients not to accept partial payments unless the debtor has been clearly advised in writing that partial payments will not waive the default. Otherwise, acceptance of a partial payment leaves a creditor open to claims of waiver, estoppel, or "lulling" on the basis of the trustor's contention that it would not have paid but for the beneficiary's agreement to delay or stop the sale. See *Tully v World Sav. & Loan Ass'n* (1997) 56 CA4th 654, 65 CR2d 545. Courts tend to view with some skepticism a beneficiary who accepts the trustor's partial payments and continues with the foreclosure sale. See *Altman v McCollum* (1951) 107 CA2d Supp 847, 236 P2d 914. In *Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413, the court distinguished *Tully* and upheld a trustee sale following acceptance of partial payment.

For discussion of trustor actions challenging foreclosure sales, see chap 7; on damages for improper actions by trustee, see §§2.26, 7.70. See also *Baypoint Mortgage Corp. v Crest Premium Real Estate Inv. Retirement Trust* (1985) 168 CA3d 818, 214 CR 531.

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V. NOTICE OF SALE

A. Timing Notice of Sale

§2.62 1. Notice Period Under CC §2924

After expiration of 3 months from the date on which the notice of default was recorded (see §2.42), if the trustor (or a junior lienholder) has not exercised the right to reinstate the obligation (see §2.51), the trustee may give notice of sale. CC §2924. (Note that this is no longer the end of the true "reinstatement period," because the trustor still has until 5 business days before the sale date to reinstate the obligation (see §2.53).) The sale notice must be given at least 20 days before the date set for sale of the property. CC §2924f(b). Thus, a trustee sale requires a total of 3 months (after recordation of the notice of default) plus 20 days (given by the notice of sale), assuming that there are no delays and that everything is done at the first opportunity. In practice, the minimum time is often increased by another 11 days to comply with federal tax lien notice requirements (see §2.31).

WARNING: For a narrow class of loans, the 3-month period between the notice of default and the notice of sale was temporarily extended by state law. See §§2.62A-2.62C.

Trustees frequently allow even more time than required when giving a notice of sale. On trustee's ability to postpone sale, see §2.88. Although a defaulting trustor usually benefits if the foreclosure process advances more slowly than required, attacking the sale may be difficult if the beneficiary or trustee has given generous time allowances. *Arata v Downer* (1937) 21 CA2d 406, 69 P2d 213. However, attorneys whose lender clients wish to adopt a generous approach should be aware of authorities that impose either estoppel or a "lulling" analysis to invalidate trustee sales when the creditor moves from a lax approach to a stricter approach without advance notice. See, *e.g.*, *Lupertino v Carbahal* (1973) 35 CA3d 742, 111 CR 112; *Lopez v Bell* (1962) 207 CA2d 394, 24 CR 626.

If a new trustee is substituted after notice of sale has been given, a new 20-day notice of sale must be given after the substitution is executed, and it must contain the name, street address, and telephone number of the substituted trustee; otherwise, the sale is void. CC §2934a(e). Consequently, any substitution of trustees (see §§2.21-2.26) is best made before starting the foreclosure process.

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2. Effect of ABX2 7 on Notice Period

§2.62A a. 90-Day Extension of Foreclosure Date

For a relatively limited class of residential loans, the California Foreclosure Prevention Act (CFPA) (CC §§2924, 2923.52-2923.55) imposes an additional 90-day waiting period following the usual 3-month mandatory waiting period (see §2.62) that follows the recordation of a notice of default and before a notice of sale issues.

The CFPA was enacted in February 2009 as an emergency measure at a second 2008-2009 legislative session as ABX2 7. See Stats 2008, 2d Extra Sess, ch 5. (Note that SBX2 7, an identical bill, was also enacted; see Stats 2008, 2d Extra Sess, ch 4.) While the provisions of the CFPA are moderate, limited, and self-terminating, the legislative findings made in support of the legislation included strongly worded statements about "skyrocketing" residential foreclosure rates; a "destabilized" housing market; a "glut" of foreclosed properties already on the market; and the deleterious effects of these circumstances on the economic health of the state. CFPA §2.

The CFPA added Section 2923.52 to the Civil Code. Under CC §2923.52(a)(1)-(4), the additional 90-day period applies only to loans meeting this criteria:

- The loan must be secured by a trust deed or mortgage recorded during the period of January 1, 2003, to January 1, 2008;
- The loan must be secured by a first priority mortgage or trust deed on property that the borrower occupied as the borrower's principal residence at the time the loan became delinquent; and
- A notice of default must have been recorded against the security for the loan.

Under CC §2923.52(d), the Act did not become operative until 14 days after the issuance of regulations providing for the creation of a loan modification program. That operative date arrived on or around June 15, 2009. The regulations required by §2923.52(d) were adopted by the California Corporations Commissioner on June 1, 2009, in Subchapter 14 added to Chapter 3, Title 10 of the California Code of Regulations (online at http://www.corp.ca.gov/OLP/pdf/rm/0509-FEO.pdf). The legislation sunsets on January 1, 2011, unless extended.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.62B b. Lender Exemptions

§2.62B b. Lender Exemptions

The regulations adopted under ABX2 7 (see §2.62A) are legislatively required to contain a form of application by lenders and loan servicers for exemption from the extended foreclosure period based on the creation of a qualified modification program. State regulators must grant such an exemption if the lender establishes a loan modification program that meets a satisfactory combination of specified features. Consumer information and lists of mortgage loan servicers who have been granted an exemption are online at http://www.corp.ca.gov/FSD/CFP/default.asp. Significantly, ABX2 7 does not require the lender to actually grant a loan modification to anyone in order to be exempt from the additional 90-day period, but only to put a qualified program in place.

Under CC §2923.53(a), to qualify for the exemption, the lender must adopt a program that has the following features:

- It must be intended to keep the borrower in the home when the lender's net recovery under the workout plan exceeds the anticipated recovery through foreclosure on a net present value basis. CC §2923.53(a)(1).
- It must target a ratio of the borrower's housing-related debt to gross income of 38 percent or less. (This is considerably higher than the 31 percent targeted by the federal Homeowner Affordability and Stability Plan.) CC §2923.53(a)(2).
- It must include "some combination" of interest rate reduction for a fixed term of at least 5 years; an extension of the amortization period to no more than 40 years from the loan's date of origin; deferral of "some portion" of principal to the loan maturity date; reduction of principal; compliance with a federally mandated loan modification program; and other factors deemed appropriate by the Commissioner of Corporations (with due regard to successful programs in other jurisdictions). CC §2923.53(a)(3)(A)-(F).

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§2.62C c. Public Policy Issues

The stated purpose for the added 90-day delay (see §2.62A) is to "provide additional time for borrowers to work out loan modifications while providing an exemption for mortgage loan servicers that have implemented a comprehensive loan modification program." CFPA §2. The alert practitioner will see the CFPA as providing opportunity for successful advocacy for distressed homeowners in a loan workout context in which there was previously no structure and no guidance.

While the Act adds more time to the trustee sale process, it does not require that any lender actually work out or modify any loan with any borrower. It appears that the legislative strategy underpinning the CFPA is to add an additional impediment to the nonjudicial foreclosure of loans in the covered class in the hope that the promise of removing that impediment will create a sufficient incentive for lenders to create comprehensive loan workout programs.

NOTE: Counsel for borrowers attempting to negotiate workouts, short sales, deeds in lieu, and other resolutions of defaulted residential secured loans are discovering that even if a lender creates a loan modification program and infrastructure, this does not necessarily mean that workouts will become easier or more available. But ABX2 7 has in its lender exemption provisions (see §2.62B) specific concepts for residential loan workouts that could be an integral part of workouts for a large class of exempt lenders. On workout strategies based on these concepts, see §§10.8A, 10.8D.

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§2.63 B. Contents of Notice of Sale

The contents of the notice of sale are prescribed by CC §2924f(b)(1). A notice of sale must contain the warning specified by CC §2924f(c)(3) in capital letters at the beginning of the notice (see first form in §2.133). The notice must do the following:

- Describe the property to be sold, including the assessor's parcel number and the street address or other common designation, if any;
- State the time of the sale;
- State the street address of the sale and the specific location at the address where the sale will be held;
- State the name, street address in California, and telephone number (either toll free or California number) of the trustee or the person conducting the sale;
- State the total amount of the unpaid balance, the reasonably estimated costs, expenses, and advances "at the time of the initial publication of the notice of sale";
- State the name of the original trustor; and
- If applicable, state whether the notice is a republication following cancellation by the next-highest bidder of an instrument given to the trustee as a cash equivalent under CC §2924h(d) (see §2.101).

If the property has no street address or other common designation, the notice must state the name and address of the beneficiary and state that directions for locating the property may be obtained from the beneficiary as stated in the notice. An error or omission in the street address or common designation, or in the directions, does not affect the validity of the notice if it includes the legal description or assessor's parcel number. Furthermore, neither an inaccurate statement of the reinstatement figure nor the failure to post the notice of sale on a door as required will "affect the validity of any sale to a bona fide purchaser for value." CC §2924f(b)(1).

Effective September 8, 2008, to January 1, 2013, for owner-occupied residences securing loans made between January 1, 2003, and December 31, 2007, the notice of default (see §2.37) must include a declaration from the beneficiary or authorized agent regarding meet-and-confer contact with the borrower as mandated by CC §2923.5. See Notes in §§2.37-2.38. However, if the notice of default had already been recorded before the effective date in §2923.5, then the notice of sale must include a declaration about contact with the borrower as prescribed in CC §2923.5(c). See exceptions and summary of related requirements in §2.49. See also declaration at end of first form in §2.133.

Effective September 8, 2008, to January 1, 2013, CC §2924.8 requires a special notice of sale for tenants of property in foreclosure if the billing address for the note is different from the property address. When mailing and posting a notice of sale under CC §§2924b and 2924f, the trustee or an authorized agent must also prepare a special notice in English and the languages described in CC §1632 that includes the form in CC §2924.8(a). See second form in §2.133. The trustee or agent must post the notice on the property and serve it by first-class mail concurrently with the notice of sale in an envelope addressed to "Resident of property subject to foreclosure sale."

Although failure to comply with service and time requirements for the notice of sale may render the sale defective (see §§2.69-2.71), minor defects in the wording of the notice will usually not render the notice invalid. See *Williams v Koenig* (1934) 219 C 656, 28 P2d 351; *Savings & Loan Soc'y v Burnett* (1895) 106 C 514, 39 P 922.

For a form notice of sale, see §2.133. For the notice issued by a levying officer in connection with an execution sale or judicial foreclosure under CCP §701.540, see §§3.73, 3.106.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.64 C. Recording, Publishing, and Mailing Notice

§2.64 C. Recording, Publishing, and Mailing Notice

The requirements for distributing the notice of sale differ from those for the notice of default (see §§2.42-2.46). The trustee, beneficiary, or other person authorized to record the notice, such as "an agent for the mortgagee or beneficiary, an agent of the named trustee, any person designated in an executed substitution of trustee, or an agent of that substituted trustee" (see CC §2924b(b)(4)) must:

- Serve the notice of sale at least 20 days before the sale (see §2.65) and record it at least 20 days before the sale (CC §§2924b(b)(2), 2924f(b); see §2.66); in contrast, the trustee records a notice of default as the first step in the trustee sale process (CC §2924b(b)(1));
- Publish the notice of sale (in addition to mailing) (CC §2924f(b); see §2.67); in contrast, the trustee publishes a notice of default only if the trustor has not requested notice (CC §2924b(d)); and
- Post the notice of sale both in a public place and on the property (CC §2924f(b); see §2.68); if the property is a single-family residence, the notice of sale must be posted on a door of the residence, or if this is not possible, in a conspicuous place on the property (CC §2924f(b)); in contrast, the trustee need not post a notice of default unless the deed of trust lacks a mailing address for the trustor (see §2.43).

A sale notice can be "premature." See, *e.g.*, *Knapp v Doherty* (2004) 123 CA4th 76, 20 CR3d 1 (finding notice was served prematurely, but declining to set aside sale in absence of prejudice to trustor).

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§2.65 1. Serving Notice of Sale

At least 20 days before the date of sale, the notice of sale must be mailed by registered or certified mail to everyone who is entitled to receive a notice of default (see §2.43). See CC §2924b(b)-(c). The notice must also be mailed to the trustor or mortgagor by first-class mail in addition to the notice by registered or certified mail, and the trustee or beneficiary must execute and retain an affidavit of the mailing. CC §2924b(e). On giving special notice to taxing entities having liens on the property, see §2.31.

Under CC §2924.8, effective September 8, 2008, to January 1, 2013, on the mailing and posting of a notice of sale under CC §§2924b and 2924f, the trustee or authorized agent must also post and mail concurrently with the mailing of the notice of sale a special notice if the property is residential and the billing address for the note is different from the property address. The special notice must (1) conform to CC §2924.8(a) (see second form in §2.133), (2) be prepared in English and the languages described in CC §1632, (3) be posted on the property in foreclosure, and (4) be served by first-class mail on persons living in the property in an envelope addressed to "Resident of property subject to foreclosure sale." See §2.49.

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§2.66 2. Recording Notice of Sale

The notice of sale must be recorded at least 20 days before the sale. CC §2924f(b). The trustee has usually conducted a record search or purchased a trustee sale guaranty in conjunction with the notice of default to ascertain the persons entitled to receive notice (see §2.34), but it need not search a second time for persons who acquired their interests in the property after the notice of default was recorded. Such latecomers must rely on posted or published notices of sale. See also Warning in §2.6.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.67 3. Publishing Notice of Sale

§2.67 3. Publishing Notice of Sale

Under CC §2924f(a)-(b)(1), the notice of sale must be published once a week for 3 consecutive calendar weeks (Monday through Saturday), with the first publication to occur at least 20 days before the sale.

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§2.68 4. Posting Notice of Sale

The requirements that copies of the notice be posted both on the property in a conspicuous place and in a public place in the appropriate city or judicial district of sale, and be published in a newspaper of general circulation (CC §2924f(b)), are designed to afford wide dissemination of the notice to potential bidders, as well as notice to interested parties including those in possession. Difficulties arise in meeting the posting requirements when the property consists of multiple lots, but the trustee is not required to post each lot separately. *Py v Pleitner* (1945) 70 CA2d 576, 161 P2d 393; *Peterson v Corporation of Am.* (1937) 21 CA2d 527, 69 P2d 904; *Security-First Nat'l Bank v De La Cuesta* (1936) 15 CA2d 302, 59 P2d 542. Separate postings are usually made only when the lots are noncontiguous. The courthouse or city hall is the usual locale for the public posting. See *McCabe v Willard* (1931) 119 CA 122, 6 P2d 258. The requirement is that the notice be posted, not that it be kept posted; testimony of an initial posting is sufficient. *Hotchkiss v Darling* (1933) 130 CA 625, 20 P2d 343.

Under CC §2924.8, effective September 8, 2008, to January 1, 2013, on the mailing and posting of a notice of sale under CC §§2924b and 2924f, the trustee or authorized agent must also mail and post a special notice if the property is residential and the billing address for the note is different from the property address. The notice must (1) conform to CC §2924.8(a) (see second form in §2.133), (2) be prepared in English and the languages described in CC §1632, (3) be posted on the property in foreclosure, and (4) be served by first-class mail on persons living in the property. See §2.63.

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§2.69 D. Effect of Noncompliance With Notice Statute

A sale that does not comply with the notice requirements is probably void (*United Bank & Trust Co. v Brown* (1928) 203 C 359, 264 P 482), although the trustor's attendance (and bidding) may cure some defects (see *Stevens v Plumas Eureka Annex Mining Co.* (1935) 2 C2d 493, 41 P2d 927).

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§2.70 1. Lack of Adequate Time

A sale should be postponed or vacated if the notice of sale did not allow the required 20-day time period before the sale and the 3-month period after the recordation of the notice of default (see §§2.42, 2.62). See *Mack v Golino* (1950) 95 CA2d 731, 213 P2d 760 (2-month postponement at trustor's request). Cancellation or postponement may be done without subjecting the trustee or beneficiary to liability because the trustor is not entitled to demand that the property be sold on foreclosure at any particular time. *Scott v Security Title Ins. & Guar. Co.* (1937) 9 C2d 606, 72 P2d 143.

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§2.71 2. Lack of Actual Receipt of Notice

As with the notice of default, a properly noticed sale is valid whether or not the trustor has received actual knowledge of it. *Sargent v Shumaker* (1924) 193 C 122, 223 P 464. See §2.46. Strict compliance with statutory requirements is all that is required. *Lopez v Bell* (1962) 207 CA2d 394, 24 CR 626. The notice must comply with the statute in effect at the time of the sale, not the one in force at the time the deed of trust was executed, even if the deed of trust incorporates the earlier statutory requirements. *United Bank & Trust Co. v Brown* (1928) 203 C 359, 264 P 482.

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§2.72 E. Reinstatement After Notice of Sale

The statutory right to reinstate (see §§2.51-2.61) continues until 5 business days before the date of the foreclosure sale. CC §2924c(e); see §2.53. Reinstatement is possible even within the final 5 days before the sale if the beneficiary is willing, because the notice of sale may be vacated by agreement at any time. If the beneficiary does not agree, the debtor's sole right after expiration of the reinstatement period is either to file a bankruptcy (see chap 11) or redeem the property under CC §§2903 and 2905 (see §2.73). See also Practice Tip in §2.59 on borrower's potential use of CC §2924c(d) to extend reinstatement period.

If terms in the deed of trust give the trustor more generous reinstatement rights, those contractual terms will control. More liberal provisions are often required for loans that are to be sold on the federal secondary mortgage market, such as the provisions in the Federal National Mortgage Association's and Federal Home Loan Mortgage Corporation's uniform deed of trust. See also §2.39.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.73 VI. REDEMPTION

§2.73 VI. REDEMPTION

A defaulting trustor has the right to redeem the property by paying the debt before the foreclosure sale. CC §§2903-2906. At common law, this right was called the mortgagor's equity of redemption. (On common law equity of redemption, see §1.33.) To redeem, the trustor must pay the entire debt plus interest and costs, not just the past arrearages. CC §2905; *Wadleigh v Phelps* (1906) 149 C 627, 645, 87 P 93; *Randall v Duff* (1894) 101 C 82, 88, 35 P 440. The term "foreclosure" refers to the foreclosing or final cutting off of this equity or right of redemption by some act prescribed or permitted by law. Historically, the redemption right could be cut off by way of a simple decree or announcement—a process called "strict foreclosure." In modern California foreclosure practice, however, the final act cutting off the redemption right is the commencement of bidding at the foreclosure auction, hence the phrase "foreclosure by sale."

WARNING: Many courts strictly construe the equity of redemption statute (CC §2905) and the law governing performance or tender of payment (CC §§1473, 1485). See, *e.g., Nguyen v Calhoun* (2003) 105 CA4th 428, 129 CR2d 436 (holding that escrow company's mailing of full payoff check on July 9, which was not received until July 13, did not extinguish debt before foreclosure sale on July 10, despite fact that beneficiary's payoff statement included Houston mailing address for sending funds). For further discussion of *Nguyen,* see comment in 26 CEB Real Prop L Rep 87 (Mar. 2003).

Redemption opportunities end when bidding at the foreclosure sale begins, and the auctioneer must then sell to the highest bidder (see CC §§2924g(a), 2924h(a)-(c), discussed in §§2.74-2.79). Thus, trustors or junior lienholders who are able to raise sufficient funds to pay off the defaulted loan (see CC §2904) should either make their redemption tenders to invoke redemption rights before the sale commences or participate as a bidder in the foreclosure process. See *Sullivan v Superior Court* (1921) 185 C 133, 195 P 1061; *Kleckner v Bank of America Nat'l Trust & Sav. Ass'n* (1950) 97 CA2d 30, 217 P2d 28. The trustee need not cancel or postpone the sale unless the full amount owed is proffered. See, *e.g., Nguyen v Calhoun, supra*; *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 92 CR 851.

The presale equity of redemption is not the same thing as postsale statutory redemption rights (see §§3.84-3.95), which apply after certain judicial foreclosure sales. Also, in contrast to a reinstatement (see §§1.33, 2.51, 2.72), if the entire debt is being paid off, the beneficiary is unconcerned with its future lien position. Thus, a redeeming trustor probably is not required to pay a third party obligation (see §§2.57-2.59), whether redeeming before or after the notice of default, even if the obligation was listed on the notice of default or if it would constitute an "other obligation" under CC §2924.

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VII. TRUSTEE SALE PROCEDURES

A. Conducting Sale

§2.74 1. Public Auction

Under CC §2924g(a), a trustee sale must be conducted by public auction in the county where all or part of the property is situated, between 9 a.m. and 5 p.m. on any business day (Monday through Friday). The sale commences when the auctioneer announces that the property is for sale and invites bids. The trustee usually acts as auctioneer, but anyone appointed by the trustee may serve as the auctioneer. *Central Sav. Bank v Lake* (1927) 201 C 438, 257 P 521. Thus, the trustee's attorney or "duly authorized agent" may conduct the sale. CC §2924a. Terms of sale are announced, and the trustee usually declares that the sale is without warranties of title. See *Brown v Busch* (1957) 152 CA2d 200, 313 P2d 19. The trustee has a duty to make reasonable efforts to make the sale fair and equitable, even to the extent of interrupting the sale to explain the bidding procedures to potential bidders. *Bank of Seoul & Trust Co. v Marcione* (1988) 198 CA3d 113, 244 CR 1; *Baron v Colonial Mortgage Serv. Co.* (1980) 111 CA3d 316, 168 CR 450. This duty, however, does not require the trustee to protect bidders from their own legal or economic errors. *Ostayan v Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 92 CR2d 577. Before beginning the bidding, the auctioneer will typically "qualify" bidders by asking them to show how much cash (typically in the form of cashier's checks) each bidder has available at the auction. Auction records showing that many prospective bidders qualified but few or only one actually made bids can be evidence of bid rigging or chilling. On bid rigging, see §2.80.

A purported sale by a former trustee who has been substituted out of that role is void and of no effect. *Dimock v Emerald Props., LLC* (2000) 81 CA4th 868, 97 CR2d 255. Reformation of the deed of trust may validate a foreclosure sale, however, when a former trustee mistakenly conducts the sale after substitution of a new trustee. See *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859. But the strictly statutory analysis adopted in *Dimock* and more recently in *Pro Value Props., Inc. v Quality Loan Serv. Corp.* (2009) 170 CA4th 579, 88 CR3d 381, casts doubt on the viability of the reformation approach adopted in *Jones*.

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§2.75 2. Order of Sale; Multiple Securities

Civil Code §2924g(b) states that when the security consists of multiple parcels, they must be sold separately and in the order designated by the trustor unless the deed of trust provides otherwise. *Humboldt Sav. Bank v McCleverty* (1911) 161 C 285, 119 P 82. Most deeds of trust permit the trustee to sell the property in a block or in the order determined by the trustee (see §§3.77, 9.4). The parcels are usually sold separately unless there is an overriding lump-sum bid for all the parcels that is greater than the total of the individual bids. A bulk sale was held invalid in *C.F. Brookside, Ltd. v Skyview Mem. Lawn Cemetery (In re Affordable Hous. Dev. Corp.)* (BAP 9th Cir 1994) 175 BR 324, in which a Chapter 11 plan effectively negated certain rights to foreclose under the deed of trust.

It is unclear whether the refusal to honor a trustor's requests concerning the order of sale jeopardizes the validity of the sale if a better price might have resulted from the trustor's proposal. Dictum in *Pacific States Sav. & Loan Co. v O'Neill* (1936) 7 C2d 596, 61 P2d 1160, appears to reject such an attack, but other courts may find different grounds for compelling the trustee to honor the trustor's demands. The result may also turn on whether the order of sale was "commercially unreasonable."

When the debtor has equity in more than one property subject to sale by the trustee but transferred the property to third parties before the sale, CC §2899 (on marshaling assets) requires that the assets be sold in the reverse order of alienation by the debtor. That is, the first property to be sold is the last alienated by the debtor (if the purchasers of that property had notice that the debtor's prior conveyance was subject to the abstracts of judgment), then the second to last property, and so on. *Commonwealth Land Title Co. v Kornbluth* (1985) 175 CA3d 518, 220 CR 774. On right of trustors and junior lienholders to require marshaling of assets under CC §§2899 and 3433, see §9.87.

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§2.76 3. Who May Bid

No party is barred from bidding, although a bid by the trustee for its own account is always suspect. *Copsey v Sacramento Bank* (1901) 133 C 659, 66 P 7. The law allows a beneficiary to bid. A contrary rule would deprive the sale of probably its best customer and bidder of last resort, and therefore lower the selling price. *Bank of America v Century Land & Water Co.* (1937) 19 CA2d 194, 65 P2d 109. Junior lienholders may also bid, and successful junior bids do not jeopardize other rights they may have under their security instruments. *Investcal Realty Corp. v Edgar H. Mueller Constr. Co.* (1966) 247 CA2d 190, 55 CR 475. See also *Pacific Loan Mgmt. Corp. v Superior Court* (1987) 196 CA3d 1485, 242 CR 547 (Small Business Administration (SBA), as junior lienholder, entitled to surplus sale proceeds over those owed to senior lienholder, even though SBA purchased property at trustee sale for less than market value). But see *Citrus State Bank v McKendrick* (1989) 215 CA3d 941, 263 CR 781 (court imposed CCP §580a's 3-month statute of limitations on purchasing junior's debt enforcement action; see §2.83 for further discussion of *Citrus*).

On bidding strategies, see §§2.80-2.87.

A partner may acquire the partnership asset at a foreclosure sale. *Jones v Wagner* (2001) 90 CA4th 466, 108 CR2d 669. Even partners of the defaulting trustor may bid at the sale. In *Jones*, partners of the trustor who provided the downpayment in the transaction were permitted to bid at the sale and did not violate their fiduciary duties in so doing.

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§2.77 4. Disclosure to Bidders

Civil Code §2924h(g) permits the auctioneer to declare that the property is being sold in an "as-is" condition. However, it is unlikely that such a declaration insulates the auctioneer or lender from liability for nondisclosure of material defects actually known to the auctioneer or lender. See, *e.g., Karoutas v HomeFed Bank* (1991) 232 CA3d 767, 283 CR 809, in which the court rejected defenses based on the exemption of foreclosure sales from the Real Estate Transfer Disclosure Statement requirements (CC §1102.2(c)) and the comprehensive nature of foreclosure regulation. Because an as-is clause is no defense against fraud in a negotiated transaction (see *Loughrin v Superior Court* (1993) 15 CA4th 1188, 19 CR2d 161; *Lingsch v Savage* (1963) 213 CA2d 729, 29 CR 201), it is unlikely that lenders or auctioneers may avoid disclosing to bidders defects that are known to them through the expedient of declaring the foreclosure sale "as is." Regarding title matters, see *Ostayan v Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 92 CR2d 577, in which the court found no actionable misrepresentation when the auctioneer warned the bidder about a possible senior encumbrance.

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§2.78 5. Bidding Procedures

Bidding at the sale is regulated by CC §2924h, which provides that each bid constitutes an irrevocable offer that is automatically canceled by a higher bid (CC §2924h(a)) or by postponement or cancellation of the sale (CC §2924h(e)). Except for bids by the foreclosing beneficiary, usually made as credit bids, also called "offset bids," all bids must be in cash or otherwise acceptable to the trustee, and the trustee may reject any bid not backed by cash or a cash equivalent. CC §2924h(b); *Hill v Gibraltar Sav. & Loan Ass'n* (1967) 254 CA2d 241, 62 CR 188; *Kleckner v Bank of America* (1950) 97 CA2d 30, 217 P2d 28.

The trustee may accept bids in cash; a cashier's check drawn on a state or national bank; a check drawn on a state or federal credit union; a check drawn on a state or federal savings and loan association, savings association, or savings bank specified in Fin C §5102 and authorized to do business in California; or other cash equivalent if previously designated in the notice of sale. CC §2924h(b). See *Baron v Colonial Mortgage Serv. Co.* (1980) 111 CA3d 316, 168 CR 450 (decided under earlier version of CC §2924h(b); current version provides that cash equivalent must be "designated in the notice of sale as acceptable to the trustee").

WARNING: Although trustees commonly allow bidders to use cashier's checks, the court in *California Golf, LLC v Cooper* (2008) 163 CA4th 1053, 78 CR3d 153, interpreted CC §2924h as referring to cashier's checks and cash equivalents as distinct and disjunctive alternative methods of bidding at trustee sales, leaving cashier's checks outside the statutory meaning of "cash equivalent." This holding was made in the context of the bidders' serious and potentially criminal misconduct and will probably not impair the acceptance of cashier's checks at most trustee sales. However, anyone contemplating making a bid should carefully review the notice of trustee sale concerning the approved bidding media and, ideally, should confirm in advance of the auction what forms of payment the trustee or its sale agent will accept.

Because the notice procedures do not definitively establish the payoff demands of other parties such as junior lienholders, their bids are no different from bids by strangers and must be in cash or a cash equivalent. *Py v Pleitner* (1945) 70 CA2d 576, 161 P2d 393. The foreclosing beneficiary is the only party allowed to credit bid because its demands have been stated in its notices and the trustor has had adequate time to challenge those demands. *Witter v Bank of Milpitas* (1928) 204 C 570, 269 P 614. The junior lienholder who expects to receive all the surplus after the senior lien is paid must nevertheless bid all cash or a cash equivalent and cannot use any part of the junior lien for a credit bid. *Nomellini Constr. Co. v Modesto Sav. & Loan Ass'n* (1969) 275 CA2d 114, 79 CR 717.

PRACTICE TIP: A junior lienholder who is interested in seeing that the property is not undersold but who is unable to bid the necessary cash or to work out satisfactory cash equivalent arrangements with the auctioneer in advance of the auction commencement should consider reinstating the senior lien before the sale (under CC §2924c; see §§2.5, 2.57-2.61) and then foreclosing the junior lien and credit-bidding at the junior sale. See *United Sav. & Loan Ass'n v Hoffman* (1973) 30 CA3d 306, 106 CR 275. See also §2.87.

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§2.79 6. Sale to Highest Bidder; Finality

The trustee sale is final when the trustee accepts the last and highest bid. CC §§2924g(a), 2924h(c); *Homestead Sav. v Darmiento* (1991) 230 CA3d 424, 281 CR 367; *Bebensee-Wong v FNMA (In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820. Afterward, the successful bidder must promptly deposit the full amount of the bid with the trustee. Failure to do so renders the bidder liable for damages and, if willful, is punishable as a misdemeanor. CC §2924h(d).

Although the sale is generally complete on acceptance of the high bid, the conclusive presumption of the regularity of the sale as recited in the trustee's deed (see §§2.99, 2.134) does not apply until the deed has been delivered. Thus, if the trustee discovers a defect in the procedure after accepting the bid but before delivering the deed, it may abort the sale, refuse to complete delivery, and return the purchase price. See *Moeller v Lien* (1994) 25 CA4th 822, 30 CR2d 777. Similarly, if the trustee learns after conducting the foreclosure auction (but before delivering the deed) that the borrower and the lender had agreed to postpone the sale, the trustee may properly abort the sale and is not liable to the purchasing bidder for either breach of contract or negligence. *Residential Capital, LLC v Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 134 CR2d 162.

The trustee is not required to deliver a deed to the bidder at the auction venue and may arrange to do so later. *Kleckner v Bank of America Nat'l Trust & Sav. Ass'n* (1950) 97 CA2d 30, 217 P2d 28. Under CC §2924h(c), the sale is deemed perfected as of 8 a.m. on the actual date of sale if the trustee's deed is recorded within 15 calendar days after the sale. If the recorder's office is closed on the 15th calendar day, the time limit is extended until the next business day. (On effect of recordation of trustee's deed more than 15 days after sale when borrower has filed bankruptcy petition, see *In re Garner* (Bankr ND Cal 1997) 208 BR 698; *Davisson v Engles (In re Engles)* (Bankr SD Cal 1996) 193 BR 23.)

The sale will usually be upheld even if the winning bid is far below the property's fair market value, unless some irregularity in the foreclosure process can be identified. See, *e.g., Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413; *Nguyen v Calhoun* (2003) 105 CA4th 428, 129 CR2d 436; *Whitman v Transtate Title Co.* (1985) 165 CA3d 312, 323, 211 CR 582; *Crofoot v Tarman* (1957) 147 CA2d 443, 305 P2d 56. The presumption that a trustee sale is valid, however, does not always cut in favor of the foreclosing creditor. See, *e.g., 6 Angels, Inc. v Stuart-Wright Mortgage, Inc.* (2001) 85 CA4th 1279, 102 CR2d 711 (court affirmed summary adjudication in favor of bidder who purchased property at trustee sale for one cent over credit bid of $10,000, which foreclosing lender claimed should have been for $100,000.) See Bernhardt, *Midcourse Correction,* 24 CEB Real Prop L Rep 80 (Mar. 2001), discussing *6 Angels.*

If the trustee believes that no bid is adequate, all bids may be rejected and the sale postponed. *Pacific Ready-Cut Homes, Inc. v Title Guar. & Trust Co.* (1929) 103 CA 1, 283 P 963. Although court approval of the sale is not required (*California Trust Co. v Smead Inv. Co.* (1935) 6 CA2d 432, 44 P2d 624), evidence of gross inadequacy of the sale price may invalidate the sale if there is also evidence of even a "slight" irregularity in the sale procedures (see *Rosner v Worcester (In re Worcester)* (9th Cir 1987) 811 F2d 1224; *Whitman v Transtate Title Co.* (1985) 165 CA3d 312, 211 CR 582).

PRACTICE TIP: Excessive reliance on the "slight irregularity" standard as a basis for attacking a trustee sale is risky. See, *e.g., Knapp v Doherty* (2004) 123 CA4th 76, 20 CR3d 1 (slightly premature service of notice of trustee sale was not prejudicial to debtor and therefore not basis for setting aside sale). Whenever possible, debtor's counsel should develop evidence that the irregularity, however "slight," was nonetheless actually prejudicial to the debtor or to the fairness of the sale.

For discussion of borrower actions and their legal bases to set aside sale, see chap 7.

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B. Bidding

§2.80 1. Bid-Chilling

It is unlawful to offer to accept (or to accept) consideration to not bid, to fix bidding, or to restrain bidding. If an interested party is defrauded as a result of such activities, the wrongdoer can be fined, imprisoned, or both. CC §2924h(g). See *South Bay Bldg. Enters. v Riviera Lend-Lease, Inc.* (1999) 72 CA4th 1111, 85 CR2d 647 (allowed tort remedy against beneficiary by junior lienholder); *FPCI RE-HAB 01 v E&G Invs., Ltd.* (1989) 207 CA3d 1018, 255 CR 157. See also 11 USC §363(n). Conspiracies between bidders to chill the bidding are improper, of course, but only the trustor can complain of such behavior because other parties can protect themselves by competitive bidding. *Bertschman v Covell* (1928) 205 C 707, 272 P 571. The formation of an otherwise proper partnership between two potential bidders can constitute bid-chilling if the purpose of the agreement is to restrict competition. *Lo v Jensen* (2001) 88 CA4th 1093, 106 CR2d 443.

Classic bid-chilling involves paying prospective bidders at the sale to not make bids. It is unclear whether an arrangement by which the foreclosing creditor agrees, before foreclosure, to sell the property to a third party if the creditor acquires the property at the foreclosure is bid-chilling. Such an arrangement effectively eliminates the third party as a potential bidder at the sale and can thus reduce the competitiveness of the sale. The court may set aside a nonjudicial foreclosure sale under CC §2924h(g) when it can be shown that two or more buyers combined to restrain competition and buy the property at a reduced price. *Lo v Jensen* (2001) 88 CA4th 1093, 106 CR2d 443.

PRACTICE TIP: Debtors seeking to set aside trustee sales should investigate bid arrangements. Evidence of bid-chilling can sometimes be developed from the trustee's bidding records. If the records show that several bidders qualified with the trustee (by demonstrating their possession of cash) but none or only one of them actually submitted bids, this may suggest that they were paid to refrain from competing. (This may occur innocently, however, such as when the foreclosing creditor opens with an unexpectedly high credit bid.) Further, because foreclosure auctions are public events, a debtor or debtor's attorney who anticipates anticompetitive activity should consider audiotaping or videotaping the entire auction.

Although CC §2924h provides remedies for fraudulent bidding, those remedies are not exclusive when the bidders engage in fraudulent and apparently felonious conduct. In *California Golf, LLC v Cooper* (2008) 163 CA4th 1053, 78 CR3d 153, successful bidders used cashier's checks to bid at a trustee sale. Subsequently, the bidders submitted affidavits to the issuing bank, falsely stating that the checks had been lost (thus inducing the bank to stop payment on the checks) and then attempted to negotiate with the trustee for a reduction in the purchase price. The court held that CC §2924h did not preclude claims for fraud and for breach of warranty under other statutes and that criminal statutes might be applicable.

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§2.81 2. Calculating Bid Amount

Ill-considered bidding is a common occurrence and is probably the most common cause of attorney malpractice claims in the trustee sale area. Bidding strategies must be tailored to the creditor's goals and desires and to the economics of the transaction. For example, counsel for the foreclosing creditor should consider (1) whether the creditor initially wants ownership of the property or prefers being paid in cash and (2) at what dollar "break point" this preference would change. The type of foreclosure will also dictate bidding strategy, which will differ between trustee sales and judicial foreclosures because of the redemption right that applies after judicial foreclosure sales. See §§3.90-3.101.

The amount bid at the foreclosure sale will have an important effect on many collateral legal issues. In a judicial foreclosure, the basic postsale redemption price is established by the final bid, which also serves as one of two guideposts (along with the fair value of the security) in adjudicating the amount of any allowable deficiency judgment (see §§3.80-3.82, 3.86-3.89, 3.93-3.94).

PRACTICE TIP: Creditor's counsel should consider putting the bidding strategy in writing to prevent any later misunderstandings with the client.

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§2.82 a. Foreclosing Creditor

In the context of a trustee sale, the amount bid has consequences to the foreclosing creditor. Bidding less than is owed will not lead to a recoverable deficiency judgment, because of CCP §580d (see §§2.10, 5.8), but, depending on how much is left unbid, will avoid the disadvantages of the full credit bid rule (see §§2.84-2.87, 2.118-2.129) and has other potential advantages to the creditor if any of the following circumstances exists:

- The obligation is secured by additional collateral or guaranties (see §§9.12-9.23, 9.89-9.112);
- Insurance or condemnation proceeds on the property are available (see §§8.50-8.73, 9.8);
- A receiver is holding accumulated rents and profits;
- The beneficiary fears being subjected to a subsequent liability to the trustor and wishes to have a potential offset against such a claim;
- The presence of hostile trustors in possession has eliminated any opportunity to inspect the premises before the sale to ascertain the property's condition;
- The beneficiary prefers cash over a problem asset; or
- The beneficiary wishes to reduce the amount realized for income tax purposes by excluding unpaid interest from the bid (see §§2.113-2.117).

For further bidding strategies, case discussions, and perspectives, see Hansen, *Wielding the Two-Edged Sword: What Every Attorney Needs to Know About Real Property Secured Transactions* (2 parts), 22 CEB Real Prop L Rep 159 (July and Aug. 1999); Akawie, *Determining the Right Bid at Foreclosure,* 19 CEB Real Prop L Rep 94 (Apr. 1996); Bernhardt, *Alliance Mortgage: Partial Answers About Full Credit Bids,* 18 CEB Real Prop L Rep 323 (Nov. 1995); Harris & Levin, *Alliance Mortgage and the Full Credit Bid Rule: Clarity or More Confusion?,* 18 CEB Real Prop L Rep 319 (Nov. 1995); Crocker, *Beneficiary's Underbid—A Neglected Tool,* 44 LA B Bull 295 (1969).

When a receiver holds undistributed rents (see §§2.107, 6.45-6.46), the beneficiary should calculate its bid at the foreclosure sale by the amount it is owed, less (at least) the sum of rent receipts held by the receiver (net of the expenses of the receivership), in order to leave enough unsatisfied obligation to permit reaching those receipts to cover any shortfall after the sale. On additional strategies for foreclosing creditors, including discussion of full credit bids, see §§2.78, 2.84-2.87. On effect of full credit-bid rule on lender postsale claims against borrower and others, see §§2.118-2.129.

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§2.83 b. Junior Secured Creditors

Bidding by junior secured creditors involves factors and concerns different from those of the foreclosing creditor (see §2.82). Although juniors bidding at the senior's sale must bid cash (see §2.78), they have one advantage if they are next in order of priority behind the foreclosing interest. Any cash bid in excess of the foreclosing interest and costs of sale will be distributed to the juniors in order of priority. CC §2924k(a)(3). See §§2.102-2.104. Consequently, a cash-bidding junior who is next in line behind the foreclosing trust deed may receive some of its bid back. This can be a distinct advantage when competing with outside cash bidders because vigorous bidding will benefit the junior whether or not it makes the ultimately successful bid.

Some disadvantages to the junior creditor can arise from bidding successfully at a senior foreclosure. One court has interpreted the fair value antideficiency statute (CCP §580a) to require a junior who purchases the security at the senior sale to give credit for the fair value of the property in any subsequent action to enforce the now sold-out junior debt. See *Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 221 CR 425. Another decision, *Citrus State Bank v McKendrick* (1989) 215 CA3d 941, 263 CR 781, imposed the 3-month statute of limitations in §580a on any debt enforcement action by the purchasing junior creditor.

PRACTICE TIP: In light of *Citrus State Bank*, a junior who acquires the property at the senior's foreclosure sale should take the precautionary step of commencing any action on the sold-out note or any other credit support within 3 months after the date of sale. On additional strategies for junior creditors, see §2.78. See also reporter articles cited in §2.82.

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3. Making Full Credit Bids

§2.84 a. Definition of "Full Credit Bid"

A full credit bid is one made by the foreclosing beneficiary, equaling the amount of the unpaid debt in foreclosure, including principal and interest, plus the costs, fees, and other foreclosure expenses. *Cornelison v Kornbluth* (1975) 15 C3d 590, 606 n10, 125 CR 557. See also *MDFC Loan Corp. v Greenbrier Plaza Partners* (1994) 21 CA4th 1045, 26 CR2d 596 (actual amount of debt rather than amount mistakenly announced at sale establishes full credit bid). The decision to make a full credit bid at a trustee sale requires the lender to consider a number of factors, most of which weigh against bidding the full amount, unless forced to do so by vigorous third party bidding (see §§2.85-2.87, 2.118-2.129).

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§2.85 b. Reasons to Make Full Credit Bid

Beneficiaries involved in trustee sales often decide to make full credit bids because CCP §580d prohibits a deficiency judgment after a trustee sale in any event (see §§2.10, 5.8), so nothing of value seems to be lost by such a bid. The ability to outbid others (because of the right to bid credit rather than cash) increases the prospect of acquiring the asset and reselling it later at a gain if its value was originally underestimated. Furthermore, it is mechanically easier merely to instruct the auctioneer to enter a one-time bid equal to the amount demanded for payoff of the debt rather than instructing the auctioneer to make an opening underbid and to incrementally raise the bid if necessary.

PRACTICE TIP: Most erroneous and potentially self-destructive bids at trustee sales occur as a result of either the foreclosing lender's laziness or failure to understand available choices. If there is a cardinal rule of trustee sales, it is that bidding at those sales needs to be taken seriously. The foreclosing lender should have someone present at the auction who understands the process well and who has ample authority to make incremental bids during the auction rather than giving the trustee orders to open the bidding with a full credit bid.

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§2.86 c. Disadvantages of Full Credit Bids

A full credit bid may preclude certain postsale remedies by the lender against the borrower and even third parties (see §§2.118-2.129).

For example, in *Cornelison v Kornbluth* (1975) 15 C3d 590, 606 n10, 125 CR 557, the supreme court held that a full credit bid at the foreclosure sale was the equivalent of "a total satisfaction of the secured obligation," thereby costing the beneficiary its right to otherwise recover damages for bad faith waste (a claim not barred by the antideficiency rules) from the trustor. 15 C3d at 606. See §2.120. (On relationship of waste to deficiency judgments, see §§2.119, 5.57-5.59.) On the other hand, the California Supreme Court has held that a lender who was induced by the fraud of third parties to make full credit bids on foreclosure may recover in tort for the fraud, despite its bids. See *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, discussed at length in §§2.123-2.126.

Another lender consideration is that a successful credit bid exceeding the outstanding principal of the defaulted debt and including accrued interest may result in the recognition of income (to the lender) on which taxes will be owed, despite the lack of receipt of cash (see §2.116). A full credit bid also deprives the beneficiary of its right to rents held by a receiver pending the foreclosure and to various other funds, such as insurance or condemnation proceeds that may be available to apply to the debt in foreclosure (see §2.107).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.87 d. Underbidding and Other Strategies

§2.87 d. Underbidding and Other Strategies

Although counsel for lenders have generally advised their clients to underbid ever since the *Cornelison v Kornbluth* (1975) 15 C3d 590, 606 n10, 125 CR 557, decision, that advice is often ignored, forcing lenders to later cast about for other ways to escape the consequences of reflexive, full credit overbidding. The history and effect of these efforts is mixed. See extensive discussion of lender postsale claims and full credit bid rule in §§2.118-2.129. Moreover, the analysis in *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, fails to include many details that lenders' counsel need in order to advise their clients and has been narrowly interpreted in some case law. See, *e.g., Lawler v Jacobs* (2000) 83 CA4th 723, 100 CR2d 52. Because the full bid may be excused only if it was proximately induced by fraud (see *Alliance,* 10 C4th at 1246; see also §2.124), and because most lender fraud cases involve deception at the time the loan was made rather than when it was foreclosed, courts will have to settle the question of how and when a secured creditor may rely on preloan representations in a postdefault bidding context. See Harris & Levin, *Alliance Mortgage and the Full Credit Bid Rule: Clarity or More Confusion?,* 18 CEB Real Prop L Rep 319 (Nov. 1995) and Bernhardt, *Alliance Mortgage: Partial Answers About Full Credit Bids*, 18 CEB Real Prop L Rep 323 (Nov. 1995). See also concurring opinion of Justice Werdegar in *Alliance* (10 C4th at 1251); *Michelson v Camp* (1999) 72 CA4th 955, 85 CR2d 539 (cited in §§2.124, 2.126-2.127).

PRACTICE TIP: Despite the unsettled nature of the law on the impact of full credit bids (or, for that matter, credit bids in any other amount), reliable bidding guidelines for the foreclosing creditor include the following:

- Attend the sale or have an authorized agent do so.
- Do not rely on a "one-size-fits-all" bidding strategy.
- Be flexible and prepared to make incrementally higher bids.
- Know, before the sale, what the "walking away point" will be, *i.e.,* the point when the creditor would prefer cash proceeds over owning the property.
- Open credit bidding on the low side at a trustee sale (between 30 to 75 percent is generally appropriate) except when tax liens present a unique risk of redemption (see §2.31), in which event a higher bid is desirable. (At judicial foreclosures, however, the opening bid should be equal or close to the amount that the creditor or its appraiser believes to be the true market value of the property (ignoring "distress sale" considerations) so as to deny the debtor a bargain redemption price (see §§3.81, 3.88, 3.93-3.94).)
- Bear in mind that the rules concerning credit bidding and the impact of such bids on later claims conform to the same logic whether the credit bid is a full credit bid or a partial credit bid. Thus, when a full credit bid would totally preclude a particular claim, a credit bid for 99 percent of the claim will not preclude claims, but it will leave little to be recovered in a later damages claim by the credit-bidding lender. See *Track Mortgage Group, Inc. v Crusader Ins. Co.* (2002) 98 CA4th 857, 120 CR2d 228.

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C. Postponing Sale

§2.88 1. Allowable Reasons for Postponement

Postponement of a trustee sale is governed by CC §2924g(c)(1). At any time before the foreclosure sale is completed, the trustee may postpone the sale at the trustee's discretion or on instructions from the beneficiary. The trustee must postpone the sale in accordance with the following:

- An order of any court of competent jurisdiction;
- A stay by operation of law; or
- A mutual oral or written agreement of any trustor and any beneficiary or any mortgagor and any mortgagee.

A frequent cause of postponement is the automatic stay imposed when a defaulting trustor files a petition for relief in bankruptcy. See chaps 7, 11. When the petition is filed before a scheduled trustee sale, publishing notices of continuing the sale from time to time does not violate the automatic stay. *Mason-McDuffie Mortgage Corp. v Peters (In re Peters)* (9th Cir 1996) 101 F3d 618; *First Nat'l Bank v Roach (In re Roach)* (9th Cir 1981) 660 F2d 1316.

Another reason for the trustee's delaying the sale is to give the bidders time to obtain the cash necessary to cover their bids. See *Security-First Nat'l Bank v Cryer* (1940) 39 CA2d 757, 104 P2d 66. The trustee may, however, reject the request for a delay and proceed with the sale. *Hill v Gibraltar Sav. & Loan Ass'n* (1967) 254 CA2d 241, 62 CR 188; *Kleckner v Bank of America Nat'l Trust & Sav. Ass'n* (1950) 97 CA2d 30, 217 P2d 28.

Trustors may contend that they received oral assurances from the beneficiary that the sale would be postponed. Unless supported by adequate consideration or justifiable reliance, such oral, gratuitous promises are not enforceable, and the trustee may proceed with the sale as noticed. *Raedeke v Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 111 CR 693; *Nguyen v Calhoun* (2003) 105 CA4th 428, 129 CR2d 436; *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 92 CR 851.

A postponement agreement between the trustor and the beneficiary that is supported by consideration in the form of a forbearance fee is enforceable, but the amount charged for the delay may constitute a "loan or forbearance" of money and therefore be subject to usury restrictions. See *Buck v Dahlgren* (1972) 23 CA3d 779, 100 CR 462. Although it may be proper for the beneficiary to insist on a partial payment of the loan as a condition for the delay, any demand for sums that will not be applied to the loan (*i.e.,* a pure forbearance fee) should be calculated carefully. On forbearance and loan workout agreements, see chap 10.

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§2.89 2. Effect on Reinstatement Right

When the sale is to be postponed and a new written notice of sale is given (see §2.91), or when the trustee announces at the originally scheduled sale (see §2.90) that the sale is postponed for a period that exceeds 5 business days, CC §2924c(e) automatically extends the reinstatement period until 5 business days before the new sale date. See §§2.53-2.54. Note that §2924c(e) states that nothing in that section shall "give rise to a right of reinstatement during" the 5-business-day period before a noticed or announced sale date.

Under §2924c(e), the reinstatement period is not revived if the postponement period is not greater than 5 business days and a notice of postponement is announced orally at the time and place of the scheduled or rescheduled sale (see §2.90).

NOTE: The trustee may serially postpone a trustee sale by oral announcement, 5 business days at a time, for several months during a borrower's bankruptcy. *Hicks v E.T. Legg & Assocs.* (2001) 89 CA4th 496, 108 CR2d 10 (covenant of good faith and fair dealing does not require lender to exercise its choices under foreclosure law in manner allowing borrower to reinstate). But if the postponement periods exceed 365 days, a new notice of sale must be recorded (CC §2924g(c)(2)), and that revives the reinstatement right (CC §2924c(e)).

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§2.90 3. Announcing Postponement

Long or frequent postponements of a trustee sale can discourage prospective third party bidders who hope to bid cash at the sale. This is true because bidders often need to bring cash or cashier's checks to the sale, thus requiring them to incur the cost of liquidating assets or holding liquidated assets for a significant time period. As a result, the legislature and state and federal courts monitor the postponement issue, arriving at results that sometimes are hard to reconcile.

At the time and location of the sale specified in the notice of sale, the trustee must publicly announce or "cry" the postponement, the reason for the postponement, and the future date, time, and place of sale. CC §2924g(a), (d). If the sale is postponed by injunction, restraining order, or operation of law for any reason other than a stay issued under the bankruptcy statutes, it cannot be held sooner than 7 calendar days after the dismissal of the action or expiration or termination of the injunction, order, or stay, whichever is earlier, unless a court orders otherwise. CC §2924g(d)-(e). See, *e.g., Abdallah v United Sav. Bank* (1996) 43 CA4th 1101, 51 CR2d 286 (bankruptcy court order terminating automatic stay and permitting lender to proceed immediately with foreclosure despite §2924g(d) overrides 7-day waiting period). A "new notice of postponement shall be given" if the sale was previously scheduled to occur during the 7-day waiting period. CC §2924g(d). Despite this language, which could be interpreted to require a new recorded notice of sale (and revival of reinstatement right), a court of appeal rejected such an argument and held that if the legislature had wanted to revive the reinstatement right in §2924g(d), it would have done so expressly. See *Hicks v E.T. Legg & Assocs.* (2001) 89 CA4th 496, 507, 108 CR2d 10.

NOTE: Civil Code §2924g(e) provides that the 7-day waiting period of §2924g(d) does not apply if postponement is based on a stay granted under Title 11 of the United States Bankruptcy Code. The sale may be conducted on the expiration of the stay granted under that title, to which a 10-day waiting period usually applies (see §2.94).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.91 4. Renoticing Sale

§2.91 4. Renoticing Sale

There are situations in which a lender must prepare and serve a new written notice of sale after postponement. See §2.92. However, an unsettled question is whether federal policy or constitutional due process requires a new notice when the borrower has filed a petition in bankruptcy. See reported decisions cited in §2.94.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.92 a. When New Notice Required

§2.92 a. When New Notice Required

A new notice of sale must be given if the sale is postponed for a period or periods totaling more than 365 days from the date set forth in the original notice of sale. Any number of postponements may be given without need of a new notice during the 365-day period. CC §2924g(c).

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§2.93 b. When New Notice Not Required

Under CC §2924g(c), any number of postponements may be called without triggering a new notice of sale (see §2.92) as long as the total period of time for all postponements does not exceed 365 days from the date set forth in the original notice of sale.

Further, under CC §§2924g(d) and 2924c(e), a trustee may orally postpone a sale for successive periods of 5 business days or less (adding up to many months) without having to give new notice after an injunction, court-ordered stay, or automatic bankruptcy stay terminates. See *Hicks v E.T. Legg & Assocs.* (2001) 89 CA4th 496, 108 CR2d 10. But see, *e.g., Tome v Baer (In re Tome)* (Bankr CD Cal 1990) 113 BR 626, cited in §2.94.

Renotice is arguably not required when, after receiving the initial foreclosure sale notice, the borrower files a bankruptcy action that is dismissed before the originally scheduled sale date. See *Carl I. Brown & Co. v Anderson (In re Anderson)* (BAP 9th Cir 1996) 195 BR 87 (decided under Arizona law). See also Note in §2.94 regarding possible requirement of new notice and federal waiting period.

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§2.94 c. When New Notice May Be Required

It is uncertain whether California law alone determines the notice rights of borrowers in bankruptcy facing a trustee sale that was postponed. Clearly, if the postponement periods exceed 365 days, a new notice of sale must be recorded (CC §2924g(c)(2)), and that revives the reinstatement right (CC §2924c(e)). But whether or not federal bankruptcy law requires a new notice after a postponement period of less than 365 days is undetermined.

Two bankruptcy trial courts have held that federal law requires a lender to renotice a postponed trustee sale after obtaining relief from the automatic bankruptcy stay (see *Tome v Baer (In re Tome)* (Bankr CD Cal 1990) 113 BR 626) or after dismissal of the bankruptcy case (see *In re Acosta* (D Az 1995) 181 BR 477). However, many other published opinions have ruled that no authority mandates renoticing the sale beyond oral postponements declared at the time of a prior noticed or postponed sale if the bankruptcy stay terminates by a stay relief order or a dismissal. See authorities cited in *Nghiem v Ghazvini (In re Nghiem)* (BAP 9th Cir 2001) 264 BR 557, aff'd (9th Cir 2002) 53 Fed Appx 489 (unpublished opinion) (see 9th Cir R 36-3), which held that neither federal nor California law requires additional notice. See also *Tully v World Sav. & Loan Ass'n* (1997) 56 CA4th 654, 65 CR2d 545. Although *Nghiem* and *Tully* may signal a trend favoring the lender (see comments in 24 CEB Real Prop L Rep 195, 269 (July and Oct. 2001)), the Ninth Circuit has not yet decided this issue. See Note in §7.108.

When the borrower files a bankruptcy action before an already scheduled trustee sale, the trustee's public announcements continuing the sale from time to time thereafter do not violate the automatic stay. *First Nat'l Bank v Roach (In re Roach)* (9th Cir 1981) 660 F2d 1316. Also, a foreclosing trustee may reschedule the trustee sale indefinitely after confirmation of a debtor's Chapter 13 plan for curing the arrearages on a secured debt, pending the success of the plan. *Mason-McDuffie Mortgage Corp. v Peters (In re Peters)* (9th Cir 1996) 101 F3d 618. Neither *Roach* nor *Peters* addressed the issue of whether federal law requires a new written notice to be recorded and served after the automatic stay terminates.

NOTE: Unless it otherwise states, an order of the bankruptcy court granting stay relief does not become effective until 10 days after its entry. Fed R Bankr P 4001(a)(3). A judgment on dismissal is effective when entered. See Fed R Bankr P 9021. In bankruptcy situations, the 7-day waiting period under CC §2924g(d) (see §2.90) does not apply. See CC §2924g(e).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.95 5. Notice of Delay to Taxing Entities

§2.95 5. Notice of Delay to Taxing Entities

To extinguish a tax lien junior to the interest being foreclosed, the trustee must give the District Director of the Internal Revenue Service (IRS) or the State Controller notice of the trustee sale if notice of the tax lien was filed more than 30 days before the date set for sale. See §2.31. An oral announcement of a postponement that complies with state law provides notice of the postponement to the IRS and State Controller. Treas Reg §301.7425-3(a)(2)(i); CC §2924g(d). If notice of sale was originally not required, because the tax lien had not been filed more than 30 days before the date originally set for sale, the postponement may now make it necessary to give notice of the sale to the appropriate taxing authority. When the postponement delays the sale until more than 30 days after the filing of the tax lien, notice to the IRS or State Controller is required. Treas Reg §301.7425-3(a)(2)(ii); Govt C §16187. See §2.31 for notice terms.

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§2.96 6. Effect of Postponement

A postponement of a sale in progress cancels any unaccepted bids. *Hatch v Collins* (1990) 225 CA3d 1104, 275 CR 476, upheld a trustee's discretionary postponement of a foreclosure sale in progress. At the *Hatch* sale, "characterized by disorder and confusion," the beneficiary's agent made a full credit bid on a single parcel, mistakenly believing that he was bidding on four parcels. At the bidder's request, the trustee postponed the sale without accepting the bid. After the conclusion of a reconvened sale, the trustors sought to have the sale set aside because of the alleged impropriety of the earlier postponement. The court of appeal, in affirming a judgment against the trustors, held that the trustee had acted within his discretionary authority in postponing the sale (CC §2924g(c)(1)) and that the postponement had canceled the mistaken bid (CC §2924h(e)).

Postponement may also effectively cancel the sale even if the trustee purports to accept the high bid at it. In *Residential Capital, LLC v Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 134 CR2d 162, the court held that the trustee acted within its authority in refusing to deliver the trustee's deed when it learned after conducting the sale that the trustor and the beneficiary had previously agreed to a postponement.

WARNING: Agreements to postpone the sale reached orally or after the beginning of bidding are risky. See, *e.g., Nguyen v Calhoun* (2003) 105 CA4th 428, 129 CR2d 436 (trustee's sale may not be set aside based on lender's alleged breach of oral agreement to postpone sale). On *Nguyen*, see also §2.73.

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§2.97 D. Unruh Act Mortgages and Deeds of Trust

Civil Code §2924f(c) contains special requirements for security instruments that contain a power of sale, encumber a single-family owner-occupied residence, and secure an obligation in a contract for goods or services subject to the Unruh Act (CC §§1801-1812.20). An attorney representing a client involved in an Unruh Act-regulated foreclosure should carefully examine CC §2924f(c). The most important requirements are as follows:

- If the trustor has failed to cure the default within 30 days after recordation of the notice of default, the trustee must mail the statement set forth in §2.132 to the trustor at its last known address. CC §2924f(c)(3). See §2.48.
- The procedure for notice of sale is the same as for other properties when the instrument contains a power of sale (see §§2.62-2.72). CC §2924f(c)(2).
- Sales of residential real property subject to Unruh Act mortgages or deeds of trust must be held in the county in which the residence is located. CC §2924f(c)(4).
- All sales must be made to the bidder making the highest offer. The trustee may receive offers to purchase for 10 days before the time of sale, and the noticed sale must be postponed to a specific date if any such offer is accepted in writing by both the trustor and the beneficiary before the sale date. The trustor may convey the property to the offeror before the date set for the postponed sale. The conveyance will terminate any further proceeding under the notice of sale, and the notice will be considered revoked. CC §2924f(c)(4).
- In addition to the trustee's fee provided by CC §2924c, the trustee or mortgagee acting under CC §2924f(c) is entitled to charge an additional $50 fee. CC §2924f(c)(5).

On a common interest development association's right to request copy of trustee's deed following sale, see §2.41.

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E. Trustee's Deed

§2.98 1. Authority to Convey Title

Only the trustee of record has the legal authority to convey title to the successful bidder after a nonjudicial foreclosure. See CC §2934a(a)(4), (d); *Dimock v Emerald Props., LLC* (2000) 81 CA4th 868, 875, 97 CR2d 255. The trustee's authority is derived from statutory law and the language of the deed of trust. After a trustee of record is removed by substitution (see §§2.21-2.26), that trustee cannot conduct a valid sale or deliver a valid trustee's deed. Any such purported sale and deed are void. 81 CA4th at 876. But see *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859 (applying equitable "reformation" of deed of trust to validate sale), cited in §§2.25, 2.74.

When a former trustee or an improperly substituted trustee mistakenly conducts a foreclosure sale and conveys title to the highest bidder, numerous parties may be affected, including subsequent purchasers. The trustee in that situation owes no duty to the subsequent purchaser because the trustee has a limited role as a common agent of the borrower and the lender. See *Heritage Oaks Partners v First Am. Title Ins. Co.* (2007) 155 CA4th 339, 66 CR3d 510, which rejected causes of action for damages on theories of negligence and equitable subrogation asserted by a subsequent purchaser against a former trustee who mistakenly conducted the sale.

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§2.99 2. Priority and Nature of Title

Title conveyed by a trustee's deed relates back in time to the date on which the deed of trust was executed. The trustee's deed therefore passes the title held by the trustor as of that earlier time plus any after-acquired title, rather than the title that the trustor held on the date of the foreclosure sale. *Hohn v Riverside County Flood Control & Water Conserv. Dist.* (1964) 228 CA2d 605, 39 CR 647; *Bracey v Gray* (1942) 49 CA2d 274, 121 P2d 770.

Liens that attached to the property after execution of the foreclosed deed of trust are therefore eliminated or "sold out," and the purchaser at the trustee sale takes title to the property free of those junior liens. *Carpenter v Smallpage* (1934) 220 C 129, 29 P2d 841; *Dugand v Magnus* (1930) 107 CA 243, 290 P 309. Certain governmental liens, *e.g.,* for real property taxes and assessments (Rev & T C §2192.1), are superior despite having been recorded after the deed of trust and are therefore not subject to elimination. See §§2.31, 9.55. Mechanics' liens are eliminated only if the date on which the work commenced (rather than the date of recordation) was later than the date on which the foreclosed deed of trust was recorded. CC §3134. See §9.54; California Mechanics' Liens and Related Construction Remedies, chap 2 (3d ed Cal CEB 1998).

The trustee's deed conveys title free and clear of the lien of the deed of trust under which the foreclosure sale itself was conducted. Because the sale proceeds are to be used to satisfy that lien, it no longer encumbers the property, even if the sale proceeds do not fully satisfy the claim. CC §2910; CCP §726. See, *e.g., Ralph C. Sutro Co. v Paramount Plastering, Inc.* (1963) 216 CA2d 433, 31 CR 174.

The trustee's deed conveys the property subject to all senior liens on title. *Streiff v Darlington* (1937) 9 C2d 42, 68 P2d 728. A junior foreclosure has no effect on senior liens (although it may give the senior lienholder the right to accelerate if there is a due-on-transfer clause in the senior instrument; see §§8.8-8.19). The title conveyed at the junior sale relates back only to the date on which the junior deed of trust was executed, and title is therefore subject to the liens that are senior because of the order of recordation or a subordination agreement. The foreclosure purchaser at the junior sale receives only the interest held by the trustor as of the day on which the junior lien was given. *Hohn v Riverside County Flood Control & Water Conserv. Dist., supra; Bracey v Gray, supra*. On priority issues from title insurance perspective, see California Title Insurance Practice §§6.65-6.66, 8.48 (2d ed Cal CEB 1997). If a successful bidder is warned by the auctioneer about possible senior encumbrances, no claim for actionable misrepresentation will be found. *Ostayan v Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 92 CR2d 577.

The title covenants in CC §1113 are probably not implied in a trustee's deed, despite the use of the word "grant." *National Pac. Oil Co. v Watson* (1920) 184 C 216, 193 P 133; *Mitchell v California-Pacific Title Ins. Co.* (1926) 79 CA 45, 248 P 1035, discussed in Comment, *Grantor and Grantee: Recovery by the Grantee of Money Paid under Mistake as to Vendor's Title,* 15 Cal L Rev 53 (1926). Section 1113 does not apply when "restrained by express terms contained in such conveyance" (see *Babb v Weemer* (1964) 225 CA2d 546, 550, 37 CR 533; see also *Lippman v Sears, Roebuck & Co.* (1955) 44 C2d 136, 280 P2d 775; *Cousins Inv. Co. v Hastings Clothing Co.* (1941) 45 CA2d 141, 113 P2d 878); trustees' deeds are always expressly made without title covenants or warranties and are therefore effectively quitclaim deeds. For discussion of covenants of title, see California Real Property Sales Transactions, chap 12 (4th ed Cal CEB 2007).

Under CC §1102.2(c), foreclosure sales are not subject to the disclosure requirements of CC §§1102-1102.17 on transfers of residential property. Despite this exemption, the foreclosing creditor may face liability based on common law theories if the creditor does not disclose (or cause the trustee to disclose) *known* material defects in the property under foreclosure. See *Karoutas v HomeFed Bank* (1991) 232 CA3d 767, 283 CR 809. See also §§2.77, 6.80.

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VIII. AFTER SALE: POSSESSION AND PROCEEDS

§2.100 A. Possession Following Sale

The purchaser at a trustee sale is entitled to immediate possession of the property. *Farris v Pacific States Auxiliary Corp.* (1935) 4 C2d 103, 48 P2d 11. The purchaser may bring an unlawful detainer action against a trustor, or anyone holding under the trustor, who refuses to relinquish possession after the sale. CCP §§1161a-1161b; *MCA, Inc. v Universal Diversified Enters. Corp.* (1972) 27 CA3d 170, 103 CR 522. For procedural discussion, see California Landlord-Tenant Practice §§8.68A-8.68E (2d ed Cal CEB 1997).

The eviction of tenants of the trustor depends on the priority of their leases vis-à-vis the mortgage. Basically, leases junior to the mortgage are automatically terminated by a foreclosure sale, while leases senior to the mortgage are unaffected by it. See §6.84. The right to evict may also be subject to local rent control restrictions. See *Gross v Superior Court* (1985) 171 CA3d 265, 217 CR 284; Landlord-Tenant §7.69.

Although a trustor or a commercial tenant is entitled to only 3 days' written notice before the unlawful detainer action may be filed (CCP §1161a(b)), a residential tenant of the trustor is entitled to 60 days' written notice to quit (CCP §1161b).

WARNING: In May 2009, the federal government enacted preemptive legislation that temporarily protects residential tenants holding possession under a month-to-month agreement or a lease from immediate eviction after the foreclosure sale by a purchaser or the foreclosing lender. See Protecting Tenants at Foreclosure Act of 2009 (Pub L 111-22, §§701-704, 123 Stat 1660), discussed in §7.75A. The Act applies to interests in property after foreclosure "on a federally-related mortgage or on any dwelling or residential real property."

The trustor may challenge the purchaser's title by asserting that the sale did not meet statutory requirements, but it may be required to "do equity" by first offering to pay the full amount of the debt in order to make that contention. *MCA, Inc. v Universal Diversified Enters. Corp.* (1972) 27 CA3d 170, 176, 103 CR 522; *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826; *Py v Pleitner* (1945) 70 CA2d 576, 582, 161 P2d 393. The tenant, as well as the trustor, may defend an unlawful detainer action under CCP §§1161a and 1161b by challenging the purchaser's title, *i.e.,* by attacking the validity of the trustee sale (although not the validity of the underlying mortgage). See *Cheney v Trauzettel* (1937) 9 C2d 158, 69 P2d 832. For discussion and strategies, see §§7.75-7.77. See also Landlord-Tenant §§8.7, 8.68A-8.68E, 10.54, 10.73, 11.62-11.69.

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§2.101 B. Rescinding Sale

The trustee sale is automatically rescinded for failure of consideration under CC §2924h(c) if the bidder's purchase funds are unavailable for payment. See §2.79. In the event of a rescission, a notice of rescission must be sent to the previous and next-highest bidder if the bidder's address is known to the trustee, and the interest of any lienholder is restored to the same priority as if the sale had not occurred. If the last and highest bidder cancels an instrument submitted to the trustee as a cash equivalent, the trustee may recover from the bidder the cost of a new notice of sale. CC §2924h(d). On contents of new notice of sale, see §2.63.

A trustee may rescind the sale before conveying the trustee's deed if the trustee discovers defects in the notice of default or the notice of sale. *Angell v Superior Court* (1999) 73 CA4th 691, 86 CR2d 657 (material defect in notice, such as gross misstatement of default amount, voids sale). See *Residential Capital, LLC v Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 134 CR2d 162, cited in §§2.79, 2.96 (sale aborted because trustee learned after accepting highest bid at foreclosure sale, but before delivering trustee's deed, that beneficiary had previously agreed to postpone sale).

WARNING: For special rules on rescission of trustee sale for lack of notice to taxing authorities holding liens, see §2.31.

Trustees generally have the authority to rescind foreclosure sales under the criteria specified in CC §§1689 and 1691 or whenever they discover a significant procedural error or violation of a bankruptcy stay. Under CC §1058.5(b), recordation of a notice of rescission of the trustee's deed restores the condition of title to the status quo before recordation of the trustee's deed.

A trustee may *not* rescind a sale simply because it mistakenly set the opening bid too low. In *6 Angels, Inc. v Stuart-Wright Mortgage, Inc.* (2001) 85 CA4th 1279, 102 CR2d 711, the loan servicer mistakenly set the opening bid at $10,000 instead of $100,000. The successful bidder bid $10,000.01. The loan servicer subsequently discovered the mistake and attempted to rescind the sale. See Bernhardt, *Midcourse Correction,* 24 CEB Real Prop L Rep 80 (Mar. 2001), discussing *6 Angels.*

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C. Distributing Sale Proceeds

§2.102 1. Obligations Paid

Under CC §2924k(a), the trustee must disburse the sale proceeds in the following order to:

(1) Reimburse its own costs and expenses of the sale and handling proceeds (see CC §§2924c(c)-(d), 2924d(b), 2924k(b));

(2) Satisfy the debt owed to the foreclosing beneficiary;

(3) Pay junior lienholders in their order of priority (see *Cal-Western Reconveyance Corp. v Reed* (2007) 152 CA4th 1308, 62 CR3d 244; *Dockrey v Gray* (1959) 172 CA2d 388, 341 P2d 746; *Sohn v California Pac. Title Ins. Co.* (1954) 124 CA2d 757, 269 P2d 223); and

(4) Pay any surplus to the trustor (*Atkinson v Foote* (1919) 44 CA 149, 186 P 831) or its successor.

The amount of the costs and expenses of the sale and handling proceeds is limited to those costs actually incurred but not exceeding the greater of $425 or 1 percent of the unpaid principal balance. CC §2924d(b). Violations of CC §2924k(a) are actionable by any party aggrieved by the trustee's actions. See, *e.g., South Bay Bldg. Enters. v Riviera Lend-Lease, Inc.* (1999) 72 CA4th 1111, 85 CR2d 647 (suit by junior lienholder against trustee and beneficiary).

Properly recorded judgment liens are payable from surplus proceeds as junior liens. See *Cal-Western Reconveyance Corp. v Reed* (2007) 152 CA4th 1308, 62 CR3d 244 (upheld distribution of surplus proceeds to county to satisfy child and spousal support arrearages, but not attorney fees because they were not included in judgment).

The surplus that must be paid to juniors or to the trustor includes only the amount received at the foreclosure sale in excess of the amount owed the foreclosing beneficiary and costs of sale. A profitable resale after the foreclosure sale does not create a surplus for the benefit of the juniors or the trustor. *Strutt v Ontario Sav. & Loan Ass'n* (1972) 28 CA3d 866, 105 CR 395.

On procedures for resolving disputes over proceeds and priority issues, see §2.106.

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§2.103 a. Notice to Juniors of Surplus Proceeds

Under CC §2924j(a), the trustee must notify the juniors of the surplus proceeds from the sale within 30 days after executing the trustee's deed. The notice must, among other things, inform them that they may be required to submit proof of their secured interests and itemize the amounts owed. CC §2924j(a). The juniors then have 30 days in which to respond with their claims. If there is no dispute about the priority of interests among the juniors (see §2.106), CC §2924j(b) requires the trustee to pay the proceeds to them within 30 days after the close of the response period. A trustee holding any undistributed proceeds must comply with the Unclaimed Property Law (CCP §§1500-1582). CC §2924j(g). The trustee has no liability to a junior creditor who fails to submit a timely claim. *G.E. Capital Mortgage v Maldonado* (9th Cir 2005) 155 Fed Appx 293 (unpublished opinion) (see 9th Cir R 36-3).

The burgeoning problem of identity theft has led to some unusual problems under CC §§2924j and 2924k. For example, in *CTC Real Estate Servs. v Lepe* (2006) 140 CA4th 856, 44 CR3d 823, a stolen identity was used to borrow money against property secured by a deed of trust in the victim's name. After a trustee sale on the trust deed, the victim made a demand on the surplus proceeds from the sale and was turned down by the trustee because she was not the actual trustor under the fraudulent trust deed. The trial court found that the victim did not fit the requirements of CC §2924j(c), denied her claim to the surplus, and ordered the funds paid into the county general fund. The court of appeal reversed, finding that the victim was entitled to the "product" of the identity theft and thus had a valid interest in the surplus funds under CC §2924j.

NOTE: Before and during the postsale claims period prescribed by CC §2924j, an uninformed owner may be vulnerable to solicitation from third parties (see §2.9) who often charge exorbitant fees to "assist" the owner in obtaining refunds of surplus proceeds, which the trustee would pay to the owner in any event. See CC §2945(a). The trustee, beneficiary, or counsel to the trustee or beneficiary is not liable for informing the owner about the owner's right to be paid surplus proceeds without the need for assistance from a third party. See CC §2924j(h), cited in §2.106.

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§2.104 b. Junior Advances

The holder of an interest inferior to the instrument in foreclosure, *i.e.,* a "junior," is entitled to make an advance to pay the senior debt and keep the senior from foreclosing as a way of protecting the junior security (see §§2.5-2.6, 6.63, 8.79). *Windt v Covert* (1907) 152 C 350, 93 P 67; *United Sav. & Loan Ass'n v Hoffman* (1973) 30 CA3d 306, 106 CR 275. The junior who makes such an advance may include it as part of the junior debt and recover out of the senior sale proceeds. If the junior does not cure the senior arrearages until after acquiring the property at a junior foreclosure sale, however, then the junior cannot claim these advances as part of the debt. *Streiff v Darlington* (1937) 9 C2d 42, 68 P2d 728. (These rules should also be true for insurance and tax payments made by the junior (see §§8.66, 8.79-8.82).) Thus, the right to recover such expenditures from the sale proceeds may depend on when they were made. See *United Sav. & Loan Ass'n v Hoffman, supra*.

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§2.105 2. Obligations Not Covered

Items that are not paid out of the sale proceeds include liens senior in priority to the interest foreclosed, expenditures made by the purchaser after the sale, and usurious interest. *Arneill Ranch v Petit* (1976) 64 CA3d 277, 134 CR 456. A junior lienholder who makes an advance to cure the senior arrearages after acquiring the property at a junior foreclosure sale cannot claim those advances as part of the debt. See §2.104.

A junior who reinstates a senior debt that is usurious is not entitled to assert a claim based on the usury laws. *Roes v Wong* (1999) 69 CA4th 375, 81 CR2d 596. It is unclear whether in a subsequent foreclosure the junior may be able to add its full payment (including the usurious interest) to the junior debt. The outcome may depend on whether the trustor (1) disputed the interest at the time the junior reinstated the senior debt and (2) afterward succeeded in any action taken on its usury claim against the senior. See §§8.79-8.82.

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§2.106 3. Resolving Disputes Over Proceeds

An erroneous payment of sale proceeds may subject the trustee to liability to a party injured by the error. *Atkinson v Foote* (1919) 44 CA 149, 186 P 831. If there is a dispute about priority of secured debts, how much should be paid, or to whom, two alternative courses of action are available to the trustee:

- Interplead the proceeds into court for a judicial determination under traditional rules of interpleader (see CC §2924j(e)); or
- Use the court deposit and summary procedure in CC §2924j(c)-(d) to resolve conflicting claims (see *Wells Fargo Bank v Neilsen* (2009) 178 CA4th 602, ___ CR3d ___; *Cal-Western Reconveyance Corp. v Reed* (2007) 152 CA4th 1308, 62 CR3d 244).

The trustee must notify juniors and other interested parties of surplus proceeds after executing the trustee's deed, unless the trustee files an interpleader action immediately. See CC §2924j(a). If within 90 days after the response period (see §2.103) the trustee cannot resolve the existing conflict with "due diligence" (CC §2924j(b), (f)), the trustee must choose between an interpleader and a deposit of the proceeds into court under CC §2924j(c). CC §2924j(b). (On §2924j(c) procedures, see mandatory form adopted by Judicial Council in §2.135; on interpleaders, see California Civil Procedure Before Trial, chap 28 (4th ed Cal CEB 2004).)

The §2924j(c) procedure is quicker; the court must hear the matter within 90 days after the deposit into court and thereafter distribute the funds to the entitled claimants. CC §2924j(d). A trustee holding any surplus proceeds that are not required to be deposited into court must comply with the Unclaimed Property Law (CCP §§1500-1582). CC §2924j(g). On attorney fee awards in summary actions under CC §2924j, see §8.90.

Under CC §2924j(h), the trustee, beneficiary, or counsel to the trustee or beneficiary is not liable for informing any person entitled to notice under CC §2924j about the owner's right to be paid surplus proceeds, which must be released within a specified period after the trustee sale if no adverse claims exist. This right is stated in CC §2924k(a). See §2.102.

A subordination agreement between some but not all of the existing lienholders on real property and a subsequent lender can create difficulty for the trustee in the distribution of proceeds. Because an incomplete or partial subordination only affects parties to the agreement and creates a circuity of liens among the lienholders, the borrower cannot take advantage of the uncertainty if the proceeds are less than the total amount of the secured debts. The court will allocate the proceeds to the lienholders in an interpleader action or summary procedure under CC §2924j(c)-(e) before giving any to the borrower. See, *e.g., Wells Fargo Bank v Neilsen* (2009) 178 CA4th 602, ___ CR3d ___.

The purchaser at the foreclosure sale need not be concerned with disposition of the surplus. Although misallocation of the sale proceeds may lead to litigation among the various claimants, it has no effect on the purchaser's title. *Hohn v Riverside County Flood Control & Water Conserv. Dist.* (1964) 228 CA2d 605, 39 CR 647.

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§2.107 4. Effect of Rent Funds Held by Receiver

The foreclosing beneficiary should exercise caution when a receiver (see chap 6) has collected rent funds during the foreclosure period. See CC §2938; *United Sav. & Loan Ass'n v Hoffman* (1973) 30 CA3d 306, 106 CR 275. Undisbursed rents held by the receiver are available to the secured creditor as additional security and may be reached by the beneficiary if the amount recovered at the foreclosure sale does not cover the entire debt. A full credit bid, by fully satisfying the debt, deprives the beneficiary of access to those rents, and they will then go either to junior lienholders (*United Sav. & Loan Ass'n v Hoffman, supra*) or to the trustor (*Eastland Sav. & Loan Ass'n v Thornhill & Bruce, Inc.* (1968) 260 CA2d 259, 66 CR 901). See Practice Tip in §2.87.

The court monitors disbursements of rent proceeds made by the receiver after the trustee sale (see §6.46), but the court does not monitor the trustee's distribution of trustee sale proceeds. On trustee's distribution, see §2.102. An action may be brought afterward to challenge any trustee distribution errors (see, *e.g., South Bay Bldg. Enters. v Riviera Lend-Lease, Inc.* (1999) 72 CA4th 1111, 85 CR2d 647).

TAX CONSIDERATIONS: Rents accruing and collected before foreclosure by a receiver are generally not considered rent income to the beneficiary for tax purposes. Instead, such rents are credited toward the principal or interest income under the obligation secured by the deed of trust. (Although interest is generally taxable as ordinary income, principal repayment is not generally taxable, except in installment sales; see IRC §453. By contrast, rent income is generally taxable.) If applied to the debt, the rents are considered rent income to the trustor, even if the trustor did not actually receive them, and they are applied to either principal or interest, depending on the terms of the note. (For the trustor, the interest payment is currently deductible, deductible in a subsequent tax year, or nondeductible, depending on the nature of the debt, character of the property, and other factors; see IRC §163.)

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D. Effect of Homestead on Surplus Proceeds

§2.108 1. Distribution in Nonbankruptcy Sales

The distinction between consensual security interests and liens (mortgages and deeds of trust) and nonconsensual liens (judgment liens) is crucial in the area of homesteads. In some instances, a homestead can give the homeowner significant advantages as against judgment creditors. But the homestead is generally of little consequence to the holders of mortgages and deeds of trust, which are sometimes said to "encumber the homestead" because they do not reduce recovery under them.

The effect of a homestead exemption on surplus proceeds from a foreclosure sale varies, depending on whether the exemption is statutory or the result of a declared homestead. On the differences between a statutory homestead and a declared homestead, compare CCP §§704.710-704.850 with CCP §§704.910-704.995; see *Amin v Khazindar* (2003) 112 CA4th 582, 5 CR3d 224; see also Debt Collection Practice in California, chap 9 (2d ed Cal CEB 1999). Statutory homesteads are perhaps more precisely called "automatic homesteads," since both statutory and declared homesteads are creatures of statute.

Under *Spencer v Lowery* (1991) 235 CA3d 1636, 1 CR2d 795, the trustor's *statutory* homestead exemption (CCP §704.720) does not apply to a foreclosure surplus, because a trustee sale is not a money judgment execution sale. See also *In re Cole* (BAP 9th Cir 1988) 93 BR 707 (applied statutory exemption to debtor in possession's liquidation of residence in Chapter 11 bankruptcy, reasoning that sale was involuntary and functional equivalent of execution sale within meaning of §704.720). The court in *Spencer* declined to follow the rationale of *In re Cole*. In cases involving *declared* homesteads, however, the surplus from a trustee sale is subject to the trustor's homestead as against judgment liens but not junior consensual liens. See *Smith v James A. Merrill, Inc.* (1998) 64 CA4th 94, 75 CR2d 108 (distinguished *Spencer*). See also *Title Trust Deed Serv. Co. v Pearson* (2005) 132 CA4th 168, 33 CR3d 311. *Pearson* relies on *Smith* in holding that, in a dispute over the surplus from a trustee sale involving a judgment lien that attached after the recordation of a declared homestead, the judgment lien is "reduced by the amount of the applicable homestead exemption" so that the judgment lien is effectively subordinate to the homeowner's exemption.

The trustor must prove all facts supporting the amount of the claimed homestead. See *Cal-Western Reconveyance Corp. v Reed* (2007) 152 CA4th 1308, 62 CR3d 244 (upheld trial court's conclusion that trustor did not adequately prove entitlement to $150,000 declared homestead exemption applicable to disabled homeowners). A judgment debtor not currently residing in the homestead due to a pending dissolution proceeding is nevertheless entitled to claim the exemption in the entire homestead until creation of a binding agreement or entry of a judgment dividing the community interest in the homestead. CCP §704.720.

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§2.109 2. Distribution in Bankruptcy Sales

Code of Civil Procedure §703.140(a) allows a debtor in bankruptcy to assert the homestead exemption "regardless of whether there is a money judgment against the debtor or whether a money judgment is being enforced by execution sale or any other procedure." This amendment was stated to be declaratory of existing law. Despite the ruling in *Spencer v Lowery* (1991) 235 CA3d 1636, 1 CR2d 795 (see §2.108), therefore, a debtor in bankruptcy should be able to assert (or reassert) the statutory exemption if a secured lender gets postpetition relief from the automatic stay to foreclose and sell the homestead and surplus proceeds are available from the sale, whether or not the lender chooses a trustee sale or judicial foreclosure. Consequently, a bankruptcy is a viable debtor strategy to obtain the benefit of the statutory homestead exemption in an inevitable foreclosure sale. For further discussion of debtor strategies, including bankruptcy, see chap 7.

If the homestead exemption is increased by statutory amendment, a debtor in bankruptcy is entitled to the surplus from a sale by the bankruptcy trustee only in the amount of the exemption available at the time the bankruptcy case was filed. *Hyman v Plotkin (In re Hyman)* (9th Cir 1992) 967 F2d 1316, 1318 n2. This rule is likely to apply to a secured lender's postpetition foreclosure sale conducted under a relief from stay order.

When a judicial lien is senior to a deed of trust and the total of all liens and the homestead exemption is greater than the proceeds of sale, a formula exists for dealing with the proceeds from a sale of a homestead by a *bankruptcy trustee*. See *Kenpak Converters, Inc. v Patterson (In re Patterson)* (BAP 9th Cir 1992) 139 BR 229. This formula should apply to the distribution of the surplus from a postpetition foreclosure of a deed of trust after relief from stay is granted, but it may not apply in a nonbankruptcy context by reason of the decision in *Spencer v Lowery, supra*. In *Patterson*, the court reduced the senior judicial lien to the amount by which the sale proceeds exceeded the amount of the homestead exemption, the proceeds were paid to the senior judicial lien (as reduced) and the deed of trust, and the debtor received nothing for the homestead exemption.

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IX. INCOME TAX CONSEQUENCES OF FORECLOSURE

§2.110 A. For Borrower

The gain or loss to the borrower (trustor) from a foreclosure is the difference between the borrower's adjusted basis in the property and the amount realized from the foreclosure. *Helvering v Hammel* (1941) 311 US 504, 85 L Ed 303, 61 S Ct 368; IRS Pub 544 (2004). In effect, the foreclosure sale is treated as if the borrower had sold the property to the highest bidder.

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§2.111 1. Amount Realized

The amount realized by the borrower includes any surplus foreclosure sale proceeds it receives. Treas Reg §1.1001-2(c), Example (2). It also includes the unpaid balance of any nonrecourse secured loan (*i.e.,* a loan for which a deficiency judgment is prohibited by law or language in the note) as the discharge of an indebtedness, even when the debt exceeds the value of the security. Treas Reg §1.1001-2; *Commissioner v Tufts* (1983) 461 US 300, 75 L Ed 2d 863, 103 S Ct 1826. See *Allan v Commissioner* (8th Cir 1988) 856 F2d 1169. When a deficiency judgment is possible, the amount realized is the lesser of the amount bid at the foreclosure sale or the unpaid balance of the secured debt. Treas Reg §1.1001-2. If a deficiency judgment is obtained and later forgiven, additional income may be realized by the borrower from discharge of that debt. Treas Reg §1.1001-2(c), Example (8).

The amount realized by a borrower from a foreclosure of property subject to a nonrecourse debt includes the entire amount owed on the loan (including interest), plus surplus proceeds, if any, received by the borrower (see §2.102). The fair market value of the property is not considered. See *Parker v Delaney* (1st Cir 1950) 186 F2d 455; *R. O'Dell & Sons v Commissioner* (3d Cir 1948) 169 F2d 247. See also *Woodsam Assocs. v Commissioner* (2d Cir 1952) 198 F2d 357; *Lutz & Schramm Co.* (1943) 1 TC 682, nonacq 1943 Cum Bull 35.

The amount realized by a borrower from a foreclosure of property subject to a recourse debt that is fully discharged is determined under a bifurcated approach. The amount realized by the borrower is the amount of the recourse debt up to the fair market value of the property. If the fair market value of the property is less than the amount of the recourse debt, the difference is treated as income from cancellation of indebtedness. *Richard D. Frazier* (1998) 111 TC 243; Treas Reg §1.1001-2(c), Example (8); Rev Rul 90-16, 1990-1 Cum Bull 12. The amount realized from the foreclosure of property subject to a recourse debt when the borrower continues to be liable for the unpaid portion of the debt is the proceeds from the foreclosure sale. *Mark R. Webb,* TC Memo 1995-486; *Joseph Y. Aizawa* (1992) 99 TC 197, aff'd (9th Cir 1994) 74 AFTR2d 94-5493. See IRS Pub 544 (2008) (available at http://www.irs.ustreas.gov).

Interest arrearages included in the discharged debt are also part of the amount realized by the borrower, but if payment of that interest would have generated a deduction for the borrower, then an offsetting deduction is allowed on foreclosure. IRC §108(e)(2). (However, interest expense (even under a debt secured by real property) is not necessarily deductible. See IRC §163. Interest expense is categorized in several different ways—personal interest, business interest, investment interest, home mortgage interest, and passive activities interest.) If the borrower was insolvent at the time of foreclosure, income realized from discharge of the debt may not be recognized; instead, that income may reduce net operating loss or other tax attributes, if any. IRC §108(b).

For further discussion of the income tax impact of a foreclosure on a borrower and the tax differences between a recourse and a nonrecourse debt, see RIA Fed Tax Coordinator 2d ¶¶M-3800-M-3808 (Nov. 1999) (available to subscribers at http://www.checkpoint.riag.com).

NOTE: The Mortgage Forgiveness Debt Relief Act of 2007, enacted December 20, 2007, amends provisions of IRC §108 to exclude from gross income the discharge of indebtedness on a borrower's principal residence up to the amount of $1 million. See Pub L 110-142, 121 Stat 1803.

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§2.112 2. Character of Gains and Losses

The character of the borrower's gain or loss on foreclosure usually depends on the use of the asset constituting the security. If the asset is a capital asset, the borrower's gain or loss is capital. IRC §1221. If the asset is property used for a trade or business, the amount realized may be treated as capital gain or ordinary loss, subject to the netting rules of IRC §1231. If the asset was property held for personal use, any gain is capital and no loss deduction is allowed. IRC §262. If the borrower has a statutory right to postsale redemption, gain or loss is recognized when the redemption right expires, not when the sale occurs. *Derby Realty Corp.* (1937) 35 BTA 335, acq 1937-2 Cum Bull 8. See *Commissioner v Peterman* (9th Cir 1941) 118 F2d 973, 976. The borrower may accelerate recognition, however, by quitclaiming the right of redemption and thus obtain a loss deduction in the year in which the foreclosure occurs. *Commissioner v Hill* (6th Cir 1941) 119 F2d 421.

WARNING: This chapter does not provide complete and in-depth coverage of the tax consequences of trustee sales. Borrowers' counsel should confer with qualified tax counselors or attorneys for assistance in determining the tax impact of trustee sales on their clients.

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B. For Lender

§2.113 1. If Third Party Purchases Property

When a foreclosure sale of the real property security occurs, either by trustee sale or judicial foreclosure, the amount of the lender's gain or loss is measured by the difference between the amount received by the lender and the lender's basis in the secured debt. Treas Reg §1.166-6. Any loss sustained is treated as a bad-debt loss. Treas Reg §1.166-6(a). Any gain recognized by the lender is usually ordinary gain. IRC §1222.

With a nonrecourse note, the lender will collect only the net proceeds of the foreclosure sale because no deficiency will survive the sale. If the foreclosed party is personally liable on the loan obligation, the amount received by the lender will include any additional amount that the lender collects from that party after foreclosure. The amount realized probably does not include the amount of a deficiency judgment that the lender manages to obtain unless the judgment is actually collected. The holder of the deficiency judgment bears the burden of showing that the judgment is worthless or not collectible (*e.g.,* that the debtor is bankrupt or insolvent).

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§2.114 a. Basis

The lender's basis in the secured note is usually the amount lent, plus any loan expenses (plus accrued interest if the lender is an accrual-basis taxpayer), and less any payments of principal received. If the amount collected by the lender is less than the sum of the principal plus accrued interest, the lender must recognize the interest income, unless the principal of the debt exceeds the value of the property. See *Helvering v Midland Mut. Life Ins. Co.* (1937) 300 US 216, 81 L Ed 612, 57 S Ct 423; *Nichols v Commissioner* (6th Cir 1944) 141 F2d 870. See also RIA Fed Tax Coordinator 2d ¶¶M-3700-M-3710 (Nov. 1999) (available to subscribers at http://www.checkpoint.riag.com).

If the lender purchased an existing note, the price paid for it establishes the basis. IRC §§1011-1012. A lender's basis in a purchase money note is the face value of the note unless the lender has reported gain on the sale under the installment method. In that event, the basis in the note is the excess of its face value over the gain that would be recognized if the note were paid. IRC §453.

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§2.115 b. Income and Loss

Any amount received on foreclosure by the lender in excess of basis is treated as income. If the amount received is interest income, it is treated as discussed in §1.22. If it is other income (because the borrower's basis in the note was different from the balance due on the note), then it is capital gain or ordinary income, depending on the character of the asset. See §2.110. There is a loss if the amount received is less than the lender's basis in the note (typically when the amount bid at the sale is less than the unpaid principal balance of the note). The loss is an ordinary loss if the lender was a professional lender (IRC §166); otherwise, it is a capital loss (IRC §§165, 1221).

Gain or loss occurs in the year of the foreclosure sale if the obligation is nonrecourse or if the lender does not obtain a deficiency judgment. Treas Reg §1.166-6(a). If the lender obtains a deficiency judgment that proves to be uncollectible, the lender is entitled to a bad-debt deduction in the year in which the deficiency judgment becomes worthless. Treas Reg §§1.166-3(b), 1.166-6(a). The existence of a postsale right of redemption in the borrower does not change the timing of the lender's gain or loss. The amount of a deficiency judgment that is later collected should be added to the amount realized. *Securities Mortgage Co.* (1972) 58 TC 667.

NOTE: A junior beneficiary may claim a bad-debt loss if, after a senior foreclosure sale, the junior debt becomes worthless. The mere fact that the senior foreclosed, however, may not be sufficient. See *Arthur Berenson* (1939) 39 BTA 77, aff'd (2d Cir 1940) 113 F2d 113.

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2. If Lender Acquires Property at Sale

§2.116 a. Seller-Lender

A seller-lender's reacquisition of the property at the foreclosure sale is viewed as an exchange of the debt for the property and is subject to IRC §1038. Gain is thus realized to the extent that the property's value exceeds the seller's basis in the debt. Recognition of this gain is limited, however, to the extent by which the amounts previously received by the seller exceed previously reported gain. IRC §1038. Any earlier-recognized loss is deducted from the seller's new basis in the property. IRC §1038(d).

Nonrecognition is greater if the seller qualifies under IRC §121 for a gain exclusion of $250,000 for the sale of its principal residence, but only if the seller owned and occupied it for 2 of the 5 years ending on the date of sale. The exclusion amount is $500,000 for qualifying married couples filing jointly. (These formulas apply on the sale that was undone by the foreclosure.) See Taxpayer Relief Act of 1997 (Pub L 105-34, 111 Stat 788) and Restructuring and Reform Act of 1998 (Pub L 105-206, 112 Stat 685).

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§2.117 b. Third Party Lender

When a beneficiary who is a third party lender purchases at the sale, IRC §1038 does not apply. A bad-debt loss is recognized to the extent that the amount bid is less than the beneficiary's basis in the debt, and there is gain or loss to the extent that the amount bid differs from the fair market value of the property. *Community Bank v Commissioner* (9th Cir 1987) 819 F2d 940. If the property is worth less than the debt, an underbid will usually generate an ordinary loss if the beneficiary is a professional lender; and a capital loss otherwise. See IRC §§165(a), 166. In contrast, a credit bid that includes interest arrearages produces ordinary income for the interest thus considered to have been collected, even if the property's fair market value is less than the unpaid loan balance. *Helvering v Midland Mut. Life Ins. Co.* (1937) 300 US 216, 81 L Ed 612, 57 S Ct 423; *National Life Ins. Co. v U.S.* (Ct Cl 1933) 4 F Supp 1000; *Prudential Ins. Co*. (1935) 33 BTA 332. As purchaser, the beneficiary has a basis in the property that is usually the amount bid. Treas Reg §1.166-6(b)(2).

See also nonrecognition rules under IRC §121, discussed in §2.116.

WARNING: This chapter does not provide complete and in-depth coverage of the tax consequences of trustee sales. Lenders' counsel should confer with qualified tax counselors or attorneys for assistance in determining the tax impact of trustee sales on their clients.

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X. LENDER POSTSALE DAMAGE ACTIONS

§2.118 A. Deficiency Barred After Trustee Sale

Because CCP §580d bars a deficiency judgment after a trustee sale (see §§2.10, 5.8), lenders have explored with mixed results other methods of recovering for their losses after a trustee sale when the sale did not adequately compensate the lender for the unpaid balance of the debt. Such methods include actions for waste, fraud, negligence, insurance and bond proceeds (see §§2.119-2.129), and inverse condemnation. On inverse condemnation, see Condemnation Practice in California (3d ed Cal CEB 2005).

A junior secured lender whose interest is "sold out" by the senior foreclosure may not bring an action for a deficiency judgment either, but it sometimes has the right to bring a claim directly on the underlying obligation. See §§5.3, 5.39-5.44.

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B. Actions for Waste

§2.119 1. Bad Faith Claims Not Barred by Antideficiency Laws

When a borrower (or a borrower's successor in interest) impairs or fails to maintain the security, by omission or through affirmative acts, the lender may bring an action for waste after foreclosing against the property, but only under limited circumstances. In *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, the supreme court held that the purchase money antideficiency statute, CCP §580b, prohibits a purchase money lender from recovering for waste after a foreclosure sale unless the debtor or its successors acted in bad faith. *Nippon Credit Bank v 1333 N. Cal. Blvd.* (2001) 86 CA4th 486, 103 CR2d 421; *Osuna v Albertson* (1982) 134 CA3d 71, 184 CR 338. See Bernhardt, *Faithful Waste,* 24 CEB Real Prop L Rep 151 (May 2001). The court also held that CCP §580d similarly prohibits recovery for waste after a trustee sale unless the defendant acted in bad faith. When the lender proves the bad faith, it may pursue damages for waste (see §§5.57-5.59). On full credit bid's impact on waste claims, see §2.120.

NOTE: In the event of conventional waste (*i.e.,* that which does not involve bad faith), the secured creditor can recover only if (1) the debt is recourse and not purchase money and (2) the creditor judicially forecloses and pursues a timely deficiency claim. In that instance, however, the recovery will be a deficiency judgment rather than a damages judgment for waste (see §§3.1, 3.4, 3.86-3.89).

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§2.120 2. Bad Faith Waste Claims Precluded by Full Credit Bid

If the foreclosing lender makes a full credit bid at the trustee sale (see §2.84), it cannot recover even for bad faith waste against the trustor or any successors in interest. *Cornelison v Kornbluth* (1975) 15 C3d 590, 607, 125 CR 557. The court reasoned that, if the lender enters a full credit bid for the property, the lender cannot establish any impairment of security, because the property has satisfied the debt. This view treats a waste claim as being, at least in part, statutory (see discussion of CC §2929 in §§4.51-4.53, 5.57-5.59, 6.10-6.12; see also §8.76), arising from the existence of a deed of trust on the property. Under §2929, even a nonassuming grantee has a duty not to impair the security. See 15 C3d at 599. But see discussion of *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352 (allowed fraud action despite full credit bid), and *Alliance* progeny in §§2.123-2.126. The outcome in *Cornelison* also can be explained simply as treating bad faith waste as a classic "nondignatary" tort cause of action and as recognizing that a full credit bid, in leaving the debt fully satisfied, eliminates the damages element essential to such a tort claim. See §1.27A.

The reported cases conflict on whether a full credit bid is considered to have been made if the lender holds more than one deed of trust. In *Romo v Stewart Title* (1995) 35 CA4th 1609, 1617, 42 CR2d 414, the beneficiary of both the second and third deeds of trust made a full credit bid on the third deed of trust. The court treated this full credit bid as a full credit bid on the second deed of trust as well. Distinguish this case from the circumstances when the senior lien (rather than the junior) is foreclosed: In *Evans v California Trailer Court, Inc.* (1994) 28 CA4th 540, 554, 33 CR2d 646, the court held that a beneficiary holding two deeds of trust who made a bid equaling the amount owed on the senior loan at the senior foreclosure could pursue tort claims on the junior debt for waste, fraud, and conversion because the bid was not tantamount to a full credit bid (see §5.12). See further discussion of *Romo* in §9.30.

On merger doctrine, see §§1.41, 4.44, 5.12, 9.28-9.31, 9.64.

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C. Actions for Fraud After Full Credit Bid

§2.121 1. Against Borrowers

Most appellate court decisions relying on *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557 (see §§2.119-2.120), have held that a lender's full credit bid at the trustee sale bars a later fraud claim against the trustor. See *Commonwealth Mortgage Assur. Co. v Superior Court* (1989) 211 CA3d 508, 259 CR 425; *Sumitomo Bank v Taurus Developers, Inc.* (1986) 185 CA3d 211, 229 CR 719. But see *Evans v California Trailer Court, Inc.* (1994) 28 CA4th 540, 556, 33 CR2d 646 (dictum that lender may sue borrower for fraud that induced making of loan). These decisions were not specifically mentioned by the supreme court in *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352. Their continuing validity is uncertain, however, because the rules established by *Alliance* (see §§2.123-2.126) may ultimately be extended to all fraud actions (*i.e.,* not limited to lender suits against third parties), although early indications are to the contrary. See discussion of *Lawler v Jacobs* (2000) 83 CA4th 723, 100 CR2d 52, in §2.124. The *Alliance* court, however, noted that, just as an action for fraud against the borrower is separate from an action on the promissory note, a lender's suit against its fiduciaries or agents for fraudulent inducement is separate from a suit for impairment of its security. 10 C4th at 1249. The following are key issues in evaluating the viability of any fraud, bad faith, or other tort claim following a full credit bid:

- Does the lender have any cognizable loss after its loan was "paid" in full (by its own full credit bid)?
- Did the fraud proximately cause that loss (*e.g.,* when the defendant's conduct induced the lender to make an unnecessary full credit bid and thus pay too much for the property purchaser)?

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2. Against Third Parties

§2.122 a. Pre-*Alliance* Cases

Before the supreme court's decision in *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352 (see §2.123), a significant split existed in the courts of appeal on the extent to which a full credit bid barred remedies otherwise available to a lender against nonborrowing parties. In 1980, the First District permitted a lender to sue its attorney and broker for fraud and negligence, despite the fact that the lender had acquired the property with a full credit bid. See *Brown v Critchfield* (1980) 100 CA3d 858, 161 CR 342. In 1995, the First District allowed a vendor (who financed the underlying sale by carrying back loans secured by second and third deeds of trust), despite a full credit bid on foreclosure, to recover on fraud and negligence claims against the escrow agent, but only for losses and punitive damage beyond the unpaid loans. See *Romo v Stewart Title* (1995) 35 CA4th 1609, 1619, 42 CR2d 414. See also *Foggy v Ralph F. Clark & Assocs.* (1987) 192 CA3d 1204, 238 CR 130 (not full credit bid case, but similar to *Critchfield* on damages analysis). In *Guild Mortgage Co. v Heller* (1987) 193 CA3d 1505, 239 CR 59, the Second District appeared to take a similar position.

In 1992, however, the Second District reversed its viewpoint, confined *Guild Mortgage* to its special facts, and held that a full credit bid prohibited a lender from recovering for fraud against either the trustor or third persons. *Western Fed. Sav. & Loan Ass'n v Sawyer* (1992) 10 CA4th 1615, 13 CR2d 639. The Third District reached a similar conclusion in 1994. *GN Mortgage Corp. v Fidelity Nat'l Title Ins. Co.* (1994) 21 CA4th 1802, 27 CR2d 47.

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§2.123 b. The *Alliance* Decision

In *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, the California Supreme Court held that a full credit bid does not always bar fraud claims against third parties. The supreme court ruled that a lender induced by the fraud of a third party to make the loans (and later to make full credit bids at foreclosure sale) may recover in tort for the fraud, despite its full credit bids.

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§2.124 (1) Policy Underlying *Alliance*

The supreme court, in *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, distinguished between a lender's recovery in fraud and recovery for impairment of its security, noting that the latter is barred by its full credit bid. 10 C4th at 1249. The court reasoned:

> [J]ust as a suit for fraud against a borrower "is a completely separate remedy than a suit on the promissory note secured by the deed of trust," … a lender's suit against its fiduciaries or agents for fraudulently inducing it to make loans and purchase property is a completely separate cause of action from a suit for impairment of its security.

Thereafter, a bankruptcy court held that a lender may pursue a third party real estate broker for fraudulently representing the value of the real property security, even though the lender had accepted a deed in lieu of foreclosure from the borrower. See *Hardin v Gianni (In re King St. Invs.)* (BAP 9th Cir 1998) 219 BR 848. But see *Michelson v Camp* (1999) 72 CA4th 955, 85 CR2d 539 (no recovery allowed for lender's intentional fraud action against appraiser, because lender failed to show that (1) it was induced by false representations in making the full credit bid and (2) it reasonably relied on those representations).

For analysis and discussion of the practical implications of the *Alliance* case, see Harris & Levin, *Alliance Mortgage and the Full Credit Bid Rule: Clarity or More Confusion?,* 18 CEB Real Prop L Rep 319 (Nov. 1995); Bernhardt, *Alliance Mortgage: Partial Answers About Full Credit Bids,* 18 CEB Real Prop L Rep 323 (Nov. 1995). In *Lawler v Jacobs* (2000) 83 CA4th 723, 737, 100 CR2d 52, *Alliance Mortgage* was given a narrow interpretation as a decision that "does not even fall into the camp of lawsuits pitting lender against borrower"; rather, "it was lender versus third party nonborrowers."

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§2.125 (2) Measure of Damages

Under *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, damages for fraud are not necessarily measured by the outstanding indebtedness (see §2.124) but by the statutory measure of damages for fraud, *i.e.,* out-of-pocket and consequential damages under either CC §3333 or §3343, depending on whether the parties are in a fiduciary relationship (§3333) or the fraud is in the sale of real estate (§3343). 10 C4th at 1249. The damage award and the viability of the fraud claim, however, are subject to the proximate cause analysis in the *Alliance* opinion (see §2.126). For a post-*Alliance* discussion of the fiduciary fraud exception to CC §3343, see *Strebel v Brenlar Invs., Inc.* (2006) 135 CA4th 740, 745, 37 CR3d 699 (crafting new measure of damages when neither consequential nor out-of-pocket damages adequately compensated plaintiff). On *Strebel*, see Bernhardt, *Making the Broker Pay When the Deal Goes Bad,* 29 CEB Real Prop L Rep 240 (Mar. 2006); on measure of damages for fraud, see California Real Property Remedies and Damages, chap 3 (2d ed Cal CEB 2002).

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§2.126 (3) Proximate Cause; Burden of Proof

A full credit bid leaves the foreclosure lender with no demonstrable loan loss upon which to base a tort claim against the borrower. It is based more on basic arithmetic than on any public policy. A lender's full credit bid (see §2.84) also does not as a matter of law bar the lender's fraud claims against third party (nontrustor) defendants who fraudulently induced the lender to make the loan. *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352. The holding in *Alliance* appears to be limited to the proposition that the lender may recover in damages the difference between the bid and the property value only if the defendant's fraud proximately caused the lender to make the full credit bid. See 10 C4th at 1246; *Pacific Inland Bank v Ainsworth* (1995) 41 CA4th 277, 282, 48 CR2d 489. The lender must be injured as a bidder-purchaser at the foreclosure sale rather than as an unsatisfied lender.

The *Alliance* opinion is unclear about the evidentiary burden a defrauded lender must meet in pursuing claims against third party tortfeasors after fraud in inducement of the loan is proved. To establish reliance, the lender must demonstrate that its full credit bid was a proximate result of the defendant's fraud and that, without such fraud, it would not, in all reasonable probability, have made the bid. 10 C4th at 1246.

If the full credit bid was not proximately caused by defendant's fraudulent misrepresentations or if plaintiff's reliance was either inappropriate, given the context of the relationship, or "manifestly unreasonable," then the full credit bid rule applies and the bid is deemed to establish the value of the property (or payment of the debt), thus limiting plaintiff's damages to consequential damages and specifically excluding the difference between the amount of the bid and the actual value of the property. 10 C4th at 1247. In other words, lenders may recover out-of-pocket losses if they can prove that their total monetary expenditures or losses exceeded the loan amount. See *Michelson v Camp* (1999) 72 CA4th 955, 85 CR2d 539.

In most cases of outright fraud, however, the difference between the bid and the property value will probably be the most significant part of the damage, leaving the defrauded lender with little or no recovery if it fails to prove that the bid (as opposed to the loan) was made in reasonable reliance on the fraud. See 10 C4th at 1253 (concurring opinion of Justice Werdegar). The question of whether such reliance was justifiable is a fact-based inquiry, thus ensuring case-by-case litigation of the issue. It may be difficult for the lender to establish that it was reasonable to rely on predefault representations. See, *e.g., Michelson v Camp, supra*.

PRACTICE TIP: Defendants in an action based on *Alliance* (whether they are third parties or the debtor) should review the foreclosure file to determine whether other bidders qualified at or participated in the foreclosure sale. The other bidders may have been prepared to bid more than the bid that the lender later wishes to disavow. Alternatively, those other bidders may take the position that the wrongfully induced bidding invalidates the entire sale and requires a new auction—an outcome that the plaintiff may wish to avoid.

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§2.127 D. Negligence Actions After Full Credit Bid

Because *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, involved only a fraud cause of action, the courts of appeal have been forced to decide whether similar theories of relief also come under its umbrella. The courts' division on this issue is similar to the pre-*Alliance* division on the fraud issue (see §2.122). In 1995, the Fourth District held that a prior full credit bid barred the lender from suing its appraiser for negligence in overvaluing the real property security. *Pacific Inland Bank v Ainsworth* (1995) 41 CA4th 277, 48 CR2d 489. The court in *Ainsworth* interpreted the holding in *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, as the general rule on the effect of a full credit bid, relegating *Alliance* to the creation of a narrow fraud exception to that rule when the bid itself was fraudulently induced.

The First District, however, continued its approach of limiting the full credit bid defense as much as possible by holding that such a bid did not prohibit an action against an appraiser for negligence or negligent misrepresentation. See *Kolodge v Boyd* (2001) 88 CA4th 349, 105 CR2d 749 (declined to follow *Pacific Inland Bank;* like fraud action, suit for negligence is remedy separate from action directly on real property secured loan and will lie if lender can show reasonable reliance on, *e.g.,* negligent appraisal in making full credit bid); *Arlington Inv. Co. v Tarcher* (review dismissed July 15, 1998, and remanded to court of appeal; superseded opinion at 58 CA4th 83, 67 CR2d 816), reported in 21 CEB Real Prop L Rep 30 (Jan. 1998). The *Arlington* court also read the *Alliance* decision to apply to all third party tort claims as distinct from attempts to collect the unpaid balance of the debt. See also *Michelson v Camp* (1999) 72 CA4th 955, 85 CR2d 539 (cited in §§2.87, 2.124, 2.126), and *Kolodge v Boyd*, *supra* (full bid will not preclude negligence claim against appraiser if lender-purchaser can show reasonable reliance on appraisal in making full credit bid).

On other negligence actions decided by First District, see *Brown v Critchfield* (1980) 100 CA3d 858, 161 CR 342, and *Romo v Stewart Title* (1995) 35 CA4th 1609, 42 CR2d 414, discussed in §2.120. On negligence actions against borrower, see *Sumitomo Bank v Taurus Developers, Inc.* (1986) 185 CA3d 211, 229 CR 719 (allowed negligent construction action against borrower by lender—as buyer—after it made full credit bid at trustee sale).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.127A E. Rationale of Full Credit Bid Rule

§2.127A E. Rationale of Full Credit Bid Rule

The debate about the distinction between claims against the trustor and claims against third parties may continue. The full credit bid rule arguably is not a policy-based rule (except to the extent that it is based on mathematics and the broad policy against double recovery), and it is not an aspect or corollary of the antideficiency statutes and rules. Given this, whether a former lender who has made an improvident full credit bid has a viable fraud, negligence, or other tort claim should turn not on whether the target of the claim is a former borrower or, by contrast, a third party, but whether the former lender *cum* owner can demonstrate that its unfortunate bid was induced by actionably tortious conduct. It is theoretically possible that the former borrower committed the tort that induced the bid. If so, no reason or policy exists that would warrant imposing a rigid rule barring an otherwise viable tort claim against the former borrower. After all, when the claim is a legitimate tort claim, particularly an intentional tort claim, it is based on the breach of legal rights and duties totally different than the covenants of the loan documents. As a practical matter, however, successful tort claims against a former borrower by a full credit-bidding lender will be relatively rare for two reasons: (1) the borrower's "inducements" to the lender will be remote in time and concerning a loan later known to have gone into default long before the bidding event and (2) further reliance on anything previously said or done by a defaulting borrower strains the bounds of plausible reasonableness.

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§2.128 F. Intentional Interference and Conspiracy

The potential for junior secured creditors (or owners-borrowers) to acquire a senior trust deed for the express purpose of wiping or squeezing out a trust deed with lower priority has always existed. Although this strategy may have inequitable consequences, there has been little authority prohibiting this stratagem. However, one court of appeal described such conduct as "sham foreclosure" and upheld a jury verdict awarding compensatory and punitive damages for such conduct based on intentional interference with contract and conspiracy-to-interfere theories. *Webber v Inland Empire Invs., Inc.* (1999) 74 CA4th 884, 88 CR2d 594. In *Webber,* a corporate borrower, which had the ability to pay off its loans, used affiliated and controlled corporations to purchase a first priority trust deed so as to set up a scenario for wiping out a second priority purchase money trust deed held by an assignee of the seller. Applying an alter ego analysis to disregard the separateness between the corporations, the court upheld a jury verdict finding the foreclosure to be a sham. The court also rejected the borrower's contention that CCP §580b precluded the interference claim. See also §§5.56, 10.77.

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§2.129 G. Insurance and Bond Claims After Full Credit Bid

If the lender makes a full credit bid in foreclosing on the deed of trust securing a note guaranteed by mortgage bonds (similar to mortgage insurance for lenders), the lender may not recover against the bond. *Bank of America v Quackenbush* (1997) 56 CA4th 1167, 66 CR2d 81. Similarly, after making a full credit bid, a lender may not recover on property insurance procured by the trustor. *Armsey v Channel Assocs.* (1986) 184 CA3d 833, 229 CR 509. This is true even if the lender is a named insured on the policy because its full credit bid has left it with no loss. *Universal Mortgage Co. v Prudential Ins. Co.* (9th Cir 1986) 799 F2d 458 (fire and casualty insurance policy). See *Caruso v Great W. Sav.* (1991) 229 CA3d 667, 280 CR 322; *Duarte v Lake Gregory Land & Water Co.* (1974) 39 CA3d 101, 105, 113 CR 893; *Altus Bank v State Farm Fire & Cas. Co.* (CD Cal 1991) 758 F Supp 567, aff'd (9th Cir 1992) 979 F2d 854 (unpublished opinion); and additional cases cited in *Cornelison v Kornbluth* (1975) 15 C3d 590, 606, 125 CR 557. On insurance as additional loan security, see chap 8.

In an insurance bad faith case, *Track Mortgage Group, Inc. v Crusader Ins. Co.* (2002) 98 CA4th 857, 120 CR2d 228, the Second Appellate District's analysis of the credit bid rule follows that of the court in *Alliance Mortgage*. See §§2.123-2.126. *Track* is notable for its narrow reading of *Alliance Mortgage* (to the effect that claims against third parties will survive only if the third party's wrongdoing can be shown to have proximately caused the ill-advised bid) and for its recognition that the "full credit bid rule" is simply one instance of a broader "credit bid rule." Another insurance bad faith case also giving a narrow application to *Alliance Mortgage* was ordered depublished. See *Norwest Mortgage, Inc. v State Farm Fire & Cas. Co.* (ordered not published July 24, 2002; superseded opinion at 97 CA4th 571, 118 CR2d 367), reported at 25 CEB Real Prop L Rep 132 (May 2002).

An exception to the application of the full credit bid rule to insurance claims was recognized in *Countrywide Home Loans, Inc. v Tutungi* (1998) 66 CA4th 727, 78 CR2d 203, which held that, because the lender stepped into the shoes of the borrower (as a condominium owner and member of the association) after the trustee sale, the lender, as the primary insured, was entitled to earthquake insurance proceeds. The reasoning in this case is similar to that in *Sumitomo Bank v Taurus Developers, Inc.* (1986) 185 CA3d 211, 229 CR 719, cited in §2.127, because the lender was "wearing a different hat" in the lawsuit and suffered an insured loss as the owner, not as the bidder.

On recovery of insurance by lender in multiple security cases, see §§9.24-9.25. On lenders' rights to insurance policy proceeds or condemnation awards, see §§8.57-8.73. On bad faith actions against lenders for improperly appropriating insurance proceeds or condemnation awards, see §12.142.

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XI. TRUSTEE SALE FORMS

§2.130 A. Form: Notice of Default

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NOTICE OF DEFAULT AND ELECTION TO SELL UNDER DEED OF TRUST

IMPORTANT NOTICE

[*Put **headings** in 14-point boldface type if printed or in capital letters if typed*]

IF YOUR PROPERTY IS IN FORECLOSURE BECAUSE YOU ARE BEHIND IN YOUR PAYMENTS, IT MAY BE SOLD WITHOUT ANY COURT ACTION, [*put preceding phrase in 14-point boldface type if printed or in capital letters if typed*] **and you may have the legal right to bring your account in good standing by paying all of your past due payments plus permitted costs and expenses within the time permitted by law for reinstatement of your account, which is normally five (5) business days prior to the date set for the sale of your property. No sale date may be set until three (3) months from the date this notice of default may be recorded (which date of recordation appears on this notice).**

This amount is _ _[*dollar amount*]_ _ as of _ _[*date*]_ _, and will increase until your account becomes current.

While your property is in foreclosure, you still must pay other obligations (such as insurance and taxes) required by your note and deed of trust or mortgage. If you fail to make future payments on the loan, pay taxes on the property, provide insurance on the property, or pay other obligations as required in the note and deed of trust or mortgage, the beneficiary or mortgagee may insist that you do so in order to reinstate your account in good standing. In addition, the beneficiary or mortgagee may require as a condition to reinstatement that you provide reliable written evidence that you paid all senior liens, property taxes, and hazard insurance premiums.

Upon your written request, the beneficiary or mortgagee will give you a written itemization of the entire amount you must pay. You may not have to pay the entire unpaid portion of your account, even though full payment was demanded, but you must pay all amounts in default at the time payment is made. However, you and your beneficiary or mortgagee may mutually agree in writing prior to the time the notice of sale is posted (which may not be earlier than the end of the 3-month period stated above) to, among other things, (1) provide additional time in which to cure the default by transfer of the property or otherwise; or (2) establish a schedule of payments in order to cure your default; or both (1) and (2).

Following the expiration of the time period referred to in the first paragraph of this notice, unless the obligation being foreclosed upon or a separate written agreement between you and your creditor permits a longer period, you have only the legal right to stop the sale of your property by paying the entire amount demanded by your creditor.

TO FIND OUT THE AMOUNT YOU MUST PAY, OR TO ARRANGE FOR PAYMENT TO STOP THE FORECLOSURE, OR IF YOUR PROPERTY IS IN FORECLOSURE FOR ANY OTHER REASON, CONTACT:

_ _[*Name of beneficiary or mortgagee*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _

If you have any questions, you should contact a lawyer or the governmental agency which may have insured your loan.

Notwithstanding the fact that your property is in foreclosure, you may offer your property for sale, provided the sale is concluded prior to the conclusion of the foreclosure.

Remember, YOU MAY LOSE LEGAL RIGHTS IF YOU DO NOT TAKE PROMPT ACTION.

[*Put preceding warning in 14-point boldface type if printed or in capital letters if typed*]

NOTICE IS HEREBY GIVEN THAT under the deed of trust executed by _ _[*name*]_ _ as trustor, to _ _[*name*]_ _ as trustee, and _ _[*name*]_ _ as beneficiary, recorded on _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ in the Official Records of _ _ _ _ _ _ County, California, a breach of the obligation secured by the deed of trust has occurred, that the nature of the breach is _ _[*specify acts or omissions constituting breach*]_ _, and that the beneficiary (1) declares all sums secured by the deed of trust immediately due and payable and (2) elects to sell or cause to be sold the trust property to satisfy the obligation.

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify, e.g., corporation*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*If appropriate (see §2.38), add*]

DECLARATION UNDER CC §2923.5

I declare that the following facts are personally known to me, and that if called as a witness I could competently testify to them:

I am _ _[*the beneficiary/an authorized agent of the beneficiary*]_ _ **of the foregoing deed of trust. I initially attempted to contact the borrower (trustor under the deed of trust) by sending a first-class letter that included the toll-free telephone number made available by the United States Department of Housing and Urban Development (HUD) to find a HUD-certified housing counseling agency.**

[*Add one of the following alternatives under CC §2923.5(b), (g)-(h)*]

[*Alternative 1: Borrower contacted]*

I contacted the borrower _ _[*in person/by telephone*]_ _ **on** _ _[*date*]_ _ **to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure. During the initial contact, I advised the borrower that he or she had the right to request a subsequent meeting and, if requested, that it would be scheduled within fourteen (14) days. The borrower** _ _[*did/did not*]_ _ **request the subsequent meeting. I also gave the borrower the toll-free telephone number made available by HUD to find a HUD-certified housing counseling agency.**

[*Alternative 2: Borrower not contacted after due diligence]*

I attempted to contact the borrower _ _[*in person/by telephone*]_ _ **on the following dates** _ _[*list all dates of attempted contact and results of each attempt*]_ _**. This was done to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure. I exercised due diligence to further contact the borrower as follows:** _ _[*list all actions taken to contact borrower and results as required by CC §2923.5(g)*]_ _**.**

[*Alternative 3: No contact with borrower required]*

No contact with the borrower was required because the borrower surrendered the property on _ _[*date*]_ _ **to the** _ _[*trustee/beneficiary/authorized agent*]_ _**, the borrower contracted with an organization, person, or entity whose primary business is advising how to extend the foreclosure process, or the borrower filed a bankruptcy petition and the bankruptcy court has not entered an order closing or dismissing the bankruptcy case or granting stay relief.**

[*Continue*]

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and

correct, and that this declaration was executed on _ _[*date*]_ _, at _ _[*city*]_ _, California.

__[*Signature of declarant*]__
_ _[*Declarant's typed name*]_ _

Comment: This is primarily a statutory form. The language of the headings and the first nine paragraphs of the notice are dictated by CC §2924c. If the notice is printed, it must appear in at least 12-point boldface type, except for certain portions of the notice required to be in 14-point boldface (if printed) or capital letters (if typed). The notice of default must be in Spanish or other designated non-English language prescribed by CC §1632 if the loan is covered by §1632 and if negotiations have taken place primarily in that language. CC §2924c(b)(1). (Note that CC §2924c(b)(1) refers to an earlier version of CC §1632 and does not reflect current law under §1632.) See §§2.37-2.41 for discussion of notice contents and for explanation of declaration regarding contacting borrower at end of notice.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.131 B. Form: Request for Notice of Default

§2.131 B. Form: Request for Notice of Default

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REQUEST FOR NOTICE OF DEFAULT AND NOTICE OF SALE UNDER DEED OF TRUST

In accordance with Civil Code §2924b, I hereby request that copies of any notice of default and any notice of sale under the deed of trust recorded on _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ in the Official Records of _ _ _ _ _ _ County, California, be mailed to me, _ _[*name*]_ _, at _ _[*address*]_ _. The deed of trust was executed by _ _[*name of trustor*]_ _, as trustor, with _ _[*name of beneficiary*]_ _, as beneficiary, and _ _[*name of trustee*]_ _, as trustee, and described the real property as: _ _[*Provide legal description*]_ _.

NOTICE: A copy of any notice of default and of any notice of sale will be sent only to the address contained in this recorded request. If your address changes, a new request must be recorded.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

[*Add acknowledgment*]

Comment: See discussion in §§2.6, 2.41. The request for notice must be signed and acknowledged by the requesting party. The request must be in substantially the form set forth in CC §2924b(a).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.132 C. Form: Unruh Act Special Notice

§2.132 C. Form: Unruh Act Special Notice

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YOU ARE IN DEFAULT UNDER A _ _[*deed of trust/mortgage*]_ _, DATED _ _[*date*]_ _. UNLESS YOU TAKE ACTION TO PROTECT YOUR PROPERTY, IT MAY BE SOLD AT A PUBLIC SALE. IF YOU NEED AN EXPLANATION OF THE NATURE OF THE PROCEEDING AGAINST YOU, YOU SHOULD CONTACT A LAWYER.

Comment: The language of this notice is dictated by CC §2924f(c)(3). On service and timing requirements, see discussion in §2.48. Apparently, §2924f(c)(3) does not require that this notice be recorded. It is separately prepared and served in addition to the notice in §2.130.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.133 D. Form: Notices of Sale for Trustor and Residential Tenant

§2.133 D. Form: Notices of Sale for Trustor and Residential Tenant

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NOTICE OF TRUSTEE SALE UNDER DEED OF TRUST

YOU ARE IN DEFAULT UNDER A DEED OF TRUST, DATED _ _[*date*]_ _. UNLESS YOU TAKE ACTION TO PROTECT YOUR PROPERTY, IT MAY BE SOLD AT A PUBLIC SALE. IF YOU NEED AN EXPLANATION OF THE NATURE OF THE PROCEEDING AGAINST YOU, YOU SHOULD CONTACT A LAWYER.

NOTICE IS HEREBY GIVEN that the real property situated in _ _ _ _ _ _ County, California, known as _ _[*street address*]_ _, having assessor's Parcel Number _ _[*number*]_ _, and described as _ _[*provide legal description or refer to attachment*]_ _, will be sold AT PUBLIC AUCTION at _ _[*street address and location of sale, e.g., on steps of county courthouse*]_ _ on _ _[*date and time*]_ _, TO THE HIGHEST BIDDER for cash; cashier's check drawn on a state or national bank; check drawn on a state or federal credit union, savings and loan association, savings association, or savings bank specified in Financial Code §5102 and authorized to do business in California; or _ _[*other designated cash equivalent*]_ _.

The sale will be made without covenant or warranty of title, possession, or encumbrances to satisfy the obligation secured by the deed of trust, all advances thereunder, interest provided therein, and fees, charges, and expenses of the trustee. The original sum stated in the deed of trust is _ _[*dollar amount*]_ _, executed by _ _[*name*]_ _, as original trustor, to _ _[*name*]_ _, trustee, for the benefit of _ _[*name*]_ _, beneficiary, and recorded on _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ in the Official Records of _ _ _ _ _ _ County, California. The total amount of the unpaid balance of the obligation secured by the real property to be sold and the reasonably estimated costs, expenses, and advances at the time of initial publication of this notice is _ _[*dollar amount*]_ _.

[*Add if appropriate*]

The beneficial interest under the deed of trust and the obligations secured by it were assigned to _ _[*name*]_ _ by an assignment dated _ _[*date*]_ _, and recorded on _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ in the Official Records of the County.

[*Add if appropriate*]

The undersigned trustee was appointed and substituted as trustee under the deed of trust by an agreement dated _ _[*date*]_ _, and recorded on _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ in the Official Records of the County, and executed by _ _[*name*]_ _.

[*Add if appropriate*]

This notice is republished by the undersigned trustee under Civil Code §2924h(d) because of cancellation by the previous last and highest bidder of an instrument submitted to the trustee as a cash equivalent.

[*Add if property has no street address or other common designation*]

This sale is conducted at the request of _ _[*name*]_ _, as beneficiary, whose address is _ _[*address*]_ _. Directions to the property may be obtained by submitting a written request to the beneficiary within ten (10) days of the first publication of this notice.

[*Continue*]

Notice of default and election to sell the described real property under the deed of trust was recorded on _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ in the Official Records of the County.

Date: _ _ _ _ _ _ __[*Signature*]__

_ _[*Typed name*]_ _

_ _[*Trustee's name or name of person conducting sale*]_ _
_ _[*Street address in California*]_ _
_ _[*Telephone (toll-free or California) number*]_ _

[*If appropriate (see §2.63), add*]

DECLARATION UNDER CC §2923.5

I declare that the following facts are personally known to me, and that if called as a witness I could competently testify to them:

I am _ _[*the beneficiary/an authorized agent of the beneficiary*]_ _ **of the foregoing deed of trust. I initially attempted to contact the borrower (trustor under the deed of trust) by sending a first-class letter that included the toll-free telephone number made available by the United States Department of Housing and Urban Development (HUD) to find a HUD-certified housing counseling agency.**

[*Add one of the following alternatives under CC §2923.5(c), (g)*]

[*Alternative 1: Borrower contacted]*

I contacted the borrower _ _[*in person/by telephone*]_ _ **on** _ _[*date*]_ _ **to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure. During the initial contact, I advised the borrower that he or she had the right to request a subsequent meeting and, if requested, that it would be scheduled within fourteen (14) days. The borrower** _ _[*did/did not*]_ _ **request the subsequent meeting. I also gave the borrower the toll-free telephone number made available by HUD to find a HUD-certified housing counseling agency.**

[*Alternative 2: Borrower not contacted after due diligence]*

I attempted to contact the borrower _ _[*in person/by telephone*]_ _ **on the following dates** _ _[*list all dates of attempted contact and results of each attempt*]_ _**. This was done to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure. I exercised due diligence to further contact the borrower as follows:** _ _[*list all actions taken to contact borrower and results as required by CC §2923.5(g)*]_ _**.**

[*Continue*]

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct, and that this declaration was executed on _ _[*date*]_ _**, at** _ _[*city*]_ _**, California.**

__[*Signature of declarant*]__
_ _[*Declarant's typed name*]_ _

[*If appropriate, prepare the following as a separate (second) notice to be served at the same time and posted with the usual notice of sale*]

NOTICE TO RESIDENT OF PROPERTY SUBJECT TO FORECLOSURE SALE; CC §2924.8

Foreclosure process has begun on this property, which may affect your right to continue to live in this property. Twenty (20) days or more after the date of this notice, this property may be sold at foreclosure. If you are renting this property, the new property owner may either give you a new lease or rental agreement or provide you with a 60-day eviction notice. However, other laws may prohibit an eviction in this circumstance or provide you with a longer notice before eviction. You may wish to contact a lawyer or your local legal aid or housing counseling agency to discuss any rights you may have.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

_ _[*Trustee's name or name of person conducting sale*]_ _
_ _[*Street address in California*]_ _
_ _[*Telephone (toll-free or California) number*]_ _

Comment: The contents of the first notice of sale, including the declaration under CC §2923.5 (see §2.63) and requirements for recordation, posting, and service (see §§2.64-2.68), are prescribed by CC §§2923.5(c), 2924f(b). Many foreclosure and title companies have printed notice-of-sale forms generally available to the public.

The contents of the second notice (Notice to Resident of Property Subject to Foreclosure Sale; CC §2924.8; see §§2.49, 2.63) and requirements for posting and service (see §§2.65, 2.68) are prescribed by CC §2924.8, effective September 8, 2008, through December 31, 2012.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.134 E. Form: Trustee's Deed

§2.134 E. Form: Trustee's Deed

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TRUSTEE'S DEED UPON SALE

_ _[*Name*]_ _, _ _[*state capacity, e.g., a California corporation*]_ _, **as trustee under the deed of trust described below, hereby grants to** _ _[*name*]_ _, **but without covenant or warranty, express or implied, all right, title, and interest in the real property situated in** _ _ _ _ _ _ **County, California, known as** _ _[*street address or other designation*]_ _, **and described as:** _ _[*Provide legal description*]_ _.

This conveyance is made under the powers conferred on the grantor by the deed of trust executed by _ _[*name*]_ _ **as trustor, and naming** _ _[*name*]_ _ **as trustee, and** _ _[*name*]_ _ **as beneficiary, dated** _ _[*date*]_ _, **recorded on** _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ **in the Official Records of** _ _ _ _ _ _ **County, California;**

[*Add if appropriate*]

and assigned to _ _[*name*]_ _ **by an assignment dated** _ _[*date*]_ _, **recorded on** _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ **in the Official Records of** _ _ _ _ _ _ **County, California;**

[*Add if appropriate*]

and by the appointment and substitution of the trustee under the deed of trust by an instrument dated _ _[*date*]_ _, **recorded on** _ _[*date*]_ _, _ _[*in/as*]_ _ _ _[*book and page or instrument number*]_ _ **in the Official Records of** _ _ _ _ _ _ **County, California, and executed by** _ _[*name*]_ _;

[*Continue*]

and after fulfilling the conditions specified in the deed of trust authorizing the conveyance as follows:

1. The trustor defaulted on the obligations for which the transfer in trust was made as security, and notice of default and election to sell was recorded in the office of the County Recorder of _ _ _ _ _ _ **County, the nature of the default being the failure to** _ _[*specify*]_ _. **This default still existed at the time of sale.**

2. Not less than three (3) months elapsed between the recordation of the notice of default and election to sell and the posting and first publication of the notice of sale of the property.

3. The beneficiary made due and proper demand on the trustee to sell the property under the terms of the deed of trust.

4. The trustee gave notice of the default and election to sell the property in accordance with the laws of California and the terms of the deed of trust, including sending the notice of default by certified mail, postage prepaid to each person entitled to notice within ten (10) days after its recordation.

5. The trustee gave notice of the time and place of the sale of the property in accordance with the laws of California and the terms of the deed of trust, including (a) sending the notice of sale at least twenty (20) days before the date of sale by certified mail, postage prepaid to each person entitled to notice, (b) publishing the notice of sale once a week for three (3) consecutive weeks beginning on _ _[*date*]_ _ **in the** _ _[*name of newspaper*]_ _, **and posting the notice of sale in a conspicuous place on the property to be sold and in one public place in the city where the sale was to be held.**

6. The property was sold by the grantor at public auction on _ _[*date*]_ _, **in** _ _ _ _ _ _ **County, California, in which the property** _ _[*or part of it*]_ _ **is situated, in full accordance with the laws of the State of California and the terms of the deed of trust.**

The grantee, as the highest bidder at the sale, became the purchaser of the property and (a) paid the trustee _ _[*dollar amount*]_ _, the amount bid, in lawful money of the United States, or (b) made a credit bid as the beneficiary of the above-described deed of trust.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Trustee

[*Acknowledgment*]

Comment: The recitals in the trustee's deed concerning compliance with the notice-of-default and notice-of-sale requirements are important in protecting third party purchasers from subsequent attacks. CC §2924(c). Although a properly conducted nonjudicial foreclosure sale settles the rights between the borrower and the lender, the conclusive presumption in favor of the bona fide purchaser (under §2924) does not take effect until delivery of the trustee's deed. *Moeller v Lien* (1994) 25 CA4th 822, 30 CR2d 777. See §§7.61-7.63 on effect of recitals when trustor seeks to attack trustee sale. See also discussion of recitals in §§2.20, 2.50, 2.98-2.99.

The default provision in most standard deed of trust forms attempts to make all recitals in the trustee's deed conclusive, without regard to their content or whether the grantee is a bona fide purchaser. Although that provision would not be binding against those holding interests affected by the foreclosure (*e.g.,* junior lienholders) who did not join in the deed of trust, they may estop the trustor from challenging the recitals. See *Mersfelder v Spring* (1903) 139 C 593, 73 P 452. But see *Garfinkle v Superior Court* (1978) 21 C3d 268, 146 CR 208, discussed in 2.20.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/2 Trustee Sales/§2.135 F. Form: Petition and Declaration Regarding Unresolved Claims and Deposit of Undistributed Surplus Proceeds of Trustee Sale (Judicial Council Form MC-095)

§2.135 F. Form: Petition and Declaration Regarding Unresolved Claims and Deposit of Undistributed Surplus Proceeds of Trustee Sale (Judicial Council Form MC-095)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, state bar number, and address):*	*FOR COURT USE ONLY*
TELEPHONE NO.: FAX NO. *(Optional):* E-MAIL ADDRESS *(Optional):* ATTORNEY FOR *(Name):*	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
IN RE *(ADDRESS OF REAL PROPERTY):*	
PETITION AND DECLARATION REGARDING UNRESOLVED CLAIMS AND DEPOSIT OF UNDISTRIBUTED SURPLUS PROCEEDS OF TRUSTEE'S SALE	
Jurisdiction *(check all that apply):* ☐ **ACTION IS A LIMITED CIVIL CASE** **Amount deposited** ☐ **does not exceed $10,000** ☐ **exceeds $10,000, but does not exceed $25,000** ☐ **ACTION IS AN UNLIMITED CIVIL CASE (exceeds $25,000)**	CASE NUMBER:

1. Petitioner *(name):* is the trustee under the Deed of Trust described in items 2 and 3 below.

The Deed of Trust

2. The Deed of Trust encumbered the real property commonly known as *(describe):*

   (the "property") and legally described ☐ in Attachment 2 ☐ as follows:

3. The Deed of Trust was
   a. Executed by *(name):* as trustor.
   b. Executed on *(date):*
   c. Recorded:
      (1) Date:
      (2) County:
      (3) Instrument number:

Form Adopted for Mandatory Use
Judicial Council of California
MC-095 [Rev. January 1, 2004]

Civil Code, § 2924j

CEB

Print

IN RE:	CASE NUMBER:

The Trustee's Sale, Surplus Proceeds, and Notice to Potential Claimants

4. The property was the subject of a trustee's sale that was held on *(date):*

5. A trustee's sale guarantee was prepared for the trustee's sale. *(A copy of the trustee's sale guarantee must be attached as Attachment 5.)*

6. The total sale price of the property was: $

7. After payment of the amounts required by Civil Code section 2924k(a)(1)–(2), there were surplus proceeds from the trustee's sale available to potential claimants in the total amount of: $

8. Within 30 days after the trustee's sale, the trustee sent written notice under Civil Code section 2924j(a) to all persons with a recorded interest in the real property as of the date immediately prior to the trustee's sale who would be entitled to notice. The names and addresses of all persons sent notice under Civil Code section 2924j(a) are as follows:

☐ Continued on Attachment 8.

The Claims

9. The trustee has received a total of *(specify number):* written claims from potential claimants.

10. The trustee has exercised due diligence to determine the priority of the written claims received by the trustee to the trustee's sale surplus proceeds from the persons identified in item 8 to whom notice was sent.

11. The trustee submits this declaration under Civil Code section 2924j(c) for the following reason:
    a. ☐ After due diligence, the trustee is unable to determine the priority of the written claims received by the trustee to the trustee's sale surplus proceeds. *(If this reason applies, describe the problem of determining priorities in Attachment 11a.)*
    b. ☐ The trustee has determined that there is a conflict between potential claimants to the surplus proceeds. *(If this reason applies, identify the claimants and describe the conflict in Attachment 11b.)*

12. The trustee provides the following additional information relevant to the identity, location, priority of potential claimants, and the conflict of claims:

☐ Continued on Attachment 12.

Notice of Intent to Deposit Funds and Proof of Service

13. The trustee has provided written notice to all persons with a recorded interest in the property who would be entitled to notice under Civil Code section 2924b(b)–(c). The notice includes the following information:
    a. The trustee intends to deposit funds from the trustee's sale with the clerk of the court.
    b. A claim for funds must be filed with the court within 30 days from the date of notice.
    c. The address of the court in which the funds are to be deposited and a telephone number for obtaining further information.

    *(Proof of Service of the notice on **all** persons entitled to notice under Civil Code section 2924j(d) must be attached to this declaration as Attachment 13.)*

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Print

IN RE:	CASE NUMBER:

Deposit

14. **Distributions**
The trustee has distributed the total amount of: $ to the following claimants based on their written claims:
Name of claimant: Amount:

☐ Continued on Attachment 14.

15. **Trustee's Fees and Expenses**
The trustee has incurred reasonable fees and expenses totaling: $. These fees and expenses are recoverable under Civil Code section 2924k(a)(1) and (b) and are described ☐ in Attachment 15 ☐ as follows *(specify):*

16. **Deposit**
The amount to be deposited is calculated as follows:

a. Trustee's sale proceeds	$	
b. Debt to foreclosing creditor	$	
c. Available surplus proceeds *(a minus b)*	$	0.00
d. Claims paid by trustee *(from item 14)*	$	
e. Trustee's fees and expenses *(from item 15)*	$	
f. Remaining surplus proceeds *(c minus (d plus e))*	$	0.00
g. Filing fee	$	
h. Deposit *(f minus g)*	$	0.00

(*If the trustee is represented by an attorney, the attorney's signature follows*):

Date:

(TYPE OR PRINT NAME OF ATTORNEY) ▶ (SIGNATURE OF ATTORNEY)

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:

(TYPE OR PRINT NAME OF TRUSTEE) ▶ (SIGNATURE OF TRUSTEE)

Comment: This form is mandatory if the trustee seeks summary disposition of conflicting claims to surplus proceeds

after a trustee sale. See §2.106. The recoverable amount of costs and expenses of the sale and of handling sale proceeds is limited to those actually incurred but not exceeding the greater of $425 or 1 percent of the unpaid principal balance. CC §2924d(b). Prudent counsel for each party should scrutinize the filed form, request additional line-item accounting from the trustee, if necessary, and challenge any charges that are unallowed, which, if unchecked, would reduce the proceeds available for distribution. See §§2.102-2.107.

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3

Judicial Foreclosure

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I. CHOOSING THE REMEDY

§3.1 A. "Judicial Foreclosure" Defined

The trustee sale process described in chapter 2 is the most common mechanism used by real estate secured creditors whose loans have gone into default, but it is not the only one. Far older and more wide-ranging is a judicial action brought by a secured creditor to have a court (1) determine that the loan is in default, (2) order that the security be sold to satisfy the loan balance and to cut off the debtor's equity of redemption, (3) at the creditor's request declare that the debtor is liable for any deficiency arising from an insufficient sale price at the foreclosure sale, and (4) enter a deficiency judgment. This procedure is known as "judicial foreclosure." For details on the definition and the nature of a judicial foreclosure, including its enabling legislation, see §§3.12-3.15.

The purpose of the foreclosure sale is to apply the security to payment of the debt. The effect of the sale is to terminate the trustor's equity of redemption (*i.e.,* the right to clear its title of the deed of trust by paying the debt). CC §§2903, 2931. See *Hibernia Sav. & Loan Soc'y v Lauffer* (1940) 41 CA2d 725, 107 P2d 494. See also §2.73.

At common law, extinguishment of the debtor's equity of redemption was accomplished by "strict foreclosure," by which the property was simply forfeited to the creditor (in total or partial satisfaction of the debt), with no sale involved. For discussion of the common law method of foreclosure, see Nelson & Whitman, Real Estate Finance Law, chap 7 (5th ed 2007). Strict foreclosure is not permitted in California, and a foreclosure sale is always necessary. See CC §2889; CCP §744.

Although CCP §726(a) allows the deficiency to be obtained in the same action as the foreclosure, these two outcomes are achieved in two distinct and effectively bifurcated phases of the action. In the first phase, the court adjudicates the debt, the default, and the defenses. If the creditor prevails and does not waive a deficiency (and the debt is recourse and not subject to any deficiency bar), the court enters a decree ordering the property sold and declaring the debtor to be potentially liable for a deficiency (see §§3.67-3.70, 3.103). In the second phase, the creditor applies for a hearing after the sale to establish the amount of the deficiency, and a judgment is entered (see §§3.86-3.89, 3.113). Completing the entire process typically involves the following steps:

- Filing civil complaint in superior court (see §§3.39-3.55, 3.102);
- Recordation of lis pendens under CCP §405.20 (not strictly necessary but very commonly done) (see §§3.56-3.57);
- Serving summons and complaint on defendants (see §3.15);
- Filing responsive pleadings by defendants or taking their default if they do not respond (see §§3.23-3.36, 3.59-3.63);
- Seeking summary judgment if appropriate under CCP §437c or conducting trial of the action (see §3.64);
- Entry of decree of foreclosure and order of sale (see §§3.67-3.71, 3.103);
- Obtaining writ of sale (see §§3.72, 3.104);
- Giving notice of levy and notice of sale (see §§3.73-3.76, 3.105-3.106);
- Conducting foreclosure sale (see §§3.77-3.83);
- Issuing certificate of sale if postsale redemption applies (see §§3.85, 3.107-3.108) or deed of sale if deficiency judgment waived (see §§3.84, 3.110);
- Timely filing (within 3 months after sale date) of application for fair value deficiency hearing (see §§3.87, 3.111-3.112);
- Hearing on fair value issue (see §§3.88, 5.16-5.23);
- Issuance of fair value finding by the court and entry of money judgment against obligors for deficiency amount (see §§3.89, 3.113);
- Filing of levying officer's accounting (see §§3.83, 3.109); and
- Issuance of deed of sale if property is not redeemed (see §§3.101, 3.110).

Because the entire procedure is conducted under court supervision, judicial foreclosure is distinct from a trustee sale

conducted under CC §§2924-2924*l*, which bypasses the courts entirely and is appropriately referred to as "nonjudicial" or "extrajudicial" foreclosure. Nonjudicial foreclosure is discussed in chap 2. For discussion of considerations in choosing between judicial and nonjudicial foreclosure, see §§2.1-2.3, 2.10-2.17, 3.2-3.11. For discussion of tax consequences of foreclosure, whether by trustee sale or judicial foreclosure, see §§2.110-2.117.

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B. Considerations in Choosing Judicial Foreclosure

§3.2 1. Effect on Junior Tax Liens

Before 1960, a trustee sale did not eliminate junior federal tax liens. Because that rule was changed (see *U.S. v Brosnan* (1960) 363 US 237, 4 L Ed 2d 1192, 80 S Ct 1108), the existence of federal tax liens is no longer a reason to select judicial foreclosure. See §2.31 for discussion of federal tax liens and nonjudicial foreclosure.

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§3.3 2. Lack of Power of Sale Clause

Only security instruments that contain appropriate language (*i.e.,* power of sale clauses) can be foreclosed extrajudicially (see §2.14). Mortgage substitutes (*e.g.,* a covenant not to convey, a deed absolute intended as a mortgage; see, *e.g.,* §§4.33, 5.46, 5.51, 8.9-8.10) usually lack a power of sale and must therefore be foreclosed judicially. (Mortgage substitutes are also known as "hidden" or "disguised" mortgages; see §§3.44, 3.97, 7.12.)

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3. Advantages of Judicial Foreclosure

§3.4 a. Availability of Deficiency Judgment

The chief reason secured creditors elect to foreclose judicially rather than by trustee sale is to keep open the possibility of obtaining a deficiency judgment (defined in §5.3). See §§3.86-3.89. A deficiency judgment is always prohibited after a trustee sale has been completed (see CCP §580d; *Marriage of Oropallo* (1998) 68 CA4th 997, 80 CR2d 669; authorities cited in §§2.118, 5.4-5.12).

NOTE: Under CCP §580b, deficiency judgments are strictly prohibited after the foreclosure sale of residential real property that secures a purchase money loan, regardless of the method of foreclosure. See §5.24.

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§3.5 b. Supporting Appointment of Receiver

The beneficiary may file a judicial foreclosure action not because it seriously intends to conduct a judicial foreclosure sale but to create a lawsuit context in which it can obtain a court-appointed receiver to manage the property and collect the rents while the trustee sale is pending. See §§6.15, 6.33-6.43. In that event, the complaint for judicial foreclosure (see §3.102) will typically include a separate cause of action for specific performance of the rents assignment and be accompanied by a simultaneous application for appointment of a receiver (see §§6.99-6.110). *Baumann v Harrison* (1941) 46 CA2d 84, 115 P2d 530. Note, however, that filing a judicial foreclosure cause of action is not strictly necessary to seek the appointment of a "rents-and-profits" receiver during the course of a nonjudicial foreclosure. Code of Civil Procedure §564(b)(11) permits both interlocutory and postjudgment appointment of a receiver in an action to specifically enforce a rents-and-profits assignment in a mortgage or deed of trust, whether or not the action also includes a judicial foreclosure count. Inclusion of a judicial foreclosure cause of action is still advisable because CCP §564(b)(2) provides for appointment of a receiver to prevent waste during an action to foreclose.

If the goal is to have the broadest grounds for seeking appointment of the receiver, counsel for the secured creditor should (1) include counts for both judicial foreclosure and specific performance of the rents-and-profits clause in the complaint and (2) introduce into evidence all reasons for the appointment of the receiver in the papers supporting the application for a receiver.

Whether the beneficiary ultimately decides to foreclose judicially or by a trustee sale, creditor's counsel should assess with the beneficiary the utility of a receivership if the property is producing income (*i.e.,* the debtor is renting or leasing the property to a tenant). See §§6.34, 6.49. On additional factors to consider on whether receivership is suitable for foreclosure action, see §§3.55, 3.99, 6.35. On economics of having receiver appointed, see §6.36.

WARNING: Because entry of final judgment for judicial foreclosure will constitute an election of remedies by the creditor (see §3.70), counsel are cautioned against seeking entry of judgment until the comparative benefits of a judicial foreclosure and a trustee sale have been fully weighed.

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§3.6 c. Resolving Disputes

Judicial foreclosure may be preferable, safer, or necessary when disputes exist (1) between the creditor and the debtor about the existence or nature of the default or (2) between the foreclosing creditor and other creditors over lien priority. Often, the parties can more economically resolve their disagreements before any sale as part of the foreclosure action rather than after a nonjudicial sale in an action that might conclude that the sale was improper because of the disputed issues. See *Dobbins v Economic Gas Co.* (1920) 182 C 616, 189 P 1073; *Mercantile Trust Co. v Sunset Rd. Oil Co.* (1920) 50 CA 485, 195 P 466. But see *Rowley v Davis* (1915) 169 C 678, 147 P 958.

Although judicial foreclosure is generally considered the more cautious course of action, the secured creditor must be careful not to violate the "one-action" and "security-first" aspects of CCP §726 (discussed in chap 4). No authority has ever decided, *e.g.,* whether the secured creditor who proceeds to judgment and loses (as would occur if no default were found to have occurred) has had its one action and is therefore precluded from further relief.

PRACTICE TIP: Such issues can generally be avoided by dismissing or amending the action before judgment. See *Kirkpatrick v Westamerica Bank* (1998) 65 CA4th 982, 76 CR2d 876. In all events, the secured creditor should generally refrain from commencing and prosecuting any kind of foreclosure until a solid and provable default can be established.

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§3.7 d. Liquidating Debt

Mortgages and deeds of trust are commonly used to secure readily calculated monetary obligations. The exact amount due, however, sometimes requires judicial liquidation before the creditor knows what is due and what may be credit-bid at foreclosure. This situation may arise if a dispute exists about an element of the debt (*e.g.,* late charges, advances, or default interest; see chap 8). A need for liquidation can also arise because the obligation itself is not a simple monetary sum of principal, interest, and other charges. For example, in enforcing a personal service contract secured by a deed of trust, judicial foreclosure may be needed to calculate the amount owed. Furthermore, the secured creditor may need to use the judicial foreclosure procedure but may have no wish for the typical outcomes of judicial foreclosure, *i.e.,* postsale redemption rights and a potential right to a deficiency judgment. In that event, the creditor may take advantage of CCP §726(b) and (e), which permits the creditor to waive deficiency rights and avoid postsale redemption (see §3.8) in a judicial foreclosure action. This is, of course, the same combination of outcomes that flow from trustee sales (see §2.10). This choice belongs to the creditor and must be made before entry of the foreclosure decree (see §3.11).

On pursuing declaratory relief action to liquidate debt under CCP §1060 as alternative to judicial foreclosure, see §3.12.

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4. Disadvantages of Judicial Action

§3.8 a. Redemption and Possession

The major drawback of judicial foreclosure has historically been the prospect of statutory redemption following the judicial sale. CCP §§726(e), 729.010-729.090. See §§3.90-3.101. Postsale redemption rights mean that the purchaser does not acquire an absolute nonredeemable title at the sale but must wait another period (either 3 months or 12 months; see §3.92) until those redemption rights expire. Postsale redemption carries with it the debtor's right to possession of the property for the duration of the redemption period (see §3.99). The purchaser is not entitled to take or sue for possession until after the redemption period has passed. Finally, the property may actually be redeemed by the debtor or its successor in interest, and the redemption price is based on the final bid price at the judicial sale rather than the total amount of the obligation foreclosed.

The existence of the trustor's rights to redemption and possession generally cause bidding at judicial foreclosure sales to be lower than at nonjudicial trustee sales. See, *e.g., San Paolo U.S. Holding Co. v 816 S. Figueroa Co.* (1998) 62 CA4th 1010, 1013, 73 CR2d 272; *U.S. v Stadium Apartments, Inc.* (9th Cir 1970) 425 F2d 358, 365.

Current law allows the plaintiff in a judicial foreclosure to avoid postsale redemption by waiving its claim to a deficiency judgment (CCP §§726(e), 729.010; see §§3.54, 3.67-3.71, 3.84-3.85, 3.90). If the reason for the choice of a judicial action is something other than the desire to pursue a deficiency judgment (see §§3.5-3.7), the plaintiff will probably waive the deficiency and the action will not carry the heavy price of redemption as a deterrent. Section 726(e) effectively gives the creditor the ability to elect the same array of outcomes in a judicial foreclosure as would result from a trustee sale.

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§3.9 b. Delays, Control, and Costs

Judicial foreclosure proceedings almost always take longer and are considerably more expensive to conduct than trustee sales and may cost more than allowable trustee sale fees. If the creditor waives a deficiency judgment, notice of sale is extended and cannot be given until 120 days *after* judgment (plus the 20-day notice of sale itself). See §§3.75-3.76. Even if the foreclosure judgment results from a motion for summary judgment, the duration of a judicial foreclosure sale is at least twice that of a trustee sale. A creditor has less control over court proceedings than it has in a trustee sale. For example, the creditor enjoys the unilateral right to postpone the trustee sale but not the sheriff's sale in a judicial foreclosure. See §3.78.

In addition to postjudgment delays, a judicial foreclosure action is subject to the delays typical of most superior court civil calendars. Before embarking on a judicial foreclosure, creditor's counsel should consider docket congestion in the county in which the security is located and should realistically evaluate the potential for obtaining judgment on a summary basis.

PRACTICE TIP: If the potential deficiency is relatively small, the combined disadvantages to the creditor of docket delay, postsale redemption, and problematic collectability may make judicial foreclosure less desirable than a trustee sale.

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§3.10 c. Effect of Statute of Limitations

It is too late to file a judicial foreclosure action after the statute of limitations has run on the underlying obligation (see §3.16). This is true whether the security interest is embodied in a mortgage or a deed of trust. In contrast, a nonjudicial foreclosure (see chap 2) under a *deed of trust* is not affected by expiration of the relevant statute of limitations. *Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090; *Sipe v McKenna* (1948) 88 CA2d 1001, 200 P2d 61. See §§2.10, 7.31-7.34.

Both judicial and nonjudicial enforcement of a *mortgage* is barred after the limitations period ends. Civil Code §§2909-2911 provide that a lien is incidental to the obligation that it secures and that the lien is time-barred if the obligation is time-barred. Because California law initially viewed mortgages as creating liens (lien theory) and deeds of trust as creating nonlien security interests (title theory), the limitations period affects mortgages and trust deeds differently. This is the only remaining distinction of practical significance between deeds of trust and mortgages with power of sale following the supreme court's decision in *Bank of Italy Nat'l Trust & Sav. Ass'n v Bentley* (1933) 217 C 644, 20 P2d 940. As discussed more fully in §§3.16-3.20, the theoretical distinction that had been the basis for differential treatment of trust deeds and mortgages under the statute of limitations has been undermined by a number of statutory enactments and called into question by recent case law.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.11 C. When to Choose Remedy

§3.11 C. When to Choose Remedy

The decision about which type of foreclosure to use need not be made as soon as a default occurs, because neither filing a complaint for judicial foreclosure nor recordation of a notice of default constitutes an election of remedies (see §§2.13, 4.12-4.22). Creditors may initiate both judicial and nonjudicial procedures simultaneously, a process sometimes called "dual tracking." See §2.13. The creditor may discontinue a judicial foreclosure action at any time before judgment and proceed with a trustee sale, unless the trustor can show that special harm will result from this decision. *Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090; *Commercial Centre Realty Co. v Superior Court* (1936) 7 C2d 121, 59 P2d 978; *Mayhall v Eppinger* (1902) 137 C 5, 69 P 489; *Carpenter v Title Ins. & Trust Co.* (1945) 71 CA2d 593, 163 P2d 73. Actual entry of the judgment of foreclosure (see §3.70) constitutes an election of remedies (*Vlahovich v Cruz* (1989) 213 CA3d 317, 261 CR 565) and prohibits a subsequent preference for a trustee sale. The doctrine of binding election of remedies arising from entry of a foreclosure judgment primarily benefits the borrower or trustor, not third party purchasers. See *California Golf, LLC v Cooper* (2008) 163 CA4th 1053, 78 CR3d 153.

The mere entry of a default in the action without following it up with a final judgment does not constitute an election of remedies. *Madigan v Potrans Int'l, Inc. (In re Madigan)* (BAP 9th Cir 1991) 122 BR 103 (direct action on debt); *Tidrick v General Bank (In re Tidrick)* (Bankr CD Cal 1989) 105 BR 584 (action to foreclose deed of trust). See *Kirkpatrick v Westamerica Bank* (1998) 65 CA4th 982, 76 CR2d 876. But see *Shin v Superior Court* (1994) 26 CA4th 542, 31 CR2d 587, and CCP §483.012 (addressing effect under CCP §726 of attachment on one parcel before filing judicial foreclosure on another parcel). See also §§4.18-4.22.

Although mortgage law does not impose an election of remedies on the basis of the mere filing of a judicial foreclosure, California courts, under mandatory delay reduction programs, are often unwilling to allow a judicial foreclosure to lay fallow while the creditor assesses its remedies or pursues other remedies. Many courts require the creditor to serve summons, insist that the creditor take the default of the debtor if no responsive pleadings are filed, and require both parties to attend case management conferences and participate in trial calendaring, even when the creditor tells the court that the judicial foreclosure will probably not be pursued to judgment.

PRACTICE TIP: Because of the litigation costs involved in keeping the foreclosure lawsuit moving forward, counsel should engage in dual tracking only if there is at least some realistic chance that the creditor will ultimately choose to complete the judicial foreclosure.

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II. PREPARING THE ACTION

§3.12 A. Nature of Action

California law permits only one form of judicial action for the recovery of a debt or enforcement of a right that is secured by a mortgage or deed of trust on real property. CCP §726. See chap 4. This action, known as a foreclosure action (or judicial foreclosure), culminates in a sale of the secured property to pay off the unpaid balance of the debt. It is called "foreclosure" because the effect of the sale is to foreclose or cut off the debtor's right to pay the debt in order to redeem the encumbered property (see §§2.1, 2.10, 2.51, 2.73, 3.8). The sale thus terminates the equity of redemption. CC §§2903, 2931. See *Duff v Randall* (1897) 116 C 226, 48 P 66; *Hibernia Sav. & Loan Soc'y v Lauffer* (1940) 41 CA2d 725, 107 P2d 494. Because the judicial foreclosure action is equitable in nature, equitable principles apply. *Kirkpatrick v Stelling* (1940) 36 CA2d 658, 98 P2d 566; *Brichetto v Raney* (1926) 76 CA 232, 245 P 235. There is no right to a jury trial even if a personal judgment for a deficiency is sought. *Downing v Le Du* (1890) 82 C 471, 23 P 202; *Van Valkenburgh v Oldham* (1910) 12 CA 572, 108 P 42.

NOTE: A creditor with a trust deed or mortgage containing a "rents-and-profits" or "assignment or rents" clause may pursue rents and profits by way of an action for specific performance under CCP §564(b)(11) and may even do so in the absence of a cause of action for judicial foreclosure. But this procedure is usually employed as an adjunct or interim remedy pending judicial or nonjudicial foreclosure. For more on rents assignments, see CC §2938, discussed in chap 6 and in California Real Estate Finance Practice: Strategies and Forms, chap 5 (Cal CEB 2000).

An action solely for declaratory relief under CCP §1060 may be allowed as an alternative to judicial foreclosure if the creditor desires a declaration liquidating the debt prior to nonjudicial foreclosure but has no wish to complete a judicial foreclosure or to pursue a deficiency. The safety of the declaratory relief approach under the one-action rule has not been fully developed in the case law, but it is clear that the risk of one-action sanctions (see chap 4) is greatly enhanced if the creditor seeks or obtains any coercive relief (*i.e.,* other than a pure declaration of rights) in the course of the action.

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§3.13 B. Jurisdiction

An action to foreclose a lien on real property is an equitable action that comes under the subject matter jurisdiction of the superior court. Cal Const art VI, §10; CCP §86. See *Curtin v Salmon River Hydraulic Gold Mining & Ditch Co.* (1903) 141 C 308, 74 P 851; *Downing v Le Du* (1890) 82 C 471, 23 P 202. On proper superior court in which to file action, see §3.14.

The action may be brought in federal court if the United States is a defendant (28 USC §2410) or if the requirements for diversity jurisdiction are met (28 USC §1332). If an action naming the United States as a defendant is brought in state court, the United States may have it removed to federal court. 28 USC §1444.

California courts have jurisdiction only over California real property and may not foreclose liens on property outside the state. *Title Ins. & Trust Co. v California Dev. Co.* (1915) 171 C 173, 152 P 542; *Lilly-Brackett Co. v Sonnemann* (1910) 157 C 192, 106 P 715; *Felton v West* (1894) 102 C 266, 36 P 676; *Allen v Allen* (1892) 95 C 184, 30 P 213. Similarly, the courts of sister states have no power to enforce foreclosures under mortgages secured by California real property. *Lilly-Brackett Co. v Sonnemann, supra*. If the security instrument covers real property in more than one state, a California court may foreclose the lien on the part of the property that is in California. *Hartwick v Superior Court* (1959) 174 CA2d 809, 345 P2d 304.

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§3.14 C. Venue

In an action to foreclose a lien on real property, the proper venue is the county in which the property or part of it is located (CCP §392(a)(2)), even if a deficiency judgment is sought or if an additional cause of action seeking a personal judgment is joined. *Appel v Hubbard* (1957) 155 CA2d 639, 318 P2d 164; *Case v Kirkwood* (1931) 119 CA 207, 6 P2d 110. If there is a single mortgage or deed of trust covering real property in more than one county, venue is proper in either county. CCP §726(d); *Kent v Williams* (1905) 146 C 3, 79 P 527; *Murphy v Superior Court* (1902) 138 C 69, 70 P 1070. When multiple deeds of trust secure a single obligation, they should be foreclosed in one court action even if the property is located in more than one county; otherwise, the omitted security may be lost under CCP §726 (see §§4.4, 4.8, 9.4-9.6). *Stockton Sav. & Loan Soc'y v Harrold* (1900) 127 C 612, 60 P 165; *Appel v Hubbard, supra*.

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§3.15 D. Personal Jurisdiction; Service of Process

Only the interests of parties who are subject to the court's jurisdiction will be properly terminated, *i.e.,* foreclosed, by the judgment and the succeeding foreclosure sale. *Morrissey v Gray* (1911) 160 C 390, 117 P 438; *Johnston v San Francisco Sav. Union* (1883) 63 C 554; *Montgomery v Tutt* (1858) 11 C 307; *Hurt v Pico Inv. Co.* (1932) 127 CA 106, 15 P2d 203. To acquire jurisdiction over a party, the plaintiff in a foreclosure action must cause that party to be properly served with the summons and complaint. CCP §415.10. Substituted service on a party under CCP §415.20(b) is sufficient to confer jurisdiction over that party, including jurisdiction to enter a deficiency judgment. *Korea Exch. Bank v Yang* (1988) 200 CA3d 1471, 246 CR 619. A party's general appearance in the action confers the court's jurisdiction over that party as if the party had been personally served. CCP §1014.

Service of the summons and complaint in foreclosure actions is made in the same manner as in civil actions generally. See CCP §§410.10-418.11. For discussion of jurisdiction and service of process, see California Civil Procedure Before Trial, chaps 6, 14, 17 (4th ed Cal CEB 2004).

Foreclosing creditors sometimes prefer to foreclose against some junior interests but not others on a given piece of property. Such an outcome might be desirable when, *e.g.,* in the foreclosure of an office building or shopping center involving numerous leases, some are more favorable to the landlord and foreclosure sale purchaser than others. Secured creditors sometimes attempt to "cherry pick" the leases in this situation by intentionally not naming as defendants the tenants whose leases they hope to retain in an unforeclosed condition. See §§3.25, 6.88. It is unclear whether the courts will permit this strategy to succeed.

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§3.16 E. Statutes of Limitations

Neither a mortgage nor a deed of trust may be judicially foreclosed after the statute of limitations has run on the underlying obligation (see §§3.17-3.19), but the historical differences between mortgages and trust deeds allows a trustee sale on a deed of trust to proceed regardless of the statute of limitations on the underlying obligation (see §3.10). Both mortgages and deeds of trust, however, are affected by the marketable title statutes (see §3.20), which act as "statutes of repose" because they place an outside limit on the enforceability of the mortgage or deed of trust. For further discussion, see §§2.10, 7.31-7.34.

Counsel dealing with the statute of limitations in the context of real property secured loans should not accept uncritically that the statute of limitations on the secured obligation does not apply to nonjudicial foreclosure—the "never outlaws" rule. See §3.10. The different treatment of deeds of trust under the statute of limitations is based on the theory that they involve transfers "in trust" rather than liens. But over the past half-century, the legislature enacted statutes indicating that deeds of trust create "liens." See, *e.g.,* CC §§882.020-882.040, 1133(a), 1916.11, 1917.003-1917.004(a), 1917.133(e), 1917.614-1917.615, 2924e(a), 2924h(c), 2931a, 2941.7, 2953, 2954.9(a)(1), 2954.11(h), 2955(b), 2898. The supreme court confirmed that "trustees" under deeds of trust are not really trustees in the sense of the law of trusts and estates. See *Monterey S.P. Partnership v W.L. Bangham, Inc.* (1989) 49 C3d 454, 261 CR 587. A court of appeal, after reviewing the theoretical distinction between mortgages and deeds of trust, noted that contemporary jurisprudence views a deed of trust to be a lien on the property. *Aviel v Ng* (2008) 161 CA4th 809, 817, 74 CR3d 200. See Bernhardt, *Midcourse Corrections: When First Might Be Worst,* 31 CEB Real Prop L Rep 75 (May 2008) and Andrew, *A Further Thought on* Aviel v Ng: *Enforcement of an Automatic Lease-Subordination Provision,* 31 CEB Real Prop L Rep 155 (Sept. 2008), discussing *Aviel*.

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§3.17 1. Underlying Obligation Governs Time Frame

Before 1992, the applicable statute of limitations on the secured obligation (typically, a promissory note) was almost always the 4-year period for written obligations under CCP §337(1). In rare instances (in which the mortgage or deed of trust secured an enforceable oral promise), the statute would be the 2-year period under CCP §339.

The limitations analysis became more complex with the enactment in 1992 of Com C §3118, which provides for a 6-year limitations period on the enforcement of certain negotiable instruments. The effect of §3118 will likely be to extend the limitations period on some note obligations and to spawn more litigation over whether a particular note is a "negotiable instrument" even if no classical holder in due course issue is presented. Although §3118 may affect note and deed of trust arrangements, it is unlikely to have any effect on mortgage transactions, because mortgages are rarely used and they may not meet the definition of a "negotiable instrument" under the Commercial Code.

The limitations period applies not only to the maturity date of any note but also to the maturity date of any unpaid installment. *Trigg v Arnott* (1937) 22 CA2d 455, 71 P2d 330. Partial late payments start the running of a new period even though they cannot revive a cause of action that has become completely time-barred. CCP §360. Under older case law, the statute of limitations on demand notes (*i.e.,* those payable when the obligee demands payment) begins to run when the instrument is executed. See, *e.g., Tilden Lumber Co. v Perino* (1934) 2 CA2d 133, 37 P2d 466. Consequently, the limitations period might expire even before a default occurs. Under Com C §3118(b), however, the limitations period expires 6 years after the demand, or, if no demand is made, enforcement is barred if "neither principal nor interest … has been paid for a continuous period of 10 years."

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§3.18 a. Mortgages

No statute of limitations separately governs actions to foreclose liens. A lien is incidental to the principal obligation it secures and is therefore deemed extinguished when the statute of limitations runs on that principal obligation. CC §2911. California law typically controls both actions on the note and actions on the mortgage lien unless the statute is trumped by a paramount federal limitations period. See *U.S. v Thornburg* (9th Cir 1996) 82 F3d 886. Neither a mortgage nor a deed of trust may be judicially foreclosed after the statute has run. See *Miller v Provost* (1994) 26 CA4th 1703, 1707, 33 CR2d 288 (explaining limitations on deeds of trust). A mortgage may not be nonjudicially foreclosed under a power of sale clause, because the power to sell derives from the lien and is extinguished along with the lien under CC §2911. *Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090.

When the statute of limitations has run on a note secured by a mortgage instrument (as opposed to a note secured by a deed of trust), a subsequent owner of the encumbered property may bring a quiet title action to clear the records of the stale claim. Although the quiet title remedy is denied to the original mortgagor, who executed the note and has failed to pay it, on the ground that one who seeks equity must do equity (see *Aguilar v Bocci* (1974) 39 CA3d 475, 114 CR 91), a successor owner who is not the debtor is not subject to this rule (*Faxon v All Persons* (1913) 166 C 707, 137 P 919) even if it purchased the property with knowledge of the old mortgage (*Mix v Sodd* (1981) 126 CA3d 386, 178 CR 736). The decision in one partnership case has suggested that the requirement of "doing equity" is not absolute. *Dickson, Carlson & Campillo v Pole* (2000) 83 CA4th 436, 99 CR2d 678. On quiet title actions, see California Real Property Remedies and Damages, chap 7 (2d ed Cal CEB 2002).

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§3.19 b. Deeds of Trust

Although a deed of trust beneficiary may not judicially foreclose after the statute of limitations has run on the underlying obligation (see §3.18), no statute of limitations directly bars exercise of the power of sale under a deed of trust, because it is classified as a nonlien, trust-based security interest (see §3.10). Subject to the marketable record title statutes (see §3.20), that power of sale is held to endure as long as the trust purpose lasts. *Miller v Provost* (1994) 26 CA4th 1703, 33 CR2d 288. See *Nicolopulos v Superior Court* (2003) 106 CA4th 304, 130 CR2d 626.

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§3.20 2. Effect of Marketable Record Title Act

Until recently, California's Marketable Record Title Act (MRTA) (CC §§880.020-887.090) provided that the lien of a mortgage or deed of trust expired 10 years after the maturity date of the obligation if the maturity date could be "ascertained from the record" or 60 years after the date of recordation if no maturity date could be ascertained "from the record." See *Ung v Koehler* (2005) 135 CA4th 186, 37 CR3d 311 (holding that recordation of notice of default that specifies maturity date of underlying obligation does not make maturity date ascertainable "from the record"). For a useful discussion of the statutory history of the MRTA through 2006, see *Ung v Koehler, supra*.

Effective January 1, 2007, CC §882.020(a) was amended to provide that (1) if the final maturity date or the last date fixed for payment of the debt or performance of the obligation is ascertainable from the *recorded evidence of indebtedness* (as opposed to "from the record"), the lien of the mortgage or deed of trust expires 10 years after that date and (2) if the final maturity date or the last date fixed for payment or performance is not ascertainable from the *recorded evidence of indebtedness*, or there is no final maturity date, then the lien expires 60 years after the recordation date of the note or evidence of indebtedness. Thus, to get the protection of the 10-year time limitation rather than the longer, 60-year period, a trustor would have had to insist on recordation of the note or evidence of indebtedness that contained a final payment date or maturity date. See *Slintak v Buckeye Retirement Co.* (2006) 139 CA4th 575, 585, 43 CR3d 131. This is not commonly done, and most notes are never created in a recordable format. For further discussion, see Soffer, *The Marketable Record Title Act—Is Private Foreclosure Barred 10 Years After Maturity, or Not?,* 25 Cal Real Prop J 16 (No. 2, 2007).

The beneficiary may record a notice of intent to preserve the security interest (prescribed by CC §880.340), in which case the interest is extended for another 10 years after the recordation date of the notice. CC §882.020(a)(3).

The recordation of a lis pendens against the title of a property resets the MRTA time limitations. *Slintak v Buckeye Retirement Co.* (2006) 139 CA4th 575, 586, 43 CR3d 131. The resetting of the limitations clock occurs on the date of the recordation of the lis pendens and is not extended or affected by the outcome of the litigation that gave rise to the lis pendens. CC §§880.260, 882.020; *Slintak v Buckeye Retirement Co., supra*.

A court will not consider unrecorded but related loan documents to ascertain the maturity date. Rather, that information must be contained in the recorded deed of trust. *Nicolopulos v Superior Court* (2003) 106 CA4th 304, 130 CR2d 626. Whether or not a mortgage or a deed of trust is involved, CC §882.020(a) does not overrule CC §2911, but the mortgagee does not have the power available under a deed of trust to conduct a trustee sale. See *Miller v Provost* (1994) 26 CA4th 1703, 1708, 33 CR2d 288.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.21 F. Title Company Services

§3.21 F. Title Company Services

Before filing an action to foreclose a mortgage or deed of trust, an attorney should obtain a litigation or a foreclosure guaranty from a title company. The guaranty shows the present condition of the record regarding ownership, encumbrances, taxes, and parties who should be joined in the action. It also includes other information that may be helpful in preparing the complaint. For further discussion of guaranties, see California Title Insurance Practice §§9.9-9.12 (2d ed Cal CEB 1997). For discussion of title companies and other companies that conduct trustee sales and render related services, see §§2.21, 2.33; Title Ins §§15.10-15.17.

PRACTICE TIP: When a lender acquires the property at its foreclosure, the lender should consider purchasing an owner's policy of title insurance. Even though the lender's policy usually continues in effect after the lender acquires title by foreclosure, the policy provides coverage only as of the date of the policy and differs from an owner's policy in the scope of title defect coverage. See Title Ins §§6.63-6.67, 7.4.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.22 G. Federally Insured or Guaranteed Loans

§3.22 G. Federally Insured or Guaranteed Loans

If the loan has been insured or guaranteed by the Federal Housing Administration (FHA) or the Veterans Administration (VA), the foreclosing creditor's attorney should notify the applicable agency before instituting litigation and ascertain what procedures the agency may require. See, *e.g.,* 38 USC §3713 (VA). Failure to comply with agency procedures may preclude the creditor from recovering from the agency any shortfall from the sale. See 12 USC §§1707-1715z-22a (FHA); 38 USC §§3701-3736 (VA). See also §2.27. These agencies do not necessarily take over when a loan is in default; instead of repurchasing the security interest, they may permit the beneficiary to complete its foreclosure. *Rank v Nimmo* (9th Cir 1982) 677 F2d 692 (VA). Certain FHA-insured loans may be assigned to the government before foreclosure (see §2.28).

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H. Parties

§3.23 1. Plaintiffs

A foreclosure action may be brought by (1) the mortgagee under a mortgage, (2) either the beneficiary or the trustee under a deed of trust, or (3) their successors in interest. CCP §725a. If there are two or more holders of the secured obligation, all should join as plaintiffs; any holder who refuses to join or cannot join should be joined as a nominal defendant. Lack of consent from the other beneficiaries does not prohibit one of the beneficiaries from foreclosing to protect the common estate. *Perkins v Chad Dev. Corp.* (1979) 95 CA3d 645, 157 CR 201. See §§1.46, 2.34, 9.33-9.35.

Civil Code §2941.9 provides a statutory mechanism for a "Majority Action Affidavit" in foreclosure situations if there are multiple beneficiaries of a single deed of trust. For discussion of joinder of parties, see California Civil Procedure Before Trial, chaps 14, 31 (4th ed Cal CEB 2004).

Most common interest communities organized under California law allow their homeowners' associations to foreclose against their members' property to enforce liens for delinquent assessments. Special notice and alternative dispute resolution requirements must be met before proceeding with a trustee sale or judicial foreclosure in that situation. See CC §§1367-1367.5, discussed in Advising California Common Interest Communities, chap 5 (Cal CEB 2003).

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2. Defendants

§3.24 a. Owners: Past, Present, and Future

It is essential that the present owner "of record" of the mortgaged property be named as a defendant in any foreclosure action. See CCP §726(c). Even though the current owner may not have been the original debtor and may never have assumed the obligation (thereby insulating the owner from any personal liability for a deficiency judgment after sale), the property cannot be taken from the owner through judicial foreclosure unless it has had an opportunity to be heard and to protect itself. *Burton v Lies* (1862) 21 C 87; *City & County of San Francisco v Lawton* (1861) 18 C 465; *Boggs v Fowler & Hargrave* (1860) 16 C 559. For discussion of compulsory and permissive joinder, see California Civil Procedure Before Trial, chaps 14, 31 (4th ed Cal CEB 2004).

If ownership of the property is shared, omission of any co-owner excludes that fractional interest from the foreclosure and sale, although the sale remains valid with regard to the interests of owners "of record" who were named in the action. See CCP §726(c); *Goodenow v Ewer* (1860) 16 C 461; *Montgomery v Tutt* (1858) 11 C 307. See also *Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 77 CR2d 581 (foreclosure valid against parties served and mortgagee permitted second foreclosure against parties omitted).

When the foreclosure sale of all or any part of the property is defective, CCP §701.680(c) provides that the debtor or its successor may (1) have the sale set aside if the beneficiary is the purchaser and (2) recover damages for the impropriety. Whether this remedy applies to an owner of record who was omitted as a party from a judicial foreclosure action on a real property secured debt is unclear. Because early case law held the sale absolutely invalid as against the omitted interest, the omitted debtor can probably have the sale set aside regardless of whether the purchaser is the beneficiary or a stranger. *Goodenow v Ewer* (1860) 16 C 461, 469. The predecessor code section to CCP §701.680 (former CCP §708) also provided that the frustrated bidder at such a sale could recover the purchase price from the foreclosing creditor; this remedy is also probably available when the sale is set aside because an essential party was not before the court. A purchaser who has acquired some interest in the property because of the inclusion of other proper parties as defendants may be able to bring a second foreclosure action against the omitted parties whose interests survived the first, defective, foreclosure. *Burns v Hiatt* (1906) 149 C 617, 87 P 196; *Hagan v Gardner* (9th Cir 1960) 283 F2d 643; *Tutt v Van Voast* (1939) 36 CA2d 282, 97 P2d 869.

A former owner that may be potentially liable for a deficiency judgment should be named as a defendant even though it no longer has any interest in the property. *Braun v Crew* (1920) 183 C 728, 192 P 531; *Hutchison v Barr* (1920) 183 C 182, 190 P 799. See *Robson v O'Toole* (1923) 60 CA 710, 214 P 278. Prior owners who neither assumed any obligations nor currently own any interest in the real property need not be named. See *Johnson v Home Owners' Loan Corp.* (1941) 46 CA2d 546, 116 P2d 167.

WARNING: Borrowers often believe that they are relieved of liability if they sell the property to a buyer who expressly assumes the mortgage obligation. This arrangement, however, does not exonerate the borrower, although it typically makes the assuming party primarily liable and the original borrower only a surety on the original debt once the secured creditor is made aware of the assignment and assumption. See *Everts v Matteson* (1942) 21 C2d 437, 447, 132 P2d 476. The only way to completely insulate the original borrower is to obtain an express release from the secured creditor. See §§9.124, 9.126, 9.130. On effect of purchase money loan on original borrower's liability, see §§9.132-9.135.

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b. Holders of Other Interests in Encumbered Property

§3.25 (1) Tenants

The complaint need not include as defendants in the foreclosure action tenants whose leases are *prior* to the deed of trust, because their leaseholds are not affected by elimination of the mortgagor's reversionary interest. See §§6.84-6.85; California Landlord-Tenant Practice §§8.7, 8.68-8.68E (2d ed Cal CEB 1997). This is probably also true for tenants who occupy under attornment and nondisturbance agreements. See §§6.97-6.98. It is not uncommon for such tenants to be named in the foreclosure action together with a prayer that the judgment confirm the continued existence of their leases, in compliance with the attornment and nondisturbance provisions. For examples of SNDA clauses, see Office Leasing: Drafting and Negotiating the Lease, chap 28 (Cal CEB 1996).

Tenants with leases subordinate to the deed of trust are proper defendants in a judicial foreclosure action. CCP §379. Because they hold real property interests that will be extinguished by foreclosure, most states hold them to be necessary parties. See 1 Nelson & Whitman, Real Estate Finance Law §7.12 (5th ed 2007). See also *Sullivan v Superior Court* (1921) 185 C 133, 195 P 1061 (dictum that tenant entitled to surplus from foreclosure sale and to statutory redemption); *Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 7, 77 CR2d 581. Tenants are also entitled to receive notices of default and sale in trustee sale proceedings. See CC §2924b. *McDermott v Burke* (1860) 16 C 580 appears to hold to the contrary, but that opinion may apply only to tenants who acquired their interests in the property after a foreclosure action had been filed.

Including junior tenants in the foreclosure action should terminate their leases unless there is a contrary nondisturbance agreement (see §6.97). On tenants' rights after foreclosure, see §§6.84-6.98. It is unclear whether a junior lease is preserved by the intentional omission of the tenant as a defendant in the action, although such a result seems technically required by the omission (see §§3.15, 3.24, 3.33; see also Practice Tip in §6.88).

For discussion of compulsory and permissive joinder rules, see California Civil Procedure Before Trial, chaps 14, 31 (4th ed Cal CEB 2004).

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§3.26 (2) Easement Holders

The foreclosure complaint should include as defendants in the action persons holding easements that are inferior to the deed of trust or mortgage if their interests are to be properly extinguished. Omission of a subordinate dominant tenant (*i.e.,* holder of the benefit of an easement) does not invalidate the sale, and the defect may later be cured by filing a subsequent quiet title action against the omitted party. The initial omission means, however, that the omitted party's equity of redemption (the right to pay the entire debt (see §§2.73, 3.63)) was not terminated at the sale and that there will be a right of postsale redemption (the right to pay the amount bid (see §3.93)) after the second decree. See *Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 77 CR2d 581. Omitting an easement holder from a trustee sale has no such consequences (see §2.44).

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§3.27 (3) Vendees Under Land Sale Contracts

Persons who have purchased the encumbered property under recorded installment land sale contracts (see §§1.59-1.66) (and purchasers under unrecorded contracts who are known to the beneficiary) should be named as defendants in the foreclosure action to eliminate their equitable ownership interests in the property. See *Perry v O'Donnell* (9th Cir 1984) 749 F2d 1346; *Wienke v Smith* (1918) 179 C 220, 176 P 42; *Fish v Fowlie* (1881) 58 C 373. See §3.28 on unrecorded interests.

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§3.28 (4) Unrecorded Interests

Persons with unrecorded interests in the property need not be named as defendants, but they are nevertheless bound by the judgment as if they had been included. CCP §726(c). Courts have read CCP §726 so literally as to excuse the omission even of successors to the original owners whose unrecorded interests were actually known to the foreclosing mortgagee. *Redondo Improvement Co. v O'Shaughnessy* (1914) 168 C 323, 143 P 538; *Hager v Astorg* (1904) 145 C 548, 79 P 68; *Hibernia Sav. & Loan Soc'y v Cochran* (1904) 141 C 653, 75 P 315; *Johnson v Home Owners' Loan Corp.* (1941) 46 CA2d 546, 116 P2d 167. In light of cases such as *Sniadach v Family Fin. Corp.* (1969) 395 US 337, 23 L Ed 2d 349, 89 S Ct 1820 (see §2.12), and *Randone v Appellate Dep't* (1971) 5 C3d 536, 96 CR 709, the continued vitality of a rule that an interest in property may be foreclosed judicially without actual notice to its holder may be open to question.

PRACTICE TIP: Despite the rule in CCP §726, it is the better practice to name all persons known to have or to claim interests in the property to be sure that their interests are eliminated.

On notice issues related to trustee sales, see chap 2; *I.E. Assocs. v Safeco Title Ins. Co.* (1985) 39 C3d 281, 216 CR 438 (statutory procedures are exclusive source of notice rights); *Garfinkle v Superior Court* (1978) 21 C3d 268, 146 CR 208.

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§3.29 (5) Adverse Owners

Persons who own interests in the property that are not subject to the deed of trust should not be included in the foreclosure action. *Cody v Bean* (1892) 93 C 578, 29 P 223; *Ord v Bartlett* (1890) 83 C 428, 23 P 705. If two or more persons own individual interests in the property and not all of them executed the deed of trust, the nonsigning owners need not be named in the complaint, because the decree and sale will not affect their interests. *Hoppe v Hoppe* (1894) 104 C 94, 37 P 894. If the security consists of a leasehold interest in the property, the lessor need not be included in the action unless the lessor's reversionary interest has been subordinated to the deed of trust. See *Matthews v Hinton* (1965) 234 CA2d 736, 44 CR 692. Although a foreclosure action is generally not an appropriate action in which to try title, if an adverse claimant who has been named as a defendant elects to have the issue determined, the court may resolve the conflicting claims in the foreclosure action. *Beronio v Ventura County Lumber Co.* (1900) 129 C 232, 61 P 958. See *Cady v Purser* (1901) 131 C 552, 63 P 844; *Williams v Cooper* (1899) 124 C 666, 57 P 577.

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(6) Other Lienholders

§3.30 (a) Senior Lienholders

A foreclosure action leaves undisturbed all liens and other interests in the property that are senior to the lien being foreclosed. Therefore, senior lienholders need not be joined as defendants in the foreclosure action. A senior lienholder is a proper party, however, if named as a defendant and may cross-complain to foreclose the superior lien if it is otherwise due or in default. *Van Loben Sels v Bunnell* (1901) 131 C 489, 63 P 773. If the senior lien is due and the senior lienholder cross-complains, the judgment may then order a sale to satisfy both liens. When the parties disagree about the priority of the liens involved, the foreclosure action is an appropriate vehicle to resolve the priority dispute. See §3.6. Joining a senior lienholder may also be appropriate to resolve conflicting claims of priority regarding rents and profits from the property. On rents and profits, see chap 6.

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§3.31 (b) Government Agency as Lien Claimant

The United States should be made a defendant in the foreclosure action when the federal government claims a mortgage or other lien on the property junior to the lien being foreclosed (see §3.33). In such a case, the complaint must specify the details regarding the liens to be affected by the foreclosure. 28 USC §2410. See *U.S. v Brosnan* (1960) 363 US 237, 4 L Ed 2d 1192, 80 S Ct 1108 (junior liens held by federal entities are subject to state law requirements on notice and due process).

The State of California should be joined as a defendant if it holds a junior lien on the property. CC §2931a. See *Wayland v State Dep't of Employment* (1958) 161 CA2d 679, 326 P2d 954.

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§3.32 (c) Junior Lienholders

All junior lienholders of record should be named as defendants in a foreclosure action in order to cut off their liens and foreclose their rights to reinstate the loan and to redeem the property from the senior lien under CC §§2903-2905 and 2924c.

Under the "scramble redemption" system of former CCP §701, even junior lienholders included as parties had rights of statutory postsale redemption, not to be confused with preforeclosure equity of redemption, and under former CCP §703, such liens reattached to the property following postsale redemption by the debtor. Under CCP §§701.630 and 729.080(e), however, scramble redemption has been eliminated, and junior liens extinguished by a senior foreclosure sale are not given postsale redemption rights and do not reattach on statutory redemption by the debtor, as long as their holders are properly included as defendants in the senior foreclosure action. For further discussion, see Dyer*, Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 56 (Apr. 1983).

NOTE: Under nonstatutory redemption by the debtor, an extinguished junior lien may equitably reattach. See *DMC, Inc. v Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 120 CR2d 761, cited in §3.97. Also, if the foreclosing lender purchases the property at the sale and the debtor succeeds in having the sale set aside for irregularities, junior liens may also revive and reattach under CCP §701.680(c)(1). See §3.79.

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§3.33 (d) Effect of Omitting Junior Lienholder

When a junior lienholder has been omitted from the senior foreclosure action and sale, the property remains subject to the junior lien, and the termination of those rights discussed in §3.32 does not occur. *Carpentier v Brenham* (1870) 40 C 221; *Fox v California Title Ins. Co.* (1932) 120 CA 264, 7 P2d 722. See CCP §726(c). The foreclosure and sale are not void but are ineffective in foreclosing as far as the junior lien is concerned. *Carpentier v Brenham, supra*. The purchaser at such a defective foreclosure sale has two choices: (1) to acknowledge the defect and pay off the junior lien or (2) to act as if it purchased the senior lien (rather than the property) at the sale. As assignee of the senior lien, the purchaser may bring a separate foreclosure action against the junior and insist that the junior either pay off the senior lien or lose the right to redeem the property under CC §§2903-2905 and 2924c. This second foreclosure action against the junior will not include the original mortgagor (whose interest in the property was terminated by the first foreclosure and sale) and will be a "strict" foreclosure if the junior does not redeem the property, because there is nothing left to sell. *Goodenow v Ewer* (1860) 16 C 461. See *Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 77 CR2d 581 (purchaser may sue to quiet title against omitted junior easement holder or lienholder), discussed in §§3.63, 3.91.

The omitted junior is placed as nearly as possible in the same position (*i.e.,* with the same remedies) as if the senior had not foreclosed. The junior retains redemption rights under CC §§2903-2905 and 2924c. The junior may also elect to foreclose the junior lien, but it must do so as a junior lienholder; omitting the junior from the foreclosure action does not alter the parties' respective priorities.

Either the foreclosure sale purchaser or the omitted junior may elect to act first. If the omitted junior believes that the property is worth more than the senior debt, the junior should offer to pay off the senior debt (*i.e.,* tender redemption) and then foreclose. If the property is worth less than the senior debt, there is no reason for the junior to take any action; the junior has not been prejudiced by the omission from the senior's foreclosure action. The junior may, however, be compelled to bring a foreclosure action to obtain a deficiency judgment because the lien has not been eliminated and the junior cannot sue for a deficiency as a "sold-out" junior (see §§5.10-5.12).

The foreclosure sale purchaser must take some action to eliminate the omitted junior lien. If the property is worth less than the combined amounts of the junior and senior liens, the purchaser should foreclose against the junior in a separate action. Only if the purchaser believes the property to be worth more than both debts should it offer to pay off the junior debt instead and keep the property.

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§3.34 c. Persons Acquiring Interests After Complaint Filed

Persons who acquire an interest in the property after commencement of a judicial foreclosure action need not be joined as defendants as long as the plaintiff records and serves a lis pendens immediately on filing the complaint. The lis pendens binds such persons as effectively as if they had been joined in the action. CCP §§405.24, 1908(a)(2). See §§3.56-3.57; *Albertson v Raboff* (1956) 46 C2d 375, 295 P2d 405. See also California Real Property Remedies and Damages, chap 13 (2d ed Cal CEB 2002).

WARNING: When creating the lis pendens, practitioners must fully comply with the exacting service requirements of CCP §405.22. Failure will result in an otherwise valid lis pendens being void and of no effect. CCP §405.23.

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§3.35 d. Persons Liable for Deficiency Judgment

All persons who may be liable for a deficiency judgment should be named as defendants to avoid defenses based on their exclusion. *Hubbard v University Bank* (1899) 125 C 684, 58 P 297; *Craiglow v Williams* (1920) 45 CA 514, 188 P 76. See *White v Schader* (1921) 185 C 606, 198 P 19. Co-obligees and former property owners who either originally executed the note or subsequently assumed it (see §§9.113-9.136) should be named as defendants if a deficiency is to be sought against them. Because of the one-action rule (see §§4.4, 4.8), the secured creditor may not get a second chance to obtain a judgment against these defendants if they were not included in the original action. Guarantors may be joined as defendants in the same lawsuit (as defendants in a separate cause of action) but may also be pursued in a separate lawsuit. On rights and liabilities of guarantors, see §§9.89-9.112.

When a partnership and the partners are jointly liable for a deficiency judgment, the lender's assignment of its interest in the deficiency judgment to the partnership and some of the partners extinguishes the judgment against the other partners. *Great W. Bank v Kong* (2001) 90 CA4th 28, 108 CR2d 266. In *Kong*, the partnership and 11 of 12 partners bought the deficiency judgment against them from the foreclosing bank. The 12th partner was not liable on the debt but remained liable in equitable contribution to the partnership for the partner's share of the amount paid to acquire the judgment.

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§3.36 e. Trustee as Defendant

Although the trustee under a deed of trust may bring the foreclosure action as a plaintiff, the beneficiary is nearly always the one that brings the action and will either name the trustee as a defendant or omit the trustee entirely. See *Field v Acres* (1937) 9 C2d 110, 69 P2d 422. Although joinder of the trustee is not compulsory (CCP §389), the trustee may be joined as a defendant. *Carpenter v Title Ins. & Trust Co.* (1945) 71 CA2d 593, 163 P2d 73. See *Churchill v Woodworth* (1906) 148 C 669, 84 P 155. On rules for compulsory and permissive joinder of defendants, see California Civil Procedure Before Trial, chaps 14, 31 (4th ed Cal CEB 2004). If any affirmative relief is sought against the trustee, it should definitely be named.

A trustee named only as a nominal defendant should nevertheless be served. It is customary for the plaintiff's attorney to stipulate with the trustee that its default may be taken and that it will abide by all court decrees in the action as long as no monetary relief is sought against it. See §3.61 for a statutory alternative for the trustee, who under certain conditions may refrain from participating in an action in which it is named solely in its capacity as trustee.

When a junior deed of trust has a large number of beneficiaries, the judicially foreclosing senior may sometimes attempt to serve those beneficiaries by serving their trustee. This strategy was disapproved in *Monterey S.P. Partnership v W.L. Bangham, Inc.* (1989) 49 C3d 454, 261 CR 587, and should be avoided.

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3. Death or Incompetency of Beneficiary or Trustor

§3.37 a. Beneficiary

If the beneficiary is deceased, the representative of the estate chooses and pursues the remedy on default in the name of the representative alone. *Fox v Tay* (1891) 89 C 339, 26 P 897. In the case of an incompetent beneficiary, the foreclosure action is brought in the name of the ward by his or her conservator. *Dixon v Gries* (1895) 106 C 506, 39 P 857. For discussion of powers of representatives and conservators in dealing with parties' interests under mortgages and deeds of trust, see 1-3 California Decedent Estate Practice, chaps 10-11, 29 (2d ed Cal CEB 2009).

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§3.38 b. Trustor

When a judicial foreclosure action is commenced after the death of the trustor, it survives against the personal representative appointed for the estate or the decedent's successor in interest to the extent provided by statute. CCP §377.40. If the creditor wants a deficiency judgment, it must file a probate claim before judicially foreclosing. Prob C §§9351, 9370. If no deficiency or attorney fees are sought from the other assets of the probate estate, no probate claim is necessary if the complaint waives all recourse against the other property of the estate. Prob C §9391; 2 California Decedent Estate Practice, chap 14 (2d ed Cal CEB 2009). In 1996, §9391 was amended to clarify that the personal representative may seek to enjoin any action by the secured creditor to enforce a lien when the representative intends to sell the property to satisfy the lien. Decedent Estate Prac, chap 14. See §§2.35, 2.43 on effect of trustor's death on nonjudicial foreclosure.

Minor and incompetent defendants not having a general guardian or conservator generally must be represented by a guardian ad litem. See CCP §372. See also California Civil Procedure Before Trial, chap 9 (4th ed Cal CEB 2004).

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III. DRAFTING FORECLOSURE COMPLAINT

§3.39 A. Checklist: Essential Allegations

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A complaint for judicial foreclosure must contain these allegations:

- That the underlying promissory note or other obligation was executed and delivered and, if applicable, assumed. See §§3.41, 3.46.
- That the mortgage or deed of trust securing the original obligation was executed and delivered. The date of recordation and any applicable subordinations should also be alleged to establish priority over subsequent liens. See §3.42.
- The plaintiff's status as payee, mortgagee, beneficiary, assignee, and, if applicable, holder in due course. If the plaintiff is an assignee, the facts of the assignment should also be alleged. See §§3.40, 3.45.
- The interests of other defendants, if any. See §3.47.
- The event entitling the plaintiff to bring the action, *i.e.,* the default. Most notes contain an acceleration clause permitting the holder to declare the entire principal sum due in the event of nonpayment of a single installment, and the election to accelerate should also be pleaded. See §§3.48-3.52.
- That the plaintiff is entitled to attorney fees and other expenses, if provided for in the mortgage or deed of trust. See §3.53.

See form complaint in §3.102. For further discussion of elements of action for judicial foreclosure, see 5 Witkin, California Procedure, *Pleading* §§675-678 (5th ed 2008). For discussion of formal aspects of drafting complaint, see California Civil Procedure Before Trial, chaps 14-15 (4th ed Cal CEB 2004).

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B. Foreclosure: Pleading Ultimate Facts

§3.40 1. Introductory Allegations; Parties

Either the beneficiary or the trustee may bring the action to foreclose. CCP §725a. See §§1.40, 1.43, 3.23, 3.36 on naming trustee as plaintiff or defendant. On parties to consider naming as defendants, see §§3.24-3.38. The complaint (see form in §3.102) must state a cause of action against each fictitiously named defendant. This may be done either in the fictitious-name paragraph or in the paragraph containing the particular charging allegation. For example, with unknown guarantors or assuming grantees who might be liable for a deficiency judgment, the Doe defendants could be designated as such in the paragraph alleging liability of a guarantor or assuming grantee or in a separate cause of action asserted against guarantors known or unknown. See §§3.35, 3.46. For discussion of fictitious defendants, see California Civil Procedure Before Trial, chaps 14-15 (4th ed Cal CEB 2004).

For further discussion of parties in real property secured transactions, see chap 1.

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§3.41 2. Underlying Note or Other Obligation

The allegation in ¶5 of the form in §3.102 assumes that the deed of trust being foreclosed secures a promissory note. Technically, an obligation is all that is required, whether or not it is manifested in note form (see chap 1), and a writing is necessary only if required by the statute of frauds (CC §1624(a)(6)). The obligation may thus be in a form other than a note (see §§1.9, 1.11, 1.14, 2.11). Part of the strategy of many hidden mortgage transactions (see examples in §3.44) is to dispense with any debt instrument, counting on the force of the numbers involved to put real coercion on the disguised obligor (see §5.51). Although it is common in such instances for the claimed debtor to assert that the true purpose of the transaction was to obligate the debtor to the creditor, a creditor who decides to enforce the obligation as a secured obligation in a judicial foreclosure action should allege the nature and facts leading to the creation of the obligation underlying the security (see §3.39).

PRACTICE TIP: If the action is based on a promissory note, the borrower should file a motion in limine (or vigorously object during trial) to prevent the admission into evidence of anything other than the original note (and documents firmly establishing an assignment, if applicable). The lender may be required to produce the original note or to offer (before judgment is entered) sufficient and reasonable indemnification on a lost or destroyed note. See *Randolph v Harris* (1865) 28 C 561. See also §§2.34, 3.65. On using this strategy to oppose stay relief motions in debtor bankruptcy proceedings, see §§7.105-7.106.

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§3.42 3. Deed of Trust or Other Security Device

Both mortgages and deeds of trust are proper subjects for judicial foreclosure. The plaintiff should allege that the parties intended to create a security interest. See CCP §725a; *Talcott v Meakin* (1915) 26 CA 293, 146 P 897. See also §§1.32-1.57. The date of recordation and any applicable subordinations should be alleged to establish priority. If a copy of both the security instrument and a property description are attached as exhibits and incorporated by appropriate language, reference to them in the complaint also constitutes sufficient description of the property. *Johnston v McDuffee* (1890) 83 C 30, 23 P 214. If the security instrument is a mortgage instead of a deed of trust, the drafter of the complaint should make appropriate changes in the terminology of ¶6 of the form in §3.102. The instrument need not be quoted verbatim.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.43 4. Property Descriptions

§3.43 4. Property Descriptions

Property descriptions, particularly those based on metes and bounds, are notoriously susceptible to typographical errors. Whenever possible, property descriptions in the complaint, in a lis pendens, in the judgment, and in other contexts should be re-created by reprographic techniques. When optical scanning techniques are used to reproduce a property description, errors can easily occur, so close proofreading is essential.

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§3.44 5. Hidden Security Devices

Foreclosure is the appropriate remedy for hidden security instruments, *i.e.,* documents that do not appear on their face to be mortgages but serve the same economic function. See, *e.g.,* §§4.33, 5.51. If a court concludes that an instrument was intended to function as a mortgage, it is treated as a mortgage, and the one-action rule (CCP §726; see §4.3) mandates foreclosure. *Kaiser Indus. Corp. v Taylor* (1971) 17 CA3d 346, 94 CR 773. Because such instruments almost always omit a power of sale clause (because including one is a giveaway that the transaction is a mortgage), judicial foreclosure is typically necessary unless the security has become worthless. *Kaiser Indus. Corp. v Taylor, supra*. See §§4.33, 5.50, 6.9-6.18, 8.9.

The appropriate procedure is for the creditor to bring an action to have the instrument declared to be a mortgage and simultaneously foreclosed as such. See alternative language in ¶6 of form in §3.102. The most common hidden mortgages are deeds absolute (often combined with options to repurchase) and covenants not to convey (or further encumber so-called negative pledges). *Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379; *Keese v Beardsley* (1923) 190 C 465, 213 P 500; *Vance v Gilbert* (1918) 178 C 574, 174 P 42; *Russell v Zink* (1939) 32 CA2d 566, 90 P2d 360. But see *Wachovia Bank v Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 52 CR3d 168; *Tahoe Nat'l Bank v Phillips* (1971) 4 C3d 11, 92 CR 704; *Orange County Teachers Credit Union v Peppard* (1971) 21 CA3d 448, 98 CR 533.

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§3.45 6. Plaintiff's Ownership of Note and Deed of Trust

The complaint must allege the plaintiff's interest in the note and deed of trust, including its status as payee, mortgagee, beneficiary, or assignee. If the plaintiff is a transferee of the obligation, the facts of the assignment or endorsement should also be alleged. See ¶7 of form in §3.102. See also §§1.24-1.30, 2.16, 2.34, 3.41, 7.105-7.106.

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§3.46 7. Interest of Guarantors, Endorsers, or Assuming Grantees

If the plaintiff seeks a deficiency judgment against a guarantor, endorser, or assuming grantee, the complaint must contain an allegation justifying the inclusion of that person as a defendant, and the prayer should expressly seek relief against any such defendants. For discussion of guarantors, endorsers, and assuming grantees, see §§3.35, 9.88-9.136.

Because of CCP §726, the inclusion of all parties liable as principal obligors for the secured obligation is crucial. See chap 4. But because true (as distinct from sham; see §§4.30, 9.107-9.109) sureties and guarantors are generally not in the class protected by §726, a creditor may properly sue the guarantor in a separate contract action (*i.e.,* one not for judicial foreclosure) either before, concurrently, or after the judicial foreclosure action. See §9.91. From the standpoint of efficiency, it generally makes sense to join the guaranty claim in the same action, and doing so may also avoid problems if the guaranty is later challenged as a sham. See, *e.g., Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1997) 205 BR 427, aff'd (9th Cir 1999) 164 F3d 1214.

PRACTICE TIP: Even when the claims are joined, however, creditor's counsel should be careful to act in a manner consistent with the position that the guarantor's liability is independent from that of the principal debtor and not subject to the fair value antideficiency rules or procedures of CCP §726(b).

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§3.47 8. Interest of Other Defendants

Holders of recorded subordinate interests in the property must be named as defendants to terminate their presale reinstatement and redemption rights. See §3.32. Included in this category are holders of junior judgment liens, purchasers under recorded contracts of sale, tenants under recorded leases, and holders of subordinate easements. See §§3.25-3.33. If there are multiple claimants to the property with different types of claims, separate allegations should be used for each type of claim. See ¶9 of form in §3.102.

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§3.48 9. Right to Accelerate on Default

Nearly all deeds of trust contain acceleration clauses (see §§8.2, 8.8). See ¶10 of form in §3.102. If neither the note nor the deed of trust contains such a provision, CCP §728 contains some comparable relief by providing that, when property cannot be sold in portions without injury to the parties, then all of it may be ordered sold and the entire debt paid off in a foreclosure action. *Yoakam v White* (1893) 97 C 286, 32 P 238. If the property is severable, however, the foreclosure sale must cease as soon as there is a bid sufficient to cover the installments unpaid as of the date of the foreclosure decree. *Bank of Napa v Godfrey* (1888) 77 C 612, 20 P 142; *Hunt v Dohrs* (1870) 39 C 304. After that sale, the beneficiary may conduct further foreclosure sales to cover later unpaid installments, either by making supplementary motions in the same action (*Byrne v Hoag* (1899) 126 C 283, 58 P 688), as provided in the original decree (*Bank of Napa v Godfrey, supra*), or by filing periodic, successive foreclosure actions (*Higgins v San Diego Sav. Bank* (1900) 129 C 184, 61 P 943; *McDougal v Downey* (1872) 45 C 165; *Zingheim v Marshall* (1967) 249 CA2d 736, 57 CR 809). See *Furesz v Garcia* (1981) 120 CA3d 793, 174 CR 803 (beneficiary may elect not to enforce acceleration clause and to conduct piecemeal foreclosure (dictum)).

Although these cases support the idea of piecemeal foreclosure in the absence of acceleration, creditor's counsel should proceed with caution in choosing this approach. All but one of these cases predate *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897, which sets the pattern for modern applications of the one-action rule of CCP §726 and is fundamentally hostile to the idea of piecemeal judicial foreclosure.

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§3.49 10. Default in Loan Payments

The complaint must allege that the obligor defaulted in some way; the default usually consists of delinquent loan payments (see §3.7). See ¶11 of form in §3.102, which assumes that the action is based on an installment note containing an acceleration clause. If a single payment note (or a note on which the obligation has matured) is involved, the references to acceleration can be omitted. If the note is an installment note without an acceleration clause, but the property cannot be sold in portions, allegations conforming to CCP §728 should be used to overcome the omission of a contract right to accelerate. See §3.48. If the obligation is not in the form of a loan, then both its nature and the nature of the default should be set forth.

On interest rates and related issues, see §§1.19-1.23.

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§3.50 11. Default in Tax Payments

Most deeds of trust require the trustor to keep current the payment of all property and other local taxes assessed against the property. If taxes are delinquent, the allegations in ¶12 of the form in §3.102 should be included, which give the beneficiary the additional option of foreclosing against the public entity or buyer after a completed tax sale. For discussion of trustor's obligation to pay taxes on property and corresponding beneficiary's rights, see §§8.74-8.82.

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§3.51 12. Default in Insurance Payments

Most deeds of trust require the trustor to maintain fire and other insurance on the property. If insurance premiums are delinquent, the allegations in ¶13 of the form in §3.102 should be included, which give the beneficiary the additional option of adding any premiums it has paid to the principal balance owed. For discussion of trustor's obligation under deed of trust to pay insurance premiums and corresponding beneficiary's rights, see §§8.57-8.66.

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§3.52 13. Future Advances; Monetizing Default

Most deeds of trust require the trustor to reimburse the beneficiary whenever the beneficiary advances any money to protect its security in the property. The allegations in ¶14 of the form in §3.102 allow the beneficiary to plead and prove all expenditures made before and after the complaint is filed. For discussion of beneficiary's right to reimbursement for advances made to protect its security, see §§8.58, 8.74-8.75, 8.79. On need to cure defaults on "recurring obligations," see §§2.57-2.59.

Because of the risks and disadvantages to a lender involved in declaring a doubtful or difficult-to-liquidate default, the lender should generally wait for a clear-cut default before commencing foreclosure. The lender should "monetize" the default, *i.e.,* advance the necessary sums to pay taxes, insurance, or repairs, and then make written demand on the debtor to reimburse the advance. If the advance is not repaid, the lender can then declare a concrete monetary default on the liquidated amount.

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§3.53 14. Entitlement to Attorney Fees and Costs

Attorney fees in judicial foreclosure actions are usually authorized by provisions in the loan documents. *Chase Manhattan Mortgage Corp. v Lessel* (1997) 55 CA4th 10, 64 CR2d 113. Promissory notes and deeds of trust typically require that (1) the trustor pay the amount found by the court to have been reasonably spent by the beneficiary for the foreclosure action and (2) that amount becomes a lien on the real property. See allegations in ¶15 of form in §3.102. On calculating attorney fees for reinstatement, see §3.63.

Even if the loan documents provide for another method of establishing the amount of attorney fees, CCP §730 explicitly requires the court to set the fees as part of the foreclosure action. Also, *Chase Manhattan Mortgage Corp. v Lessel, supra,* held that §730 does not independently authorize a court to award attorney fees unless the mortgage or deed of trust provides for them. For detailed discussion of beneficiary's right to attorney fees and related disputes, see §§8.83-8.90.

Contractual attorney fees are ordinarily fixed by the court in a contested action on motion by the prevailing party after entry of judgment. See Cal Rules of Ct 3.1702; *Santisas v Goodin* (1998) 17 C4th 599, 71 CR2d 830. In a default (*i.e.,* failure to answer complaint; see §3.64), attorney fees are awarded under a memorandum of costs, usually calculated according to the local court fee schedule. See generally California Trial Practice: Civil Procedure During Trial, chap 26 (3d ed Cal CEB 1995); California Attorney Fee Awards, chaps 11-16 (2d ed Cal CEB 1994).

When the loan documents are silent or inadequate on the issue of attorney fees, CCP §580c appears to provide an independent basis for a discretionary award of reasonable attorney fees and specified actual costs to the successful lender in a judicial foreclosure action, but it may be subject to the same interpretation as CCP §730 was given in *Chase Manhattan Mortgage Corp. v Lessel, supra*. See analysis of attorney fee statutes in foreclosure actions in §§8.83, 8.85, 8.87.

Recovery of costs and expenses of the foreclosure action is also authorized by CCP §1032(b) if the prevailing party timely files a cost memorandum after entry of judgment. See Cal Rules of Ct 3.1700. Allowable costs and expenses are specified in CCP §§1032-1034. The cost amounts may be contested by a motion to tax costs or to strike the cost bill. See Cal Rules of Ct 3.1700.

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§3.54 15. Demand for Judgment (Prayer)

The demand at the end of the complaint for monetary relief in the judgment should be for the entire unpaid principal plus accrued interest (together with costs and attorney fees to be set by the court). Under CC §3289(a), prejudgment interest is calculated at the rate established in the promissory note and under CCP §685.010; postjudgment interest is at the statutory rate of 10 percent, unless the parties mutually agree to have postjudgment interest calculated at the contract rate. See *Citicorp Real Estate, Inc. v Smith* (9th Cir 1998) 155 F3d 1097, 1107.

The names of all parties whose interest in the security is to be terminated by the foreclosure should be included, along with the name of the principal trustor (see ¶3 of form in §3.102). See §§3.24-3.38. The request for a deficiency judgment (see ¶4 of form in §3.102) should be expanded, when appropriate, to include other defendants who may be liable for a deficiency (see §3.35). If no deficiency judgment is desired or allowable, the postsale redemption period can be entirely eliminated merely by inserting a statement in the prayer and, ultimately, in the judgment, that a deficiency judgment is waived. Even if a deficiency is not waived in the complaint, the redemption period will be reduced from 12 months to 3 months if the creditor makes a full credit bid at the foreclosure sale. CCP §729.030. See CCP §§716.020, 726(e), 729.010-729.090.

For further discussion of effect of deficiency judgment waiver on postsale redemption rights, see §3.84; Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 56 (Apr. 1983). On attorney fees and costs, see §3.53.

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§3.55 C. Application for Receivership

Foreclosure complaints often contain an additional cause of action for specific performance of the rents-and-profits clause in the deed of trust and for appointment of a receiver to collect the rents and profits. See §§3.5, 6.15, 6.33-6.48. The complaint form in §3.102 may be modified to include a cause of action for enforcement of the rents-and-profits clause (see allegations in form in §6.94), and a motion for the appointment of a receiver may be made soon after the foreclosure complaint is filed (see discussion and forms in §§6.38-6.49, 6.99-6.106), or an ex parte application may be made when the complaint is filed, if necessary to avoid waste by the party in possession or to prevent rent skimming by the debtor (see procedures in §6.38). On additional reasons for requesting appointment of receiver, see §§3.5, 6.15, 6.34, 10.19, 10.36, 10.45.

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D. Lis Pendens

§3.56 1. Purpose

Immediately on filing the complaint, the plaintiff should record a notice of action pending (lis pendens) in the same county. See CCP §§405.20-405.24. Under CCP §405.20, any other party to the action who asserts a claim to the property may also record such a notice (a change from the requirement of former CCP §409 that a party must first file a complaint or a cross-complaint before recordation of the lis pendens; see *Arrow Sand & Gravel, Inc. v Superior Court* (1985) 38 C3d 884, 215 CR 288). The lis pendens should be recorded on the same day the complaint is filed and must be served on the defendants. CCP §§405.22-405.23. Under CCP §405.21, the attorney of record must sign the notice, and a litigant filing an action in propria persona must have the lis pendens approved by the court. The general rules on preparation, recordation, service, and expungement of a notice of action pending are found in CCP §§405-405.61. See California Real Property Remedies and Damages, chap 13 (2d ed Cal CEB 2002).

WARNING: Because of past abuses of the "sleeper" lis pendens (recorded but not served in a way calculated to give the property owner notice until an urgent need to clear title arose), the current lis pendens law contains detailed and mandatory service requirements that should be followed strictly. See §3.57.

A properly served and recorded lis pendens imparts constructive notice of the action underlying it (and of the named parties in the action), thus binding subsequent purchasers, encumbrancers, or other transferees to any judgment eventually entered in the action. CCP §405.24. See *Albertson v Raboff* (1956) 46 C2d 375, 295 P2d 405. A lis pendens in a foreclosure action will cause owners and junior lienholders who acquired their interests after the recordation of a procedurally proper lis pendens to be bound by the judgment and their interests to be terminated by the foreclosure sale. *Dobbins v Economic Gas Co.* (1920) 182 C 616, 189 P 1073; *Hibernia Sav. & Loan Soc'y v Cochran* (1904) 141 C 653, 75 P 315; *Johnson v Friant* (1903) 140 C 260, 73 P 993; *McNamara v Oakland Bldg. & Loan Ass'n* (1901) 132 C 247, 64 P 277. If no lis pendens has been recorded, these persons still take subject to the mortgage or deed of trust if it was recorded, but they are not affected by the foreclosure action unless they are added to the action in a supplemental complaint (see California Civil Procedure Before Trial, chap 16 (4th ed Cal CEB 2004)). A new foreclosure action must be brought against them if neither a lis pendens nor a supplemental complaint is used. See *Carpenter v Lewis* (1897) 119 C 18, 50 P 925.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.57 2. Service Requirements

§3.57 2. Service Requirements

In all litigation except eminent domain actions, the person preparing the notice must, before recordation, mail a copy of the notice by registered or certified mail, return receipt requested, to all parties with known addresses who have adverse claims and to all owners of record shown on the latest county assessment roll. CCP §405.22. If an address is unknown, the *serving party must sign* a declaration under penalty of perjury to that effect *and record it* with the lis pendens. CCP §405.22. Proof of service that complies with CCP §1013a or the declaration under penalty of perjury must be recorded with the lis pendens. CCP §405.23. For lis pendens forms and particular procedures, including expungement and challenges to lis pendens, see California Real Property Remedies and Damages (2d ed Cal CEB 2002).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.58 E. Order of Reference

§3.58 E. Order of Reference

A common alternative dispute resolution clause in deeds of trust provides that, in a judicial foreclosure action, the beneficiary may apply to the court for an order of reference under CCP §638. This procedure is adopted in lieu of an arbitration clause because an order to arbitrate (under CCP §1281.2) or a confirmation of award (under CCP §1287.4) might constitute an action under the one-action rule. If the reference clause is sufficiently broad and sufficiently specific, the reference proceedings could presumably pertain to both the foreclosure and the deficiency judgment. A well-drafted reference provision can provide the parties with a relatively quick and efficient means of obtaining complete resolution of the dispute without the delays and distractions of many civil dockets. In some cases, a reference procedure may make judicial foreclosure an economically practicable alternative when it would otherwise not be. But even though reference proceedings represent a useful hybrid of ordinary civil proceedings and private arbitration, and although a reference format requires the referee to follow the law and to make findings based on substantial evidence, such proceedings do not have the finality of private contractual arbitration and are subject to court conformation and potentially lengthy appeals.

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IV. DEFENSES; DEFENDANTS' RIGHTS

§3.59 A. Trustor

Any defenses the trustor has to an action on the note or other secured obligation (*e.g.,* lack of consideration, illegality, fraud) are equally good against an action to foreclose the instrument securing it. These defenses must be timely raised or lost. See *Citicorp Real Estate, Inc. v Smith* (9th Cir 1998) 155 F3d 1097, 1103. (On enforcement defenses, see chaps 7-9, 12.) If the obligation was embodied in a negotiable note, however, defenses against the original creditor may not be effective against a foreclosing creditor who is a holder in due course. See Com C §§3104, 3302, 3305. See also §§1.24-1.30, 12.103. The statute of limitations (see §§3.16-3.20) may be raised by general demurrer if the defect appears on the face of the complaint (CCP §430.10(e)) or in the answer, whether or not the defect appears in the complaint (see *California Safe Deposit & Trust Co. v Sierra Valleys Ry.* (1910) 158 C 690, 698, 112 P 274).

The trustor may also have defenses relating solely to the security, *e.g.,* a denial of the allegation that the obligation is secured. Such a defense may be available when the creditor contends that some special instrument (*e.g.,* a covenant not to convey) is a mortgage and the debtor denies it or when, under a dragnet clause in a deed of trust (see §9.59), the beneficiary contends that the obligation in question is secured and the trustor disagrees.

PRACTICE TIP: Debtors' counsel sometimes desire immediately to "take the fight to the lender" by focusing first on lender liability. Strong lender liability cases certainly occur (see, *e.g.,* chaps 7, 12), but the opinion in *Brown v Boren* (1999) 74 CA4th 1303, 88 CR2d 758, illustrates the risks of exclusive reliance on fraud and other tort theories directed against the lender. By contrast, the debtor in a secured transaction has the benefit of the one-action and some of the antideficiency defenses; although not always absolute, these defenses may be more economical and practical.

Under the most potent one-action and antideficiency defenses in real estate secured transactions (see chaps 4-5), the debtor

- has a right to demand exhaustion of the security (CCP §726);
- has a complete deficiency defense if the creditor nonjudicially foreclosed any of the real property security (CCP §580d);
- has a right of postsale redemption if the creditor completed a judicial foreclosure without waiving its deficiency claim (see §§3.90-3.101); and
- has a right to fair value antideficiency protection (CCP §726(b); see also CCP §580a).

If the transaction involves a purchase money loan, the debtor may have an absolute defense to any deficiency (CCP §580b; see §3.62). Failure to timely plead and develop these defenses can constitute malpractice. *Crookall v Davis, Punelli, Keathley & Willard* (1998) 65 CA4th 1048, 77 CR2d 250.

On defenses to judicial foreclosure in multiple security actions, see §§9.2-9.10.

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§3.60 B. Junior Lienholders

Junior creditor defendants may attack the validity of the senior obligations on the same grounds as are available to the trustor (see §3.59) because an improper senior obligation detrimentally affects the juniors' priority. See *Caito v United Cal. Bank* (1978) 20 C3d 694, 702, 144 CR 751; *Valley Title Co. v Parish Egg Basket, Inc*. (1973) 31 CA3d 776, 107 CR 717; *Hayward Lumber & Inv. Co. v Naslund* (1932) 125 CA 34, 13 P2d 775. Juniors are also within the class of persons protected by CCP §726. *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712.

Junior lienholders are automatically entitled to the surplus after a foreclosure sale, distributed in order of priority, and need do nothing to preserve that right. See CCP §§726(a), 727; *Livingston v Rice* (1955) 131 CA2d 1, 280 P2d 52. It is also appropriate for a junior either to demand the surplus in its answer or to cross-complain for foreclosure of the junior debt along with the senior. *Camp v Land* (1898) 122 C 167, 54 P 839. A cross-complaint for foreclosure does not enlarge junior rights to the surplus; whereas formerly a junior cross-complaint cut off postsale redemption (*San Jose Water Co. v Lyndon* (1899) 124 C 518, 57 P 481), under current law a junior lienholder no longer has such rights (CCP §729.020; see §3.91).

On priority issues that may arise for junior defending senior foreclosure action, see chap 9.

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§3.61 C. Trustee

If the trustee is only a nominal defendant and reasonably believes that it was named solely in its capacity as trustee and not because of any alleged wrongful acts in performing its duties, it may file a declaration of nonmonetary status, thereby agreeing to be bound by the judgment. CC §2924*l*. (See also discussion of possible stipulation between trustee and plaintiff in §3.36, which may be more cost effective for trustee than procedure under §2924*l*, which does not waive appearance fee for declaration.) Absent a timely objection (15 days), the trustee is not required to participate further in the action and is not subject to any award for damages, attorney fees, or costs, although it is still required to respond to discovery and is bound by any court order relating to the deed of trust. CC §2924*l*(d). The trustee is required to participate in the action if there is a timely objection to the declaration. If any party later discovers that the trustee should participate, that party may file a motion under CCP §473 requesting that the court order the trustee to appear in the case. Effective January 1, 2005, if the court grants the motion, the court must provide enough time before trial for the trustee to be able to respond to the complaint, conduct discovery, and bring other pretrial motions. CC §2924*l*(e).

Because the trustee is not required to participate in a judicial foreclosure action in which it is only nominally joined, the trustee cannot recover costs or attorney fees for unnecessary documents that it files in the action. *Field v Acres* (1937) 9 C2d 110, 69 P2d 422. See *Carpenter v Title Ins. & Trust Co.* (1945) 71 CA2d 593, 163 P2d 73.

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§3.62 D. Defenses to Claims for Deficiency

If the note constituting the basis for the action was executed for a purchase money loan, a deficiency judgment is not available even if the deed of trust is foreclosed judicially. CCP §580b. See §§5.24-5.44. Application of §580b should be raised as an affirmative defense in the answer. If §580b is not raised, it may be held to have been waived. See *Crookall v Davis, Punelli, Keathley & Willard* (1998) 65 CA4th 1048, 77 CR2d 250; *United Cal. Bank v Tijerina* (1972) 25 CA3d 963, 102 CR 234. See also Warning in §5.29.

When a deficiency judgment is appropriate in the action generally but has been improperly asserted against a particular defendant, this defect must be raised as an affirmative defense. *Treat v Craig* (1901) 135 C 91, 67 P 7. Defendants who may assert this defense include nonassuming grantees of the encumbered property (or even assuming grantees from a nonassuming grantee) (see §§9.122-9.136) and any party initially liable but whose liability has been eliminated by subsequent acts of the parties, *e.g.,* a guarantor or original debtor who has not consented to some alteration of the basic obligation. See *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564.

On antideficiency statutes generally, see chap 5.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.63 E. Reinstatement and Presale Redemption Rights

§3.63 E. Reinstatement and Presale Redemption Rights

The trustor or mortgagor (and certain other persons having an interest in the property; see §§2.43, 2.52, 2.73, 3.32) may do either of the following *before* the foreclosure sale:

- Reinstate the loan (*i.e.,* pay the unaccelerated balance due) before the judgment of foreclosure is entered if the default is reinstatable (CC §2924c); or
- Redeem the property from the mortgage or deed of trust before the sale by paying the full amount owing to the foreclosing creditor (CC §§2903-2905).

The right of reinstatement arises solely by virtue of statute as a countermeasure to the lender's exercise of its acceleration clause. Reinstatement may be made at any time before entry of the judgment of foreclosure. Either the debtor successor or anyone having a subordinate lien or encumbrance of record may exercise this remedy. To reinstate under CC §2924c, the trustor or mortgagor (or its successor in interest) must pay the entire amount that would then be due had there been no default, plus trustee or attorney fees to date. This amount includes not only past-due installments on the note but also taxes, assessments, and insurance premiums that are in arrears or have been advanced by the beneficiary or by any other interested party. Reinstatement requires curing not merely stated defaults but also all amounts due on "recurring obligations" (see §2.58) even when not listed. On required payment of expenses for reinstatement, see §§2.57-2.60. On payment of attorney fees, see §§2.59, 8.84; *Bruntz v Alfaro* (1989) 212 CA3d 411, 260 CR 488. For extended discussion of reinstatement, see §§2.51-2.61.

PRACTICE TIP: If the debtor attempts to reinstate during a judicial foreclosure, attention should be given to CC §2924c(d), which limits the amount of trustee or attorney fees that may be charged to effect reinstatement. It is one of the few provisions of foreclosure law (CC §§2924-2924*l*) that also address judicial foreclosure issues. Civil Code §2924c(d) provides a formula for trustee or attorney fees that will be conclusively presumed lawful and valid. Both trustee fees and attorney fees are calculated by the same disjunctive formula despite the very different fee structures for law firms and foreclosure companies.

The right of redemption derives from the equity of redemption at common law (see §§1.33, 2.73) and is exercised by paying the entire amount of the debt (rather than merely its arrearages) together with any damages to which the lienholder is entitled because of the delay. CC §§2903-2905. The redemption right is terminated by the foreclosure sale. Redemption may be asserted by anyone having an interest in property subject to the deed of trust. CC §2903. Although CCP §347 appears to permit piecemeal or partial redemption when there are multiple mortgagors or parties claiming under them, it is unlikely that the Code truly permits involuntary partial releases of the security except in isolated and special cases. See, *e.g., Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 77 CR2d 581. On required payment of expenses for redemption, see §§2.73, 8.85.

On debtor's statutory right to redeem after judicial sale under CCP §§729.010-729.090, see §§3.90-3.101. For discussion of rights of reinstatement, redemption, and other remedies available to vendors under installment land contracts, see §§1.59-1.66.

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V. OBTAINING FORECLOSURE JUDGMENT

§3.64 A. Default and Trial Setting

If the defendants in a judicial foreclosure action fail to answer, their defaults may be entered by the court clerk on the plaintiff's request (CCP §585(b)-(c)), and the court will conduct a hearing to hear the evidence and then enter a judgment of foreclosure and an order of sale (see §§3.67-3.70, 3.103). The attorney must, of course, present proof of service on the defendants and an affidavit, as required by the Servicemembers Civil Relief Act (50 USC App §§501-596), that the defendants are not serving in the armed services. See §2.30. For full discussion on entering default and obtaining judgment, see California Civil Procedure Before Trial, chap 38 (4th ed Cal CEB 2004).

Because of both the "one final judgment" rule that is a general part of California civil jurisprudence and the one-action rule of CCP §726 that is peculiar to real property secured transactions, the creditor should avoid taking final judgments against any defaulting defendants when other defendants are or can be expected to be actively defending the action. A premature entry of judgment against any defendant may trigger severe sanctions under the one-action rule. See *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1994) 174 BR 557, 570; *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, aff'd without published opinion (9th Cir 1995) 46 F3d 1143.

If any defendant files an answer, the case is set for trial. On trial setting generally, see Civ Proc Before Trial, chaps 40-42. Despite the possibility of a deficiency judgment, the parties are not entitled to a jury trial. *Downing v Le Du* (1890) 82 C 471, 23 P 202; *Van Valkenburgh v Oldham* (1910) 12 CA 572, 108 P 42.

Before embarking on a judicial foreclosure, counsel must evaluate the potential for obtaining summary judgment. Sometimes judicial foreclosure makes economic sense only if it can be accomplished without the delays and large costs involved in proceeding to trial in some counties. Because some of the debtor's standard defenses are matters of law, either summary adjudication of issues or summary judgment may be feasible. Well-pleaded and plausible lender liability claims, such as lender breach (see chaps 7, 12) can effectively rule out summary judgment. See §3.59.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.65 B. Checklist: Evidence Required for Foreclosure Judgment

§3.65 B. Checklist: Evidence Required for Foreclosure Judgment

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The plaintiff must introduce the following evidence:

- The original note (see *Randolph v Harris* (1865) 28 C 561);
- The original mortgage or deed of trust or a certified copy of the recorded mortgage or deed of trust;
- The original or a certified copy of the assignment if the plaintiff is an assignee;
- The written assumption agreement if the defendant is an assuming grantee of the original trustor (CC §1624(a)(6));
- A statement of the account, including the date of the original default, the date to which interest is credited, and the unpaid balance of the obligation;
- Proof of advancements for taxes, insurance, or other expenditures secured by the deed of trust (if applicable);
- Proof of default given by the testimony of qualified witnesses if the default is based on nonmonetary covenants in the deed of trust (*e.g.,* failure to keep the property in good repair or to cultivate farmland);
- Proof of the recordation date of the deed of trust, to prove priority; and
- Proof of personal liability of all defendants who are subject to the deficiency judgment if a deficiency judgment is sought in the complaint, or instead a declaration that any deficiency judgment is waived.

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§3.66 C. Defenses; Statement of Decision

The defendants will have an opportunity to present their defenses (see substantive and procedural defenses in §§3.59-3.62) and should introduce all evidence supporting any defenses to the plaintiff's demand for foreclosures and for a deficiency judgment. See *United Cal. Bank v Tijerina* (1972) 25 CA3d 963, 102 CR 234. If the court finds in favor of the plaintiff on all elements of the case, it enters a decree of foreclosure and an order of sale, directing either the sheriff or a receiver appointed by the court to sell the real property or as much of it as may be required to satisfy the debt.

As in other contested cases, a statement of decision (see CCP §632) may be requested by any party and will usually be prepared, at the court's direction, by the prevailing party. No statement of decision is required unless requested by one of the parties within 10 days after the court has announced a tentative decision. If the trial is concluded within 1 calendar day or in less than 8 hours over 2 days, however, the request must be made before the case is submitted. CCP §632; Cal Rules of Ct 3.1590. For further discussion, see California Trial Practice: Civil Procedure During Trial §23.34 (3d ed Cal CEB 1995).

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D. Judgment (Decree) of Foreclosure

§3.67 1. Required Elements

A judgment of foreclosure is sometimes referred to as a "decree" of foreclosure but must not be confused with the money judgment for a deficiency (see §3.87) that may be entered in the case later, following the foreclosure sale and fair value proceedings. The requirements for a judgment of foreclosure are in CCP §726 (see form in §3.103). The judgment must do the following:

- Direct the sale of all or part of the property and order the sale proceeds applied first to court costs and the expenses of the levy and sale and then to the amount owing to the plaintiff, including reasonable attorney fees if the security instrument provides for them (CCP §726(a));
- Appoint the sheriff (see CCP §680.020) or a receiver (see CCP §§564(b)(4), 708.620, 712.060) to sell the property in the manner provided for execution of judgments in CCP §716.020 (deficiency waived or prohibited) or §§729.010-729.090 (deficiency permitted) (see CCP §726(e); see also §§3.71-3.85); and
- Declare the amount of the indebtedness and either determine the potential for (but not yet the quantum of) the personal liability of any named defendant who may be subject to a deficiency judgment or declare that a deficiency judgment is waived or prohibited. CCP §726(b). On procedures for obtaining deficiency judgment after sale, see §§3.86-3.89, 3.111-3.113.

A bond may be required if a receiver is appointed to conduct the sale. CCP §567(b). The receiver's powers and duties are established by CCP §§566-570, 708.610-708.620. If the sheriff is ordered to conduct the sale, no bond is required and the sheriff's fees are prescribed by law. See Govt C §26730.

When a deficiency judgment is recoverable and the sale proceeds are insufficient to satisfy the indebtedness, the plaintiff must apply within 3 months after the sale for a hearing and a deficiency judgment. The court will take evidence of the "fair value" of the security and calculate the deficiency judgment by the amount by which the indebtedness (plus interest and costs of sale) exceeds that value, rather than the amount bid at the sale, unless the amount bid exceeded the fair value. CCP §726(b).

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§3.68 2. Decree Entered as Judgment

The differing statutory terminology for the foreclosure decree and the deficiency judgment in CCP §726 suggests that the legislature "contemplated an initial determination directing the sale and ascertaining the rights of the parties, and, if a deficiency remained after that decree had been satisfied, a subsequent money judgment to conclude the action." *Kinsmith Fin. Corp. v Gilroy* (2003) 105 CA4th 447, 454, 129 CR2d 478. Courts document these two proceedings in various ways. In some cases, the court enters two separate judgments in the foreclosure action. In others, the court regards the foreclosure decree as an interlocutory order that later becomes a final judgment with an amendment establishing the amount of the deficiency judgment. Either way, these procedures do not run afoul of the one-action rule, the purpose of which "is to protect debtors from multiple collection actions, not to bar entry of more than one final determination in a foreclosure action." 105 CA4th at 453.

WARNING: Even though the foreclosure decree must be entered as a judgment in the court records to be enforced, neither the decree nor an abstract of it should be recorded. See, *e.g., Carnation Co. v Lampi (In re Kristal)* (BAP 9th Cir 1984) 37 BR 659, aff'd (9th Cir 1985) 758 F2d 454 (recordation of abstract of judicial foreclosure decree violates CCP §726 by creating or by apparently creating dual involuntary judgment lien and triggers sanctions). See chap 4.

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§3.69 3. Appealability of Decree

Foreclosure decrees conclusively establish the parties' rights on the issues adjudicated. Because the language of CCP §726 envisions "two separate decisions in a foreclosure action" (*Kinsmith Fin. Corp. v Gilroy* (2003) 105 CA4th 447, 451, 129 CR2d 478), foreclosure decrees are final decisions and therefore appealable even if the actual amount of the deficiency judgment is yet to be decided at a fair value hearing after the sale. See *United Cal. Bank v Tijerina* (1972) 25 CA3d 963, 968, 102 CR 234; *Grable v Damar Prod. Co.* (1965) 232 CA2d 510, 43 CR 16; *Citicorp Real Estate, Inc. v Smith* (9th Cir 1998) 155 F3d 1097, 1101. Even in actions in which the trial courts have labeled decrees that order the sale of property as interlocutory, courts have allowed appeals on them as severable final judgments because they finally determine the parties' property rights. See, *e.g., Stockton v Rattner* (1972) 22 CA3d 965, 968, 99 CR 787 (order authorizing sale of property under contract of assignment for benefit of creditors that permitted sale of property under certain conditions); *Degnan v Morrow* (1969) 2 CA3d 358, 364, 82 CR 557 (partition sale of property in partnership dissolution action). On substantive and procedural aspects of obtaining award of attorney fees, see §§3.53, 8.83-8.90.

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§3.70 4. Binding Election of Remedies

Actual entry of judgment of foreclosure constitutes an election of remedies and prohibits a subsequent trustee sale. *Vlahovich v Cruz* (1989) 213 CA3d 317, 261 CR 565. Even if a sale does not occur under the foreclosure decree, the foreclosing party may be barred from pursuing alternative relief against the borrower. See *C.J.A. Corp. v Trans-Action Fin. Corp.* (2001) 86 CA4th 664, 103 CR2d 538 (holding that CCP §726 barred junior lienholder (who had obtained judicial foreclosure decree but did not proceed with sheriff's sale) from converting its foreclosure judgment to money judgment as "sold-out" junior after senior lienholder's subsequent foreclosure).

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VI. FORECLOSURE SALE

§3.71 A. Summary of Applicable Procedures

Judicial foreclosure sales are governed by two different titles in the Code of Civil Procedure. Depending on whether a deficiency judgment is available, the sale is conducted under either of the following:

- The generally applicable Enforcement of Judgments Law (EJL) (CCP §§680.010-724.260); or
- Special provisions on mortgage foreclosures (CCP §§725a-730.5), which, in part, refer to the more general procedures in the EJL.

Specifically, under CCP §726(e), if a deficiency judgment is waived or prohibited, the property is sold as provided in CCP §716.020 (procedures in the EJL for enforcing nonmonetary judgments specifically for the sale of property). If a deficiency is not waived or prohibited, the property is sold subject to the debtor's (or junior lienholder's) right of redemption as provided in the mortgage sale and redemption procedures in CCP §§729.010-729.090.

The prerequisites in §§3.72-3.74 and 3.77-3.80 are common to both kinds of sale. Some (but not all) of the provisions in the division of the EJL governing money judgments (CCP §§695.010-709.030) may apply in both kinds of sale. The differences between the procedures occur primarily in (1) the presale notice periods after entry of judgment (see §§3.75-3.76); (2) the form of the notice of sale (see §§3.73-3.76, 3.106); and (3) the postsale procedures (see §§3.84-3.85).

For useful explanation of applying Enforcement of Judgments Law to judicial foreclosure, see Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 56 (Apr. 1983). In some respects, the execution procedures fit poorly for judicial foreclosure sales. The 120-day waiting period before the sale under CCP §701.545 (if a deficiency judgment is waived or does not apply) seems excessive after the delays that will have occurred before judgment. Also, the official notice of levy seems misleading, particularly the information on exemptions.

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B. Presale Procedures

§3.72 1. Obtaining Writ of Sale

The plaintiff's first step after judgment is to prepare a writ of sale, which is then issued by the court clerk after confirming that appropriate information in the writ conforms to the judgment that has been entered. CCP §§716.010-716.020, 712.010-712.060. Contents of the writ are specified in CCP §699.520, and the Judicial Council form reproduced in §3.104 covers these requirements.

After the writ has been issued, the plaintiff should deliver it to the sheriff or receiver along with the prepared notice of levy and notice of sale for service (see §§3.73-3.76, 3.105-3.106) and execution of the judgment. CCP §§716.010-716.020, 712.010-712.060. Procedures for return of the writ by the levying officer are governed by CCP §§699.560, 712.050. See §3.83.

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§3.73 2. Preparing Notice of Levy and Notice of Sale

The plaintiff's counsel prepares the notice of levy consistent with the terms of the judgment, and the sheriff or receiver records both the notice of levy and the writ of sale (see forms in §§3.104-3.105). CCP §700.015. See CCP §§699.540-699.545, 716.010-716.020. The contents of the notice of levy are specified in CCP §699.540. Use of the Judicial Council form in §3.105 should suffice to comply with these requirements. The notice of levy and the writ of sale are served by the sheriff or receiver on the debtor and other interested parties.

The notice of sale is also prepared by plaintiff's counsel, and it must conform to the judgment and comply with CCP §701.540. In addition to the legal description of the property, the notice must give the street address or other common designation. If the property has no street address or other common designation, the notice must indicate that directions to the property's location may be obtained from the sheriff or receiver by an oral or written request. CCP §701.540(a). The language in the next-to-last paragraph of the notice form (see §3.106) is required by CCP §701.547.

The notice of sale must always be preceded by, or served simultaneously with, the notice of levy (see form in §3.105), but the time within which the notice of sale may be served after service of the notice of levy varies depending on the nature of the judgment (see §§3.75-3.76). On methods of service, see §3.74.

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3. Serving Writ and Notices of Levy and Sale

§3.74 a. Methods of Service; Persons Served

The levying officer (*i.e.,* sheriff or court-appointed receiver) must record the writ of sale and notice of levy and serve them on the judgment debtor and any occupant of the property. Requirements for service are specified in CCP §700.015. See CCP §716.020(a). The officer must also give 20 days' notice of the sale. CCP §701.540. Time periods for serving the notice of levy and notice of sale are discussed in §§3.75-3.76.

Requirements for posting, publishing, and mailing the notice of sale are in CCP §701.540. In addition to serving the debtor and at least one occupant of the property (CCP §701.540(c), (e)), the levying officer must post the notice in a public place and on the property (CCP §701.540(d)) and must publish the notice in a newspaper of general circulation in accordance with Govt C §6063 (CCP §701.540(g)). The officer must also mail the notice of sale to anyone who has filed a request for notice with the clerk of the court that entered the judgment. CCP §701.550.

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b. Time of Service

§3.75 (1) If No Deficiency Judgment

Whether a deficiency judgment is available (and thus whether the trustor has a right of redemption) establishes the period of notice that must be given before the property can be sold by the levying officer. If a deficiency judgment has been waived or is prohibited, the notice of levy must be served at least 120 days before the notice of sale. CCP §§700.015, 701.545. See §3.71. After the 120-day period has run, the officer gives an additional 20 days' notice of sale. CCP §701.540. Thus, when the debtor has no postsale redemption rights (see §§3.90-3.101), the debtor is entitled to 140 days' notice before the foreclosure sale. (During this period the debtor retains the right to redeem the property under CC §2903; see §3.63.)

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§3.76 (2) If Deficiency Judgment Allowed

When the debtor has statutory postsale redemption rights (*i.e.,* when the court allows a deficiency judgment; see CCP §729.010(a)), the notice of sale (along with the notice of levy; see CCP §700.015) may be recorded and served with the writ of sale immediately on entry of the foreclosure judgment. CCP §729.010(b)(2). The notice of sale, however, must state that the property is sold subject to the statutory right of redemption. CCP §729.010(b)(1). See §3.106. The debtor has a postsale period to redeem the property within either 3 months (if the proceeds of the sale are sufficient to satisfy the indebtedness; CCP §729.030(a)) or 1 year (if the proceeds are not sufficient to satisfy the indebtedness; CCP §729.030(b)). See §§3.92, 3.108. The provisions of CCP §701.540(h), requiring that the creditor instruct the levying officer, no earlier than 30 days after the notice of levy, to mail notice of sale to lienholders of record, do not apply when the property is being sold subject to a deficiency judgment. CCP §729.010(b)(3).

NOTE: Because 3-month redemption periods are extremely rare, their occurrence suggests a level of complexity or a miscalculation. For example, a full credit bid triggers the 3-month period, and one may wonder why the creditor elected the delays of a judicial foreclosure. Even if the full bid is a third party cash bid, there is reason to question the wisdom of pursuing judicial foreclosure when the security was valuable enough to generate a bid equal to the debt, unless, for example, the amount owing on the debt was contested.

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C. Sale Procedures

§3.77 1. Location and Order of Sale

The sale must be held in the county in which some of the property is located and must be conducted between 9 a.m. and 5 p.m. CCP §701.570(a). Although the deed of trust usually recites that the beneficiary may direct the order of sale if multiple properties are involved, CCP §701.570(d) provides that the levying officer may honor the judgment debtor's request to sell in a particular order if, in the officer's opinion, that manner of sale is likely to yield an amount at least equal to any other manner of sale or equal to the amount necessary to satisfy the judgment. (This rule is different from the rule applicable to trustee sales in CC §2924g(b), which gives the terms of the deed of trust the final say.) The order of sale is also subject to the "marshaling of assets" rules of CC §2899. See *Commonwealth Land Title Co. v Kornbluth* (1985) 175 CA3d 518, 220 CR 774. For further discussion of marshaling assets, see §9.87.

NOTE: In the era of eBay, virtual home tours, and the burgeoning use of electronic auction formats to sell real estate of all sizes and types, the statutory procedures for both judicial and nonjudicial foreclosure auctions are somewhat antiquated. Electronic, Web-based auctions have become a commonplace method of voluntarily liquidating distressed real estate projects and of reselling "REO" property, *i.e.,* property that has been taken back by the lender in a prior foreclosure.

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§3.78 2. Postponement

Under CCP §701.580, a sale may be postponed only on the joint agreement of debtor and creditor (in contrast, postponement of trustee sales can occur by the creditor's or trustee's unilateral decision (CC §2924g(c)(1)); see §2.88). The postponement thereafter becomes effective by the levying officer's publicly announcing it at the time and place set for the original sale.

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§3.79 3. Eligible Bidders

Anyone except for the levying officer may bid at the foreclosure sale. CCP §§701.570, 701.610. The foreclosing creditor is entitled to bid, and a purchase in satisfaction of the judgment gives the creditor bona fide purchaser status within the meaning of the recordation statutes. *Foorman v Wallace* (1888) 75 C 552, 17 P 680. When the creditor purchases the property, the debtor has 90 days after the sale to commence an action to set aside the sale for irregularities in the proceedings (see §3.84). In that event, junior liens may also revive and reattach. CCP §701.680(c)(1). Under appropriate circumstances, federal courts may have jurisdiction to review the propriety of a state court foreclosure judgment. *Fontana Empire Ctr., LLC v City of Fontana* (9th Cir 2002) 307 F3d 987 (review of judicial foreclosure sale consistent with §701.680(c)(1), allowing separate action to set aside sale).

The trustor is also an eligible bidder, although the levying officer should scrutinize the trustor's bid carefully to ensure that it is backed by cash. *Security-First Nat'l Bank v Cryer* (1940) 39 CA2d 757, 104 P2d 66.

Assuming proper service, all junior liens are completely extinguished by the sale. CCP §§701.630, 729.080(e). These sections abrogate the previous rule under which junior liens reattached to the property if the trustor was either the successful bidder at the foreclosure sale or subsequently redeemed the property (see §3.91; *Call v Thunderbird Mortgage Co.* (1962) 58 C2d 542, 25 CR 265). Junior lienholders may, of course, bid at a senior sale, and the elimination, by 1982 legislative changes, of their former postsale redemption rights effectively encourages them to do so. See CCP §729.020; Stats 1982, ch 497, §49; Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 56 (Apr. 1983).

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4. Bidding Methods and Strategies

a. Foreclosing Creditor

§3.80 (1) Credit Bids and Cash Supplements

The foreclosing creditor may "credit-bid" (also called an "offset bid") at the sale. CC §2924h. The creditor is not required to tender cash in order to bid up to the amount it is owed, because those funds would only be returned to it as soon as the sale is complete. See *Witter v Bank of Milpitas* (1928) 204 C 570, 269 P 614. See also *Nomellini Constr. Co. v Modesto Sav. & Loan Ass'n* (1969) 275 CA2d 114, 79 CR 717. A credit bid is entered by giving the levying officer a written receipt crediting all or part of the amount required to satisfy its judgment. CCP §701.590(b). On trustee sale bidding, see §§2.80-2.87.

A bid by the foreclosing creditor in excess of the foreclosure judgment requires cash to cover the excess because only a credit bid by the creditor in the amount of the indebtedness excuses cash payment. See *Central Sav. Bank v Lake* (1927) 201 C 438, 447, 257 P 521. The circularity of receiving and returning funds paid by the foreclosing creditor at its own sale does not exist with regard to the surplus funds, because those funds will go to others; they must therefore be bid and be paid in cash.

The foreclosing creditor must also pay cash to cover items such as the foreclosing officer's costs and any preferred labor claims, exempt proceeds, or other statutory obligations. CCP §701.590(b).

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§3.81 (2) Disadvantages of Underbidding

In the trustee sale context (see chap 2), there are few negative consequences and some substantial advantages of making a low bid. An unreasonably low bid at a judicial foreclosure with deficiency judgment reserved, however, can give the debtor a statutory redemption right (see §3.93) that is, in economic effect, a transferable 1-year option to buy the property at a below-market price. Because any deficiency judgment will be based on crediting the debtor with the higher of the intrinsic fair value of the property or the measure of the successful bid price (CCP §726; see §§3.88, 5.16-5.23), a foreclosing creditor in a judicial foreclosure gains little by "underbidding" (bidding less than the fair market value of the property) or permitting an outsider to acquire title by an underbid. The underbid will not generate a larger deficiency judgment, may permit an easier and more likely postsale redemption by the debtor or a successor redemptioner, and (in the case of third party bidding) will needlessly sacrifice part of the security that could have been applied to the debt.

An automatic full credit bid that exceeds the security's fair market value, however, may be no less improvident because it can destroy various other claims and defenses the creditor might otherwise have. For discussion of full credit bidding, see §§2.84-2.86. For summary of bidding tips, comparing judicial foreclosure with trustee sale strategies, see Hansen, *Wielding the Two-Edged Sword: What Every Attorney Needs to Know About Real Property Secured Transactions* (2 parts), 22 CEB Real Prop L Rep 159 (July and Aug. 1999).

PRACTICE TIP: The foreclosing creditor should usually obtain a credible appraisal of the property before the sale and should ensure that the bid price approximates the position on value that the creditor expects to take at the fair value deficiency hearing. See §3.88.

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§3.82 b. Other Parties; Cash Bids

All bidders except the foreclosing creditor are required to support their bids with cash, certified check, or cashier's check. If the bid price exceeds $5000, however, the successful bidder has the option of treating the sale as a credit transaction and must deposit $5000 or 10 percent of the amount bid (whichever is greater) at the sale and pay the balance, together with costs and interest, within 10 days after the sale. CCP §701.590(a)-(c). If the bidder fails to pay within 10 days, the levying officer either sells the property to the second highest bidder at the old sale or conducts a new sale. CCP §701.600(a). The defaulting bidder is liable for all costs and resulting damages, and its deposit is applied to cover these items. CCP §701.600(b)-(c).

Although junior secured creditors cannot credit-bid at the senior's foreclosure sale, some junior secured creditors can still enjoy certain practical bidding advantages. This point is best made with an illustration: Assume that a foreclosure sale is being held on a first trust deed securing a debt totaling $1 million at the time of the sale (including all foreclosure fees and costs.) The foreclosing first trust deed beneficiary can credit-bid that $1 million or any part of it, but it must bid cash for any bid it wishes to make in excess of the debt. All other bidders, including junior secured lenders, must bid cash from the very first dollar. However, the junior secured lender who is next in uncontested priority behind the foreclosing lender may make a cash bid knowing that—to the extent that it bids cash in excess of $1 million—it will be bidding in "boomerang" money because it will be the first in line for distribution of the surplus bid. Other junior secured lenders, such as the beneficiary of a third trust deed, do not have this practical advantage until the bidding exceeds the combined amount secured by the first and second trust deeds.

PRACTICE TIP: A junior second deed of trust holder that intends to bid at the senior sale because it believes that the property is worth more than the senior lien often does not need to bid much more than the foreclosing creditor's full credit bid amount to protect itself. See CCP §729.060(b). A successful bid of $1 over the senior bid will give the junior a title free from redemption by all but the trustor, and the cost of redemption by the trustor will include payment of the entire junior lien (see §3.94).

Although anyone but the sheriff may bid at the sheriff's sale, the foreclosing lender's credit bidding typically drives all other bidding; consequently, the lender's failure to attend the sale can severely disadvantage the lender. For example, in *Amalgamated Bank v Superior Court* (2007) 149 CA4th 1003, 57 CR3d 686, a pension trust fund (PTF) obtained a foreclosure decree pursuant to which a sheriff's auction was scheduled. Representatives of the PTF were late to the auction. In the absence of the credit-bidding lender, a cash bidder was successful in acquiring 57 acres of land at a foreclosure sale on a $17 million mortgage in return for a bid of $2000. The sheriff refused to conduct the sale again after the PTF representatives arrived, and the court, citing CCP §701.680, declined to set aside the sale.

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D. Steps Following Sale

§3.83 1. Disposition of Proceeds

After the sale is completed, the levying officer (sheriff or court-appointed receiver) disposes of the proceeds in accordance with the judgment. CCP §716.020(c). See CCP §726(a). Usually, costs of sale and sums owed to the creditor are paid, and any surplus goes to junior creditors, if any, with the remainder going to equity, *i.e.,* the debtor.

If the foreclosing creditor has more than one lien on the property, the creditor and the debtor may validly agree on a different order of distribution between the two liens. For example, in *Guardian Sav. & Loan Ass'n v MD Assocs.* (1998) 64 CA4th 309, 75 CR2d 151, the court enforced a restructuring agreement providing for order of payment of (1) interest on the first (nonrecourse) note, (2) interest on the second (recourse) note, (3) principal on the first note, and (4) principal on the second note. On distribution after trustee sale, see §§2.102-2.109.

After distributing the proceeds, the officer files with the court a report (known as a "return of a writ" of sale) that includes an itemized accounting on the sale and disbursement of the proceeds. See CCP §712.050. See form in §3.109.

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§3.84 2. If No Deficiency Allowed; Deed of Sale; Finality

If the decree of foreclosure does not provide for a possible deficiency judgment after the sale, the levying officer gives the purchaser a recordable "deed of sale." CCP §701.660. See CCP §§716.020(b), 726(e). See also form in §3.110. The deed of sale must show the following (CCP §701.670(a)-(e)):

- The court and the action number;
- The date of judgment and its location in the official records;
- The names and addresses of the judgment creditor and the judgment debtor;
- A description of the property sold; and
- The date of sale.

Such a conveyance has finality and may not be set aside for any reason; an aggrieved debtor is limited to recovering damages from the creditor rather than nullification of the sale, except that an action to cancel the sale may be brought within 90 days after the sale if the creditor is also the purchaser. CCP §701.680. Failure to file an action to set aside the sale within this 90-day period renders the sale absolute and irreversible. *First Fed. Bank v Fegen* (2005) 131 CA4th 798, 31 CR3d 853.

The finality of the sale also applies to the creditor. For example, in *Amalgamated Bank v Superior Court* (2007) 149 CA4th 1003, 57 CR3d 686, a pension trust fund (PTF) obtained a decree of foreclosure pursuant to which a sheriff's auction was scheduled. Representatives of the PTF were late to the sale. In the absence of the creditor, a cash bidder was successful in acquiring 57 acres of land on a $17 million mortgage in return for a bid of $2000. The court, citing CCP §701.680, declined to set aside the sale.

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§3.85 3. If Deficiency Allowed; Certificate of Sale; Redemption Notice

If a deficiency judgment has not been waived or prohibited by the judgment, the levying officer will execute and deliver a "certificate of sale" (see form in §3.107) rather than a "deed of sale" to the foreclosure sale purchaser on receipt of the purchase price. CCP §§729.010(a), 729.040(a). (The application for a deficiency judgment must be made within 3 months afterward or it will be time-barred. CCP §726(b); *Life Savs. Bank v Wilhelm* (2000) 84 CA4th 174, 100 CR2d 657. See §§3.86-3.89.) A deed is inappropriate because the property remains subject to postsale redemption rights and possession under CCP §§729.010-729.090 (see §§3.8, 3.92).

The certificate of sale contains the same information as a deed of sale (see §3.84 and form in §3.110), but it also contains the following:

- The price paid for each distinct lot or parcel sold subject to the right of redemption (CCP §729.040(c)(1));
- The total price paid (CCP §729.040(c)(2)); and
- A statement that the property is sold subject to the right of redemption, indicating the applicable redemption period (CCP §729.040(c)(3)).

A certificate of sale gives the foreclosure purchaser a title equivalent to the one held by the debtor as of the date of execution of the deed of trust. It is subject to all senior liens but is free and clear of all junior liens. *Dickey v Gibson* (1898) 121 C 276, 53 P 704. See *Freelon v Adrian* (1911) 161 C 13, 118 P 220; *Johnson v Friant* (1903) 140 C 260, 73 P 993. (This rule was expressly stated in former CCP §§700-700a, but there is no reason to assume that this rule was changed by the repeal of those sections.) The title transferred to the purchaser is, of course, subject to the debtor's right of postsale redemption until that time expires. The certificate may be sold or otherwise transferred. See *Foorman v Wallace* (1888) 75 C 552, 17 P 680.

The officer must serve the debtor, personally or by mail, with a notice of redemption rights, including the applicable redemption period. CCP §729.050. See form in §3.108. (On time periods in which to redeem property, see §3.92.) If the property is not redeemed within the applicable period, the officer then executes a deed of sale and delivers it to the purchaser. CCP §729.080(a). If a timely and satisfactory redemption is made, the officer executes and delivers a recordable certificate of redemption to the redeeming party. CCP §729.080(b).

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§3.86 VII. OBTAINING DEFICIENCY JUDGMENT

A deficiency judgment is a personal judgment against the debtor, which the creditor may obtain when the proceeds of the foreclosure sale are less than the amount owing on the debt. See *San Paolo U.S. Holding Co. v 816 S. Figueroa Co.* (1998) 62 CA4th 1010, 73 CR2d 272. A creditor who judicially forecloses is not necessarily entitled to a deficiency judgment. For substantive discussion of the right to a deficiency judgment and antideficiency protections, see chap 5. Even if the foreclosure judgment (see §3.103) states that the creditor is entitled to collect a deficiency, the creditor must wait until the sale is completed for a court adjudication of the deficiency amount and entry of the deficiency judgment because the deficiency amount is the difference between the property's fair value and the outstanding debt. See *San Paolo U.S. Holding Co. v 816 S. Figueroa Co., supra,* and discussion of *San Paolo* in §3.88. Procedures for establishing the amount of the deficiency are discussed in §§3.87-3.89, 3.113.

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§3.87 A. Application for Deficiency Judgment

To establish the amount of the deficiency, the foreclosing creditor must file an application for a fair value determination and a deficiency judgment within 3 months after the date of the foreclosure sale and as part of the foreclosure action. CCP §726(b). See *Paykar Constr. v Bedrosian* (1999) 71 CA4th 803, 84 CR2d 135 (3-month period runs from date of sale (sheriff's auction), not from recordation date of certificate of sale); *Life Savs. Bank v Wilhelm* (2000) 84 CA4th 174, 100 CR2d 657 (no relief under CCP §473; statute of limitations determined by CCP §726(b)).

The application customarily takes the form of a noticed motion under CCP §1010, although it may also be done by filing a document titled "Application for Fair Value Determination and Deficiency Judgment" together with an order to show cause (executed by the judge). The notice must be served on all defendants against whom a deficiency judgment is sought at least 15 days before the hearing. CCP §726(b).

To qualify for a deficiency judgment, the secured creditor must

- hold a debt that is not "nonrecourse" by the terms of the loan documents (see §1.15);
- hold a deed of trust that does not secure a purchase money obligation (CCP §580b) (see §5.24);
- not have extrajudicially foreclosed on any part of the security (see §5.8);
- have obtained a foreclosure decree providing for a deficiency against named defendants (see §3.67);
- have received less than the full amount of the judgment indebtedness plus accruals from the sale proceeds (see §3.86);
- have applied to the court for a deficiency judgment within 3 months after the foreclosure sale (CCP §726(b); see form in §3.111); and
- have established at the hearing that the fair value of the property on the sale date was less than the debt (see §§3.88-3.89).

A junior creditor holding a recourse, non-purchase money obligation whose security is rendered worthless by a senior foreclosure sale may bring an action directly on its note without first going through a pointless foreclosure proceeding. *Savings Bank v Central Mkt. Co.* (1898) 122 C 28, 54 P 273. See §§4.42-4.46, 5.10-5.12. Such a "sold-out" junior is usually not required to bring such an action within 3 months after the senior sale (*Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873); rather, the suit need only be commenced before expiration of the statute of limitations applicable to the underlying note (see §§3.16-3.20).

Different rules apply, however, if the sold-out junior acquired the property with a successful bid at the senior's foreclosure sale. In that event, the junior must commence the action on the sold-out note within 3 months after the senior sale. See *Citrus State Bank v McKendrick* (1989) 215 CA3d 941, 263 CR 781 (relying on CCP §580a). See also §§5.11, 5.14-5.15. Based on the same analysis and statutory authority, the sold-out junior who was the successful bidder at the senior's sale must also credit the obligor with the fair market value of the property acquired at the senior's sale when seeking a deficiency judgment. *Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 221 CR 425 (credit under CCP §580a necessary to avoid windfall to acquiring junior).

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§3.88 B. Hearing on Fair Value and Deficiency Amount

At the deficiency hearing the court will receive evidence of the property's fair value. CCP §726(b). Courts have defined a property's fair value as the intrinsic value of the property, including factors affecting the underlying worth of the property at the time of sale, but not including the price-reducing effects of a forced or distress sale and the fact that the property is sold subject to a postsale right of redemption. See, *e.g., San Paolo U.S. Holding Co. v 816 S. Figueroa Co.* (1998) 62 CA4th 1010, 73 CR2d 272; *Rainer Mortgage v Silverwood, Ltd.* (1985) 163 CA3d 359, 209 CR 294; *Nelson v Orosco* (1981) 117 CA3d 73, 172 CR 457. See also *Luther Burbank Sav. & Loan Ass'n v Community Constr., Inc.* (1998) 64 CA4th 652, 75 CR2d 367 (amount of tax lien included in determining fair value). The court's determination of fair value is factual in nature. *Citicorp Real Estate, Inc. v Smith* (9th Cir 1998) 155 F3d 1097, 1106. For comprehensive discussion of fair value, see §§5.16-5.23; Bernhardt, *Changing Course: Fair Value,* 21 CEB Real Prop L Rep 100 (Nov. 1998).

Although not frequently done, the court may appoint a probate referee to appraise the property (see §3.112 for application and order form). CCP §726(b). The appraisal may be admitted into evidence and the referee may be examined as a witness. Other witnesses may also be called for their opinions on value. The owner is competent to testify about the property's value, but other witnesses must be qualified as experts. Evid C §813. See *Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476.

PRACTICE TIP: The fair value hearing is often a "battle of experts" between partisan appraisers. Courts frequently disregard expert opinions that seem extreme or out of line with empirical market and income data. See, *e.g., San Paolo U.S. Holding Co. v 816 S. Figueroa Co.* (1998) 62 CA4th 1010, 73 CR2d 272. Both creditor and debtor are well advised to aim at a moderate number rather than seek a "home run" valuation outcome that either exaggerates or eliminates the deficiency award.

The fair value hearing is limited to fair value issues. CCP §726(b). Defenses to the plaintiff's right to a deficiency judgment, as opposed to the deficiency amount, should have been raised earlier and cannot be introduced for the first time at the hearing. See *United Cal. Bank v Tijerina* (1972) 25 CA3d 963, 102 CR 234. Occasionally, defenses to the deficiency itself arise for the first time after entry of the original foreclosure judgment. See, *e.g., Carnation Co. v Lampi (In re Kristal)* (BAP 9th Cir 1984) 37 BR 659, aff'd (9th Cir 1985) 758 F2d 454 (recordation of abstract of foreclosure judgment violates CCP §726 and triggers sanctions). Because such defenses could not have been asserted earlier, they may possibly be raised at the fair value hearing. The better practice, however, is to initiate a new and original action for declaratory relief, for cancellation of instruments, to enjoin or set aside the foreclosure sale, or for other relief (see chap 7).

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§3.89 C. Entry of Deficiency Judgment

After the hearing to adjudicate the fair value of the property on the date of sale, the court enters judgment. If a deficiency is established, a conventional money judgment in the plaintiff's favor is entered for the difference between the indebtedness (plus interest and costs) and the fair value of the property (as determined by the court), unless the sale price was greater than that value. CCP §726(b). If the court finds no deficiency, it enters judgment in the defendant's favor.

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VIII. POSTSALE REDEMPTION

§3.90 A. Legal Basis; Distinguishing Other Rights

Although the foreclosure judgment cuts off the statutory right of reinstatement (CC §2924c; see §§2.51, 3.63) and the foreclosure sale terminates the traditional equity of redemption (CC §§2903-2905; see §§2.73, 3.63), a judicial sale creates in the judgment debtor and its successor in interest a new right of redemption (commonly referred to as "statutory" or "postsale" redemption) whenever the right to a deficiency judgment is not waived or prohibited. CCP §726(e). Unlike the presale equity of redemption, the statutory right of redemption is asserted not against the foreclosing creditor but against the purchaser at the foreclosure sale (who may or may not be the foreclosing creditor). Furthermore, the amount necessary to redeem is based on the foreclosure sale price, not on the secured debt (see §3.93). The mechanics of redemption are covered in considerable detail in CCP §§729.010-729.090.

Judicial foreclosure sales were initially held subject to postsale redemption because execution sales included that feature. See *McMillan v Richards* (1858) 9 C 365; *Kent & Cahoon v Laffan* (1852) 2 C 595. That a trustor already had unique presale rights of redemption and reinstatement not available to judgment debtors was apparently ignored. Furthermore, courts have recognized that the prospect of redemption lowers the value of the property and therefore the amounts that others may be expected to bid at a foreclosure sale, thereby harming the debtor by reducing any potential surplus. See *Rainer Mortgage v Silverwood, Ltd.* (1985) 163 CA3d 359, 209 CR 294; *U.S. v Stadium Apartments, Inc.* (9th Cir 1970) 425 F2d 358. Nevertheless, the right of postsale redemption after a judicial foreclosure of real property security is now firmly established by statute. CCP §726(e).

The right to postsale redemption exists only when a deficiency judgment is not waived or prohibited. CCP §§726(e), 729.010. This is a significant departure from the pre-1983 rule, which allowed redemption after any judicial foreclosure sale. The change effectively permits a beneficiary who is required to foreclose judicially for reasons other than to obtain a deficiency judgment (*e.g.,* to resolve other disputes between the parties or to liquidate the debt) to obtain the benefits of a nonredeemable sale by waiving any possibility of a deficiency judgment. This leaves the creditor with the same basic rights as it would have following a trustee sale. But when there is such a waiver by the beneficiary, the trustor's presale redemption rights are extended by the requirement that an additional 120 days after service of notice of levy on the trustor must elapse before the notice of sale can be served. CCP §701.545. The notice of sale then requires an additional 20-day delay. See CCP §701.540. See also §§3.71, 3.75. Given these postdecree time frames, the creditor is effectively forced to comply with the time frames for a trustee sale following the entry of the judicial foreclosure decree with a deficiency judgment waived.

To cut off the debtor's redemption rights, a waiver of deficiency rights must be asserted early enough in the action so that it is clearly reflected in the decree of foreclosure, because CCP §726 requires that the decree specify whether a deficiency judgment may be entered against specified defendants. See §3.67. For discussion of whether proper waiver has been made and whether beneficiary can unilaterally waive deficiency judgment, see Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 56 (Apr. 1983).

If a deficiency was not waived, but none is allowed because the entire debt was matched by the bid, the redemption period is shortened from 1 year to 3 months, but it is not eliminated entirely. CCP §729.030. See 6 CEB Real Prop L Rep at 56. It is unclear whether a postsale fair value decision denying any deficiency will shorten the redemption period.

For federal income tax purposes, the statutory right of postsale redemption does not delay recognition of gain or loss by the creditor, although it may do so for the debtor. See §§2.110-2.117.

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§3.91 B. Who May Redeem

Only the judgment debtor and the judgment debtor's successor in interest are permitted to redeem the property after a foreclosure sale. CCP §729.020. A junior easement holder omitted from a judicial foreclosure action, however, is entitled to a 1-year equitable right of redemption. If the easement potentially affects the entire property, the omitted easement holder is not entitled to pro tanto redemption but must tender the full redemption price. *Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 77 CR2d 581 (foreclosure valid against parties served, and mortgagee permitted to conduct second foreclosure against parties omitted).

The redemption statutes (CCP §§729.010-729.090) do not extend postsale redemption rights to junior lienholders. Their claims are limited to receipt of any surplus following the senior sale. This rule departs from the law as it existed before 1983, when the Enforcement of Judgments Law (CCP §§680.010-724.260) and CCP §§729.010-729.090 became effective. Under former CCP §701(2), creditors with junior liens on the property were also permitted to redeem. See *Salsbery v Ritter* (1957) 48 C2d 1, 306 P2d 897.

Even if the security may appear to be of greater value than the amount due on the first loan, a junior creditor should understand that neither the trustor nor the senior beneficiary will necessarily bid up to its full value. Without competitive bidding at the foreclosure sale, the most that will be bid is likely the amount due on the senior debt. The junior who is next in priority to the deed of trust in foreclosure should therefore be prepared to enter the bidding at the senior sale and bid high enough to cover both the senior and the junior debt, if the property has sufficient value to justify doing so. If the property has greater value than the amount due on the senior lien but not enough to cover the junior lien, the junior should bid up to the value of the property, hoping that the unpaid segment will be collectible as a money judgment.

PRACTICE TIP: An alternative strategy for a junior so situated is to avoid the sale entirely by reinstating or redeeming the senior loan. Reinstatement is usually cheaper and more reliable than bidding at the senior sale, where the junior will need cash to cover its bid (CCP §701.590(c); see §3.82).

Formerly, juniors were entitled to conduct separate foreclosure sales after a senior sale and acquire the property, thereby becoming successors in interest to the trustor and entitled to redeem the property from the senior sale. See *Fry v Bihr* (1970) 6 CA3d 248, 85 CR 742. It is unlikely that this procedure is currently permitted by CCP §§729.010-729.090, which no longer characterize the purchaser at a foreclosure sale as a "successor in interest" of the judgment debtor (CCP §729.020).

Case law predating CCP §§729.010-729.090 treated all grantees or purchasers at preceding or subsequent foreclosure sales as successors and permitted them to exercise redemption rights. See *Call v Thunderbird Mortgage Co.* (1962) 58 C2d 542, 25 CR 265; *Pollard v Harlow* (1903) 138 C 390, 71 P 454. It is unclear whether that doctrine has been altered by these new sections. For further discussion, see Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 56 (Apr. 1983).

If a junior deed of trust was executed before July 1, 1983, its beneficiary might still have a statutory right of redemption after a senior judicial foreclosure sale. *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 605 n9, 5 CR2d 712. See §§4.25-4.26, 9.25. If that right does exist, the old "scramble" redemption system might still apply to any such deeds of trust that remain outstanding. See generally *1982 Creditor's Remedies Legislation,* 17 Cal L Rev'n Comm'n Reports 1001, 1115 (1982); Comment, *The Statutory Right of Redemption in California,* 52 Cal L Rev 846 (1964).

In foreclosure actions brought by the federal government, the applicability of postsale redemption turns on the nature of the federal claim. *U.S. v Stadium Apartments, Inc.* (9th Cir 1970) 425 F2d 358, 362, held that a loan under former §221(d)(4) of the National Housing Act (to spur home-building) was not subject to state redemption requirements. But *U.S. v Ellis* (9th Cir 1983) 714 F2d 953 did impose that burden on the Farmers Home Administration (FmHA) despite the fact that the FmHA loans involved there expressly waived the right of redemption. See §§4.59, 5.7, 5.63.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.92 C. Redemption Time Period

§3.92 C. Redemption Time Period

If the proceeds of the foreclosure sale are sufficient to satisfy the secured indebtedness with interest and the costs of the action and the sale, the redemption period is 3 months after the date of sale. CCP §729.030(a). If the proceeds are not sufficient to satisfy the indebtedness plus interest and costs, the redemption period is 1 year after the sale date. CCP §729.030(b).

NOTE: In foreclosures brought by homeowners' associations in common interest communities to collect delinquent assessments, CCP §729.035 establishes the redemption period as 90 days. For further discussion, see Advising California Common Interest Communities, chap 5 (Cal CEB 2003).

Courts are divided on the issue of whether the automatic bankruptcy stay under 11 USC §362 tolls the 3-month and 1-year redemption periods. Compare, *e.g., Johnson v First Nat'l Bank* (8th Cir 1983) 719 F2d 270, 276, with *Hamblen v Federal Sav. & Loan Ins. Corp. (In re Thomas J. Grosso Inv.)* (9th Cir 1972) 457 F2d 168 and *In re Capital Mortgage & Loan, Inc.* (Bankr ED Cal 1983) 35 BR 967, 971. See also *Napue v Gor-Mey W., Inc.* (1985) 175 CA3d 608, 220 CR 799. For further discussion, see §§7.97, 11.12-11.13.

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D. Amount Needed to Redeem

§3.93 1. Foreclosure Sale Purchase Price

The redemption price is based on what the purchaser at the foreclosure sale paid for the property, not on the underlying unpaid debt. For example, if the amount of the indebtedness before foreclosure was $100,000 and the purchaser at the foreclosure sale paid $150,000 for the property, the trustor must pay $150,000, not $100,000, to redeem, and the money is paid to the purchaser, not to the beneficiary. If the property was sold for less than the indebtedness, the trustor can redeem by paying the purchaser only the amount bid.

PRACTICE TIP: The fact that the postsale redemption price is based on the successful bid means that bidding strategies at judicial foreclosure sales must be quite different from those in trustee sales. See §§3.80-3.82.

The redemption price consists of the total of the following amounts:

- The purchase price at the foreclosure sale (as opposed to the fair value of the property; see *Lindsey v Meyer* (1981) 125 CA3d 536, 178 CR 1) (CCP §729.060(b)(1));
- Any assessments or taxes and reasonable amounts for fire insurance, maintenance, upkeep, and repair of improvements on the property (CCP §729.060(b)(2));
- Amounts paid by the purchaser on a prior obligation secured by the property to the extent payment was necessary to protect the purchaser's interest (CCP §729.060(b)(3));
- Interest on the above amounts, at the rate of interest on money judgments, from the time such amounts were paid until the date on which the redemption price is deposited with the levying officer (CCP §729.060(b)(4)); and
- The amount of any liens the foreclosure sale purchaser has on the property that are subordinate to the lien under which the property was sold, plus interest. CCP §729.060(b)(5). Under former CCP §702, this principle applied when a creditor held both first and second mortgages (or other liens) on the property but foreclosed only the first lien and purchased the property at that lien sale. A redeeming party was required to pay the purchaser the amount bid at the sale plus the amount of the second lien. *Salsbery v Ritter* (1957) 48 C2d 1, 306 P2d 897. If the creditor foreclosed on the second mortgage instead, the property was sold subject to the first mortgage, which would not be a lien to be considered in the redemption price. A deficiency judgment held by the foreclosing creditor was also held not to be a lien on the property that must be paid by a party seeking to redeem. *Simpson v Castle* (1878) 52 C 644.

Any payments to the purchaser in the form of rents and profits from the property or the value of the use and occupation of the property may be offset against the amounts that are used to calculate the redemption price under CCP §729.060(b). CCP §729.060(c).

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§3.94 2. Unpaid Junior Liens

Although a junior lienholder who purchases at the senior sale need not bid up to the combined total of junior and senior liens to protect its junior lien from redemption by the debtor (see Practice Tip in §3.82), the debtor must nevertheless pay off any liens held by the purchaser that are subordinate to the lien foreclosed. CCP §729.060(b)(5). Thus when a junior is the high bidder at the senior sale, the total cost of redemption is the amount bid plus the unpaid balance of the junior lien.

The statute does not require payment of junior liens when the purchaser is a third party rather than the junior lienholder. Nor does it provide for payment of the second lien when the high bidder at the senior sale is the holder of the third lien (although it does require full satisfaction of the third lien if the trustor intends to redeem). These considerations make it all the more imperative that juniors seriously consider their bidding strategy at senior sales (see §3.82). See Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 57 (Apr. 1983).

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§3.95 E. Initiating Redemption

To redeem the property, the debtor or its successor in interest must deposit the redemption price with the levying officer during the redemption period. A successor in interest who seeks to redeem must also file with the officer proof of the right to redeem in the form of a conveyance, an assignment, or other evidence of an interest. CCP §729.060(a). When the redeeming party deposits the redemption price, the officer must tender it to the foreclosure sale purchaser. If the purchaser accepts the tender, the officer must execute a certificate of redemption, deliver it to the redeeming party, and record it. CCP §729.080(b).

If the purchaser and the redeeming party disagree on the amount of the redemption price or on whether the party seeking redemption is entitled to redeem, or if the purchaser refuses a tender of the purchase price, the party seeking redemption may file a petition with the court for an order determining the redemption price or determining whether the party seeking redemption is entitled to redeem. When the petition is filed, the petitioner must deposit the undisputed amount of the redemption price with the levying officer and give the officer written notice that the petition has been filed. CCP §729.070(a).

The petition must be written and must include the following (CCP §729.070(b)):

- The amounts demanded to which the petitioner objects and the reasons for the objections;
- Any amounts offset to which the purchaser objects and the justification for the offset; and
- The petitioner's status (*i.e.,* judgment debtor or successor in interest (CCP §729.020; see §3.91)) that qualifies the petitioner to redeem. A copy of a recorded conveyance, an assignment, or other evidence of interest must be filed with the petition (see CCP §729.060(a)).

The court must hold a hearing on the petition within 20 days after its filing unless the hearing is continued for good cause. CCP §729.070(c). The purchaser must be served with a copy of the petition and the hearing notice at least 10 days before the hearing. CCP §729.070(d). The person seeking to redeem the property has the burden of proof at the hearing. CCP §729.070(e). On affidavit or other evidence, the court must determine by order the amount required to redeem. CCP §729.070(f). If an amount in addition to that already deposited is required to redeem, the redeeming party has 10 days after the order is issued to pay the additional amount to the levying officer. CCP §729.070(g).

Tender of the redemption price determined by the court or agreed on by the purchaser and redeeming party is equivalent to payment (requiring the levying officer to deliver and record a certificate of redemption under CCP §729.080(b)) and, if the tender is refused, the officer must deposit the amount tendered with the county treasurer. If the purchaser does not claim the deposit within 5 years, it is paid into the county general fund. CCP §729.080(c).

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F. Effect of Redemption

§3.96 1. Statutory Redemption

Postsale redemption has the effect of terminating the foreclosure sale and restoring the redeeming party to the estate that was sold. CCP §729.080(d). Under CCP §729.080(e), liens extinguished by the sale do not reattach to the property after redemption, and the property that was subject to the extinguished lien may not be applied to the satisfaction of the claim or judgment under which the lien was created (see §3.98).

Junior liens are thus destroyed by a senior sale even though it may be subject to redemption by the debtor. A junior lienholder is no longer able to redeem and have its liens reattach if the debtor thereafter re-redeems from it. A sold-out junior is relegated by CCP §729.080(e) to the position of an unsecured creditor and must sue on the underlying debt, if possible (see §§4.42-4.46, 5.10-5.15). For discussion of the rationale for the new rule, see Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 56 (Apr. 1983).

NOTE: Under nonstatutory redemption by the debtor, junior liens may equitably reattach. See §3.97. Also, if the foreclosing lender purchases the property at the sale and the debtor succeeds in having the sale set aside for irregularities, junior liens may reattach under CCP §701.680(c)(1). See §3.79.

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§3.97 2. Nonstatutory Redemption

Lenders generally prefer to be paid rather than to foreclose and thus may be willing after a foreclosure sale to give their debtors options to repurchase or rights of first refusal that are not based on a statutory right. This may occur even after a trustee sale. See *DMC, Inc. v Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 120 CR2d 761. Such transactions may be deemed to constitute new hidden mortgage arrangements, however, and creditors should carefully consider them beforehand. If the trustor reacquires the property in this manner, junior liens may reattach under CC §2930 (subsequently acquired mortgage property) and estoppel principles. See, *e.g., DMC, Inc. v Downey Sav. & Loan Ass'n, supra* (junior lien reattached as equitable lien). See also *Barberi v Rothchild* (1936) 7 C2d 537, 61 P2d 760 (junior lien reattached under doctrine of estoppel because trustor repurchased from relative who purchased at foreclosure sale). But see *Energy Enters. v Oak Creek Energy Sys. (In re Oak Creek Energy Farms, Ltd.)* (Bankr ED Cal 1989) 99 BR 36, aff'd without published opinion (9th Cir 1992) 956 F2d 1167.

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§3.98 3. Debtor Protections; CCP §729.080(e)

Under CCP §729.080(e), liens extinguished by a senior sale do not reattach after a redemption, and the underlying security cannot be applied to satisfy the claim or judgment under which the lien was created. The statute appears therefore to prohibit selling the property a second time to satisfy the same debt even though title has revested in the debtor by virtue of a redemption. (Under former CCP §703, liens that had been cut off by the foreclosure sale were automatically reinstated on redemption by the debtor or the debtor's successor in interest; see *Lindsey v Meyer* (1981) 125 CA3d 536, 178 CR 1.) It is unclear, however, whether a deficiency judgment that is thereafter recorded and becomes a lien on all property owned or later acquired by the debtor (see CCP §697.340) includes the redeemed property as well.

PRACTICE TIP: Redemption by a successor does not lead to attachment of the judgment lien, because the successor is not a judgment debtor. The risk of reattachment can therefore be avoided by first conveying the right of redemption to an accommodating third party. See *Fry v Bihr* (1970) 6 CA3d 248, 85 CR 742 (judgment lien reattached following redemption after execution sale).

The effect of CCP §729.080(e) is also unclear when a sold-out junior later obtains a money judgment on the junior debt and records an abstract of judgment. Arguably, §729.080(e) would bar that judgment from becoming a lien if the property is redeemed or reacquired by the debtor. For additional analysis of §729.080(e), see Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 57 (Apr. 1983).

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G. Possession, Rents, and Profits

§3.99 1. During Redemption Period

The debtor retains the right to possession of the property during the redemption period. See CCP §729.090; *Carpenter v Hamilton* (1944) 24 C2d 95, 147 P2d 563; *Munzinger v Caffrey* (1942) 49 CA2d 180, 121 P2d 13. The foreclosure purchaser is entitled to receive from the person in possession the rents and profits from the property or the value of its use and occupation. CCP §729.090(a). See *Shintaffer v Bank of Italy Nat'l Trust & Sav. Ass'n* (1932) 216 C 243, 13 P2d 668; *House v Lala* (1963) 214 CA2d 238, 29 CR 450. The phrase "person in possession" was probably intended to include the debtor as well as any rent-paying tenants, but it is doubtful whether any type of eviction action for nonpayment would lie in favor of the purchaser during the redemption period. The court may appoint a receiver to collect the rents during that period (see CCP §564(b)(4); see also §§3.5, 3.67, 6.36, 6.65, 6.74, 6.77).

Despite a lack of any possessory right, the purchaser is entitled to enter the property during the redemption period to repair and to maintain the premises and may restrain waste. CCP §729.090(c). On other remedies for waste, see CCP §§564, 568.5, 746.

If a redemption is tendered, the purchaser must account for any rents and profits received (CCP §729.090(b)), which are offset against the redemption price (CCP §729.060(c); see §3.93).

For comprehensive discussion of trustor's postsale rents and possession rights, see §§6.72-6.82. On postsale rights of trustor's tenants, see §§6.77-6.82, 6.84-6.98.

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§3.100 2. After Debtor Redeems Property

If a tender of the redemption price is accepted by the purchaser, or if it is for the amount decreed by the court under CCP §729.070 (see §3.95), the officer executes and delivers a certificate of redemption to the redeeming party and records a duplicate of the certificate. CCP §729.080(b)-(c). On redemption, the effect of the foreclosure sale is terminated (see §3.96), and the party who redeemed the property is restored to the estate that was sold by foreclosure. CCP §729.080(d).

A redeeming party who was the debtor in the foreclosure action is often already in possession under CCP §729.090(a) and should not need to seek judicial assistance in obtaining possession. If the foreclosure sale purchaser or some other party took possession during the redemption period, the redeeming party's remedies will depend on the facts. Ejectment would certainly be available, but unlawful detainer is unlikely. See CCP §1161a; California Real Property Remedies and Damages, chap 10 (2d ed Cal CEB 2002).

A redeeming party who is a successor to the debtor may need to recover possession if the debtor has not left. In that event, the successor appears to be entitled either to ejectment or to unlawful detainer under CCP §1161a(b)(2). On ejectment, see Real Property Remedies, chap 10.

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§3.101 H. If Debtor Does Not Timely Redeem

If the debtor does not deposit the redemption price within the redemption period (see §3.95), or if any additional deposit ordered by the court under CCP §729.070(g) is not deposited within 10 days after the order is issued, the levying officer executes, delivers to the purchaser, and records a deed of sale (CCP §701.670; see §3.110). CCP §§701.660, 729.080(a).

If the nonredeeming debtor has not relinquished possession, the purchaser may bring an unlawful detainer action under CCP §1161a(b)(2) (see, *e.g., Moss v Williams* (1948) 84 CA2d 830, 191 P2d 804) or the less expeditious remedy of ejectment (see *Dickey v Gibson* (1898) 121 C 276, 53 P 704). For discussion of ejectment, see California Real Property Remedies and Damages, chap 10 (2d ed Cal CEB 2002). In cases under earlier judicial foreclosure statutes, the courts spoke of the purchaser's right to obtain a "writ of assistance" from the court that issued the foreclosure judgment as a means of obtaining possession. See *Sullivan v Superior Court* (1921) 185 C 133, 195 P 1061; *Rafftery v Kirkpatrick* (1938) 29 CA2d 503, 85 P2d 147. It is unclear whether that writ is available under the Enforcement of Judgments Law (CCP §§680.010-724.260), which does not mention it. In any event, unlawful detainer under CCP §1161a is a relatively speedy summary remedy, even though its use requires filing a separate action.

The foreclosure sale purchaser may be subject to the restrictions of local rent control ordinances when attempting to evict a tenant of the trustor, even though the deed of trust may have predated the rent control ordinance. See *Gross v Superior Court* (1985) 171 CA3d 265, 217 CR 284. For discussion of strategies and options when property is occupied by a tenant of the debtor, see California Landlord-Tenant Practice §§8.7, 8.61 (2d ed Cal CEB 1997).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/ IX. FORMS/§3.102 A. Form: Complaint for Foreclosure of Deed of Trust

IX. FORMS

§3.102 A. Form: Complaint for Foreclosure of Deed of Trust

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No. _ _ _ _ _ _**
	)	**COMPLAINT FOR**
	)	**FORECLOSURE OF**
vs	)	**DEED OF TRUST**
	)	
_ _[*Name(s)*]_ _, **Defendant(s)**	)	
_____	)	

This complaint contains a single cause of action for judicial foreclosure by Plaintiff _ _[*name(s)*]_ _ against Defendant(s) _ _[*name(s)*]_ _. Plaintiff alleges:

1. The real property on which plaintiff seeks foreclosure ("subject property") is located at _ _[*street address and county*]_ _, California, and is a _ _[*describe property, e.g., commercial office building, apartment complex, single-family residence*]_ _. The legal description of the subject property is attached as Exhibit A and incorporated in this complaint by reference. The assessor's parcel number is _ _[*number*]_ _.

2. Plaintiff is, and at all times relevant to this action was, _ _[*identify as individual, corporation, partnership, joint venture, or other entity*]_ _ engaged in the business of _ _[*describe business capacity, such as lending money to purchase real property, financing construction of office buildings*]_ _.

3. Defendant(s) _ _[*state names and capacities of defendant owner(s)*]_ _ _ _[*has/have*]_ _ a present ownership interest in or to the subject property. _ _[*The defendant(s) _ _[is/are]_ _ the successor(s)-in-interest to _ _[name of original trustor under subject deed of trust*]_ _.]_ _ _ _[*Indicate whether the present owners assumed the obligations of (and are therefore personally liable to plaintiff on) the subject note and deed of trust.*]_ _

4. Plaintiff does not know the true names, capacities, or bases of liability of defendants sued as Does 1 through _ _[*number of fictitiously named defendants*]_ _. Each fictitiously named defendant is in some way liable to plaintiff, or claims some right, title, or interest in the subject property that is subsequent to and subject to the interest of plaintiff, or both.

5. On _ _[*date*]_ _, for valuable consideration, defendant(s), _ _[*name(s)*]_ _, made, executed, and delivered to _ _[*name of plaintiff or plaintiff's predecessor*]_ _ a written promissory note ("subject note") in the sum of _ _[*dollar amount*]_ _. A copy of the note is attached as Exhibit B and incorporated in this complaint by reference.

[*Add one of the following alternatives*]

[*Alternative 1: If recorded deed of trust*]

6. To secure payment of the principal sum and interest on the subject note, and as part of the same transaction, defendant(s), _ _[*name(s)*]_ _, made, executed, and delivered to _ _[*name of plaintiff or plaintiff's predecessor*]_ _, as beneficiary, a deed of trust ("subject deed of trust"), by the terms of which defendant(s), as trustor(s), conveyed to _ _[*name*]_ _, as trustee, the subject real property. The deed of trust was recorded on _ _[*date*]_ _, under _ _[*state book and page or instrument number*]_ _ in the Official Records of _ _ _ _ _ _ County, California. A copy of the deed of trust is attached as Exhibit C and incorporated in this complaint by reference. Defendant, _ _[*name*]_ _, is the current trustee for the deed of trust and is made a party only for the purpose of having all interested parties before the Court.

[*Alternative 2: If disguised security device*]

6. As security for the payment of the _ _[*note/debt*]_ _, defendant(s), _ _[*name(s)*]_ _, made, executed, and delivered to plaintiff an instrument titled _ _[*name of security agreement*]_ _, a copy of which is attached as Exhibit C and incorporated in this complaint by reference. This instrument was agreed to by plaintiff and defendant and was intended to operate as a mortgage on the subject property.

[*Continue*]

7. Plaintiff is now, and at all times relevant to this action was, the lawful owner and holder of the subject note and beneficial interest under the subject deed of trust. _ _[*Plaintiff is the successor-in-interest to _ _[name of original beneficiary under deed of trust*]_ _.]_ _ _ _[*The subject note and beneficial interest in the deed of trust were assigned _ _[and endorsed over*]_ _ *to plaintiff. A copy of the assignment, marked Exhibit _ _[number*]_ _*, is attached and incorporated herein.*]_ _**

8. On _ _[*date*]_ _, defendant(s), _ _[*state name(s) and capacity(ies)*]_ _, _ _[*guaranteed/endorsed/assumed*]_ _ the subject note. A copy of the _ _[*guaranty/endorsement/assumption agreement*]_ _, marked Exhibit _ _[*number*]_ _, is attached and incorporated in this complaint by reference. The defendant(s) _ _[*is/are*]_ _ thus personally liable to plaintiff on the subject note.

9. Defendant, _ _[*name*]_ _, has, or claims to have, some interest in the subject property or some part of it by reason of _ _[*describe claim in detail, such as junior lienholder, lessee, holder of a judgment lien*]_ _, which interest is subsequent to and subject to that of plaintiff.

10. The subject note provides that, if the payor defaults in payment of any installment when due, or in the performance of any agreement in the subject deed of trust securing payment of the subject note, the entire principal and interest will become immediately due and payable at the option of the noteholder. The subject deed of trust provides that, if the trustor defaults in paying any indebtedness secured by the subject deed of trust, or in the performance of any agreement in the subject note or deed of trust, the entire principal and interest secured by the subject deed of trust will, at the option of the beneficiary, become immediately due and payable.

11. By the terms of the subject note, defendant(s), _ _[*name(s)*]_ _, promised and agreed to pay to plaintiff or plaintiff's predecessor monthly installments of _ _[*dollar amount*]_ _, principal and interest, beginning _ _[*date*]_ _. Defendant has wholly failed, neglected, and refused to pay the installment that was due on _ _[*date*]_ _ and subsequent months, up to and including the date of this complaint. The total of the monthly payments in default including interest is _ _[*dollar amount*]_ _. For such failure and default under the subject note and deed of trust, plaintiff has elected to declare the entire remaining sum of principal and interest immediately due and payable. The accelerated amount due consists of the principal sum of _ _[*dollar amount*]_ _, plus interest from _ _[*date of default*]_ _ to _ _[*date complaint filed*]_ _. Additional interest will accrue at the rate of _ _[*dollar amount*]_ _ per day for each additional day from _ _[*date complaint filed*]_ _ to the date of entry of judgment in this action.

12. By the terms of the subject deed of trust, defendant(s), _ _[*name(s)*]_ _, agreed to pay before delinquency all general and special city and county taxes affecting the subject property. Defendant(s), _ _[*name(s)*]_ _, _ _[*has/have*]_ _ failed and refused to pay _ _[*describe unpaid taxes*]_ _. _ _[*Because of this default the subject property was sold on _ _[date*]_ _*, to the State of California.*]_ _ The total amount of taxes now in default and delinquent, including fees and penalties, is _ _[*dollar amount*]_ _ _ _[*, which is the total amount necessary to redeem as of the date on which this complaint is filed*]_ _.

13. By the terms of the subject deed of trust, defendant(s), _ _[*name(s)*]_ _, agreed to provide and maintain in force at all times fire, earthquake, and other insurance, each in an amount satisfactory to and with loss payable to plaintiff. Since _ _[*date*]_ _, defendant(s) _ _[*has/have*]_ _ failed and refused to renew and to maintain in force fire, earthquake, and other insurance. As a result, plaintiff has been required to pay, and has paid, the premiums on the insurance policies to keep the subject property insured at all times. The payments were made on the following dates and in the following amounts: _ _[*State dates of payments, amounts paid, and periods covered*]_ _. Under the subject deed of trust, when plaintiff is required to make payments because of defendant's failure and refusal to pay required insurance premiums, the amounts paid by plaintiff may be charged to the principal due on the subject note. The sum of _ _[*dollar amount*]_ _, representing plaintiff's payments on the insurance policies, is not included in, but is in addition to, the principal sum owed on the note (see paragraph 11).

14. Plaintiff may hereafter be required to expend additional sums to protect _ _[*his/her/its*]_ _ security in the subject property. In the subject deed of trust, defendant(s) _ _[, *names of any defendants personally liable,*]_ _ agreed to pay any such sums expended by plaintiff. Plaintiff will amend this complaint to allege the nature and amounts of such sums if plaintiff is required to make the additional expenditures.

15. Under the subject note and deed of trust, defendant(s), _ _[*name(s)*]_ _, agreed that, if any action were instituted on the note or deed of trust, defendant(s) would pay the sum fixed by the court as plaintiff's attorney fees and that these charges would also become a lien against the subject property. Because of the above-described defaults, it has become necessary for plaintiff to employ an attorney to commence and prosecute this foreclosure action. The reasonable value of services of counsel in this action shall be proved at or after trial in this action.

WHEREFORE, plaintiff demands judgment as follows:

1. That the court enter a money judgment against defendant(s), _ _[*name(s)*]_ _, and each of them, for:

a. The sum of _ _[*dollar amount*]_ _ principal, together with interest from _ _[*date*]_ _, to the date of judgment, according to proof;

b. The additional sum of _ _[*specify any amounts expended, plus interest, and desired relief for any other default alleged in the complaint*]_ _;

c. Costs of this action and reasonable attorney fees; and

d. Additional sums, if any, that plaintiff hereafter expends to protect its security interest in the subject property, together with interest, according to proof.

2. That the court enter its judgment declaring that the rights, claims, ownership, liens, titles, and demands of defendant(s), _ _[*name(s)*]_ _, and each of them, are subject, subsequent, and subordinate to the subject deed of trust.

3. That the court order, adjudge, and decree that the subject deed of trust be foreclosed; that the subject property be sold according to law by the county sheriff or a court-appointed receiver; that the proceeds of the sale be applied in payment of the amounts due to plaintiff; and that defendant(s), _ _[*name(s)*]_ _, and all persons claiming under them after the execution of the subject deed of trust, as lien claimants, judgment creditors, claimants under a junior deed of trust, purchasers, encumbrancers, or otherwise, be barred and foreclosed from all rights, claims, interests, or equity of redemption in the subject property when time for redemption has elapsed.

4. That the court award plaintiff judgment and execution against defendant(s), _ _[*name(s)*]_ _, and each of them, for any deficiency that may remain after applying all proceeds of the sale of the subject property duly applicable to satisfy the amounts found due by the court under paragraph 1 of this demand for judgment.

5. That the Court order, adjudge, and decree that plaintiff or any other party to this action may purchase the subject property at the foreclosure sale, that _ _[*when the time for redemption has elapsed*]_ _ the sheriff or receiver execute a deed to the purchaser of the property at the sale, and that the purchaser be given possession of the property on production of the sheriff's or receiver's deed.

6. That the Court award all other appropriate and just relief.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Copies: Original (filed with court clerk when summons issued); copies for service (one for each defendant); office copies.

Comment: A case cover sheet prescribed by the Judicial Council must accompany the first paper filed in a court action, but it need not be served in noncomplex cases. See Cal Rules of Ct 3.220. On format of court papers and drafting and serving summons and complaint, see Cal Rules of Ct 2.100-2.119; California Civil Procedure Before Trial,

chaps 11, 14-17 (4th ed Cal CEB 2004).

This form may be modified to include a cause of action for specific performance of the rents-and-profits assignment (see allegations in form in §6.99), and a motion for the appointment of a receiver may be made soon after the foreclosure complaint is filed (see discussion and forms in §§6.38-6.46, 6.100-6.102). On prefiling considerations in judicial foreclosure and availability of alternative dispute resolution, see §§3.1-3.23. For discussion of allegations, see §§3.39-3.54. For discussion of defendant parties, see §§3.24-3.36, 3.46-3.47. On underlying obligation and security instrument, see §§1.10-1.66, 3.41-3.42. For discussion of security-first, one-action, and antideficiency defenses, see chaps 4-5. For discussion of acceleration clauses, see §§3.48, 8.2-8.24. For discussion of late charges, see §§3.7, 8.25-8.33. For discussion of insurance and taxes, see §§3.50-3.51, 8.56-8.82. On recovery of attorney fees, see §§3.53, 8.83-8.90. In addition to filing the complaint, the plaintiff should record a lis pendens in the same county (see §§3.56-3.57).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.103 B. Form: Judgment of Foreclosure and Order of Sale

§3.103 B. Form: Judgment of Foreclosure and Order of Sale

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_ _[*Name(s)*]_ _,	)	**No.** _ _ _ _ _ _
Plaintiff(s)	)	**JUDGMENT OF**
	)	**FORECLOSURE AND**
vs	)	**ORDER OF SALE**
	)	**Dep't:** _ _[*number*]_ _
_ _[*Name(s)*]_ _,	)	**Judge:** _ _[*name*]_ _
Defendant(s)	)	**Trial completed:** _ _[*date*]_ _
	)	
_____	)	

The above-titled case came on regularly for _ _[*trial/default hearing*]_ _ **on** _ _[*date*]_ _**, the Honorable** _ _[*name of judge*]_ _ **presiding. Plaintiff,** _ _[*name*]_ _**, appeared by** _ _[*his/her/its*]_ _ **attorney,** _ _[*name*]_ _**, and defendant,** _ _[*name*]_ _**, appeared by** _ _[*his/her/its*]_ _ **attorney,** _ _[*name*]_ _**. The Court, having heard the testimony and considered the evidence, and**

[*Add one of the following alternatives*]

[*Alternative 1: If statement of decision requested*]

having filed its statement of decision on _ _[*date*]_ _**, makes the following findings and conclusions:** _ _[*State factual and legal basis for decision; see CCP §632*]_ _**, and**

[*Alternative 2: If statement of decision not applicable*]

a statement of decision _ _[*not having been requested/not being applicable*]_ _**,**

[*Continue*]

HEREBY ADJUDGES, ORDERS, AND DECREES as follows:

1. Judgment shall be entered in favor of plaintiff _ _[*name*]_ _ **against defendant(s)** _ _[*name(s)*]_ _ **on the terms set forth in the following paragraphs.**

2. Defendant(s) _ _[*is/are*]_ _ **indebted to plaintiff in the following sums, which are secured by the deed of trust set forth in the complaint.**

a. Principal and interest in the amount of _ _[*dollar amount*]_ _**;**

b. Attorney fees in the sum of _ _[*dollar amount*]_ _**;**

c. Money expended for _ _[*e.g., taxes, insurance*]_ _ **under the deed of trust, as alleged in the complaint, in the sum of** _ _[*dollar amount*]_ _**; and**

d. Actual costs of foreclosure and sale in the sum of _ _[*dollar amount*]_ _**.**

[*Add one of the following alternatives*]

[*Alternative 1: If sale by sheriff*]

3. The court orders that the real property described in paragraph 9, or as much of it as may be necessary, be sold in the manner prescribed by law, and that a writ of sale be issued to the Sheriff of _ _[*name*]_ _ **County, ordering and directing the Sheriff to conduct such sale.**

[*Alternative 2: If sale by receiver*]

3. The court appoints _ _[*name*]_ _ as receiver and orders said receiver to sell the real property described in paragraph 9, or as much of it as may be necessary, in the manner prescribed by law. _ _[*He/She*]_ _ shall swear to perform _ _[*his/her*]_ _ duties according to law and shall execute an undertaking in the sum of _ _[*dollar amount*]_ _, with good and sufficient sureties.

[*Continue*]

4. Any party to this action may purchase the property at the sale. From the sale proceeds, the _ _[*Sheriff/receiver*]_ _ shall pay to plaintiff, after deducting expenses of the levy and sale, the sums adjudged owing under paragraph 2, together with interest at the annual rate of _ _[*number*]_ _ percent from the date of this judgment.

5. If any surplus remains after the payments specified in paragraph 2 are made, the surplus shall be paid to _ _[*name(s) of person(s) entitled to share in surplus in order of priority*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1: If deficiency judgment applies*]

6. Defendant, _ _[*name*]_ _, is personally liable for payment of the sums secured by the deed of trust and is a defendant against whom a deficiency judgment may be ordered. The Court retains jurisdiction to determine the amount of the deficiency, if any, after the sale.

7. After the time allowed by law for redemption has expired, defendant, _ _[*name*]_ _, will be forever barred from any right of redemption. At that time, the _ _[*Sheriff/receiver*]_ _ will execute a deed of sale to the purchasers, who may then take possession of the property, if necessary with the assistance of the Sheriff of _ _ _ _ _ _ County.

[*Alternative 2: If deficiency judgment does not apply*]

6. Defendant, _ _[*name*]_ _, is not a person against whom a deficiency judgment may be ordered and is not personally liable for payment of the sums secured by the deed of trust.

[*Alternative 3: If deficiency judgment has been waived*]

6. Plaintiff has waived judgment for any deficiency, and therefore defendant, _ _[*name*]_ _, is not personally liable for payment of the sums secured by the deed of trust.

[*After Alternative 2 or 3, add*]

7. On completion of the sale, the _ _[*Sheriff/receiver*]_ _ shall execute a deed of sale to the purchasers, who may then take possession of the property, if necessary with the assistance of the Sheriff of _ _ _ _ _ _ County.

[*Continue*]

8. Defendant, _ _[*name*]_ _, all persons claiming from or under _ _[*him/her*]_ _, all persons and their personal representatives having liens subsequent to the deed of trust by judgment or decree on the described real property, all persons and their heirs or personal representatives having any lien or claim by or under such subsequent judgment or decree, all persons claiming under them, and all persons claiming to have acquired any estate or interest in the premises after the recordation of notice of the pendency of this action with the County Recorder are forever barred and foreclosed from all equity of redemption in and claim to the premises, from and after delivery of the deed by the _ _[*Sheriff/receiver*]_ _.

9. The legal description of the property that is the subject of this judgment and order is attached to this order as Exhibit 1.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

Entered on _ _[*date*]_ _, in the Judgment Book, Volume No. _ _ at page _ _.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
County Clerk
By _ _[*name*]_ _**, Deputy**

Copies: Original (submitted to judge for signature; then filed with court clerk); conformed copies for service (one for each attorney of record and unrepresented party); office copies.

Comment: The judgment in a foreclosure action must indicate that foreclosure of the plaintiff's lien has been ordered, must set forth the amount found owing to the plaintiff, and must order the property sold to satisfy that amount. *Laubisch v Roberdo* (1954) 43 C2d 702, 277 P2d 9; *Sichler v Look* (1892) 93 C 600, 29 P 220. Neither this judgment nor an abstract issued on it should be recorded. See Warning in §3.68.

Paragraphs 6 and 7 of the form present three alternatives for the attorney drafting the judgment. The creditor must decide whether it is worth confronting redemption and postponed possession for up to 1 year as the price of seeking a deficiency judgment (see §§3.8-3.9, 3.92). The first allows the deficiency judgment and establishes the right of statutory postsale redemption (CCP §§729.010-729.090), *i.e.,* the right to redeem the property after the sale. (Note: The amount of the deficiency can be decided only after the sale determines how much of the debt has been paid and how much is owing after the sale.) The second or third alternative is used when the court denies the deficiency judgment claim on the evidence considered at trial or because a waiver of the deficiency claim has made the sale absolute and immediate.

On preparing judgment and serving notice of it, see California Trial Practice: Civil Procedure During Trial (3d ed Cal CEB 1995).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/ C. Presale Forms/§3.104 1. Form: Writ of Sale (Judicial Council Form EJ-130)

C. Presale Forms

§3.104 1. Form: Writ of Sale (Judicial Council Form EJ-130)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, State Bar number and address):*	*FOR COURT USE ONLY*
TELEPHONE NO.: FAX NO. *(Optional):* E-MAIL ADDRESS *(Optional):* ATTORNEY FOR *(Name):* ☐ ATTORNEY FOR ☐ JUDGMENT CREDITOR ☐ ASSIGNEE OF RECORD	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
PLAINTIFF: DEFENDANT:	
WRIT OF ☐ **EXECUTION (Money Judgment)** ☐ **POSSESSION OF** ☐ **Personal Property** ☐ **Real Property** ☐ **SALE**	CASE NUMBER:

1. **To the Sheriff or Marshal of the County of:**

   You are directed to enforce the judgment described below with daily interest and your costs as provided by law.
2. **To any registered process server:** You are authorized to serve this writ only in accord with CCP 699.080 or CCP 715.040.
3. *(Name):*
   is the ☐ judgment creditor ☐ assignee of record whose address is shown on this form above the court's name.
4. **Judgment debtor** *(name and last known address):*

   ☐ Additional judgment debtors on next page
5. **Judgment entered** on *(date):*
6. ☐ **Judgment renewed** on *(dates):*
7. **Notice of sale** under this writ
   a. ☐ has not been requested.
   b. ☐ has been requested *(see next page).*
8. ☐ Joint debtor information on next page.
9. ☐ See next page for information on real or personal property to be delivered under a writ of possession or sold under a writ of sale.
10. ☐ This writ is issued on a sister-state judgment.
11. Total judgment . . . . . $
12. Costs after judgment (per filed order or memo CCP 685.090) . . . . . $
13. Subtotal *(add 11 and 12)* . . . . . $
14. Credits . . . . . $
15. Subtotal *(subtract 14 from 13)* . . . . . $
16. Interest after judgment (per filed affidavit CCP 685.050) (not on GC 6103.5 fees). . . $
17. Fee for issuance of writ . . . . . $
18. **Total** *(add 15, 16, and 17)* . . . . . $
19. Levying officer:
    (a) Add daily interest from date of writ *(at the legal rate on 15)* (not on GC 6103.5 fees) of. . . . . $
    (b) Pay directly to court costs included in 11 and 17 (GC 6103.5, 68511.3; CCP 699.520(i)) . . . . . $
20. ☐ The amounts called for in items 11–19 are different for each debtor. These amounts are stated for each debtor on Attachment 20.

[SEAL]

Issued on *(date):* Clerk, by _____ , Deputy

NOTICE TO PERSON SERVED: SEE NEXT PAGE FOR IMPORTANT INFORMATION.

Form Approved for Optional Use
Judicial Council of California
EJ-130 [Rev. January 1, 2006]

WRIT OF EXECUTION

Code of Civil Procedure, §§ 699.520, 712.010, Government Code, § 6103.5
www.courtinfo.ca.gov

PLAINTIFF:	CASE NUMBER:
DEFENDANT:	

— Items continued from page 1—

21. ☐ **Additional judgment debtor** *(name and last known address):*

22. ☐ **Notice of sale** has been requested by *(name and address):*

23. ☐ **Joint debtor** was declared bound by the judgment (CCP 989–994)
a. on *(date):*
b. name and address of joint debtor:
a. on *(date):*
b. name and address of joint debtor:
c. ☐ additional costs against certain joint debtors *(itemize):*

24. ☐ *(Writ of Possession* or *Writ of Sale)* **Judgment** was entered for the following:
a. ☐ Possession of real property: The complaint was filed on *(date):*
(Check (1) or (2)):
(1) ☐ The Prejudgment Claim of Right to Possession was served in compliance with CCP 415.46.
The judgment includes all tenants, subtenants, named claimants, and other occupants of the premises.
(2) ☐ The Prejudgment Claim of Right to Possession was NOT served in compliance with CCP 415.46.
(a) $ was the daily rental value on the date the complaint was filed.
(b) The court will hear objections to enforcement of the judgment under CCP 1174.3 on the following dates *(specify):*
b. ☐ Possession of personal property.
☐ If delivery cannot be had, then for the value *(itemize in 9e)* specified in the judgment or supplemental order.
c. ☐ Sale of personal property.
d. ☐ Sale of real property.
e. Description of property:

NOTICE TO PERSON SERVED

WRIT OF EXECUTION OR SALE. Your rights and duties are indicated on the accompanying *Notice of Levy* (Form EJ-150).
WRIT OF POSSESSION OF PERSONAL PROPERTY. If the levying officer is not able to take custody of the property, the levying officer will make a demand upon you for the property. If custody is not obtained following demand, the judgment may be enforced as a money judgment for the value of the property specified in the judgment or in a supplemental order.
WRIT OF POSSESSION OF REAL PROPERTY. If the premises are not vacated within five days after the date of service on the occupant or, if service is by posting, within five days after service on you, the levying officer will remove the occupants from the real property and place the judgment creditor in possession of the property. Except for a mobile home, personal property remaining on the premises will be sold or otherwise disposed of in accordance with CCP 1174 unless you or the owner of the property pays the judgment creditor the reasonable cost of storage and takes possession of the personal property not later than 15 days after the time the judgment creditor takes possession of the premises.
► *A Claim of Right to Possession form accompanies this writ (unless the Summons was served in compliance with CCP 415.46).*

Copies: Original (prepared by plaintiff's counsel; issued by court clerk; delivered to levying officer who serves

judgment debtor); one copy for court file; extra copies for sheriff's file; copies for each other defendant; office copies.

Comment: After entry of judgment in a foreclosure action, the plaintiff obtains a writ of sale from the court clerk and delivers it to the sheriff or receiver for execution. CCP §§716.010-716.020, 712.010-712.060. See §3.72. The writ is a multipurpose form, and counsel are cautioned to check the title box designating it a writ of sale rather than a writ of execution (see Warning in §3.68; see also §§4.12-4.16, 4.21). Note that a description of the property must be filled in at 9e on the reverse side of the form.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.105 2. Form: Notice of Levy (Judicial Council Form EJ-150)

§3.105 2. Form: Notice of Levy (Judicial Council Form EJ-150)



EJ-150

ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name and Address)*: TEL NO.:

☐ Recording requested by and return to:

☐ ATTORNEY FOR ☐ JUDGMENT CREDITOR ☐ ASSIGNEE OF RECORD

NAME OF COURT:
STREET ADDRESS:
MAILING ADDRESS:
CITY AND ZIP CODE:
BRANCH NAME:

FOR RECORDER'S USE ONLY

LEVYING OFFICER *(Name and Address)*:

PLAINTIFF:

DEFENDANT:

NOTICE OF LEVY
under Writ of ☐ **Execution (Money Judgment)** ☐ **Sale**

LEVYING OFFICER FILE NO.:

COURT CASE NO.:

TO THE PERSON NOTIFIED *(name)*:

1. The judgment creditor seeks to levy upon property in which the judgment debtor has an interest and apply it to the satisfaction of a judgment as follows:
   a. Judgment debtor *(name)*:
   b. The property to be levied upon is described
      ☐ in the accompanying writ of possession or writ of sale.
      ☐ as follows:

2. The amount necessary to satisfy the judgment creditor's judgment is:
   a. Total amount due (less partial satisfactions) ..... $
   b. Levy fee ..... $
   c. Sheriff's disbursement fee ..... $
   d. Recoverable costs ..... $
   e. **Total** *(a through d)* ..... $
   f. Daily interest ..... $

3. You are notified as
   a. ☐ a judgment debtor.
   b. ☐ a person other than the judgment debtor *(state capacity in which person is notified)*:

(Read Information for Judgment Debtor or Information for Person Other Than Judgment Debtor on page two.)

Notice of Levy was
☐ mailed on *(date)*:
☐ delivered on *(date)*:
☐ posted on *(date)*:
☐ filed on *(date)*:
☐ recorded on *(date)*:

Date:

(TYPE OR PRINT NAME)

(SIGNATURE)

☐ Levying officer ☐ Registered process server

Form Approved for Optional Use
Judicial Council of California
EJ-150 [Rev. January 1, 2002]

NOTICE OF LEVY
(Enforcement of Judgment)

Code of Civil Procedure, § 699.540

Print

SHORT TITLE:	LEVYING OFFICER FILE NO.:	COURT CASE NO.:

– INFORMATION FOR JUDGMENT DEBTOR –

1. The levying officer is required to take custody of the property described in item 1 in your possession or under your control.
2. You may claim any available exemption for your property. A list of exemptions is attached. **If you wish to claim an exemption for personal property, you must do so within 10 days after this notice was delivered to you or 15 days after this notice was mailed to you** by filing a claim of exemption and one copy with the levying officer as provided in section 703.520 of the Code of Civil Procedure. **If you do not claim an exemption, you may lose it and the property is subject to enforcement of a money judgment. If you wish to seek the advice of an attorney, you should do so immediately so that a claim of exemption can be filed on time.**
3. You are not entitled to claim an exemption for property that is levied upon under a judgment for sale of property. This property is described in the accompanying writ of sale. You may, however, claim available exemptions for property levied upon to satisfy damages or costs awarded in such a judgment.
4. You may obtain the release of your property by paying the amount of a money judgment with interest and costs remaining unpaid.
5. If your property is levied upon under a writ of execution or to satisfy damages and costs under a writ of possession or sale, the property may be sold at an execution sale, perhaps at a price substantially below its value. Notice of sale will be given to you. Notice of sale of real property (other than a leasehold estate with an unexpired term of less than two years) may not be given until at least 120 days after this notice is served on you. This grace period is intended to give you an opportunity to settle with the judgment creditor, to obtain a satisfactory buyer for the property, or to encourage other potential buyers to attend the execution sale.
6. All sales at an execution sale are final; there is no right of redemption.

– INFORMATION FOR PERSON OTHER THAN JUDGMENT DEBTOR –

1. If the property levied upon is in your possession or under your control and you do not claim the right to possession or a security interest, you must deliver the property to the levying officer. If you do not deny an obligation levied upon or do not claim a priority over the judgment creditor's lien, you must pay to the levying officer the amount that is due and payable and that becomes due and payable during the period of the execution lien, which lasts two years from the date of issuance of the writ of execution. You must execute and deliver any documents needed to transfer the property.
2. You must complete the accompanying Memorandum of Garnishee.
3. If you claim ownership or the right to possession of real or personal property levied upon or if you claim a security interest in or lien on personal property levied upon, you may make a third-party claim and obtain the release of the property pursuant to sections 720.010–720.800 of the Code of Civil Procedure.
4. **Make checks payable to the levying officer.**

Copies: Original (issued by levying officer and served on judgment debtor); one copy for court file; extra copies for

sheriff's file; copies for each other defendant; office copies.

Comment: The notice of levy is issued by the sheriff or court-appointed receiver to carry out the writ of sale (see §§3.72-3.73, 3.104). CCP §§700.015, 699.540-699.545, 716.010-716.020. When the debtor has postsale redemption rights (*i.e.,* when a deficiency judgment is not waived or prohibited), the notice of levy must be served on the defendants (CCP §700.015), and a 20-day notice of sale may be given at the same time (CCP §729.010(b)(2)). See §3.76. When a deficiency judgment has been waived or is prohibited, the notice of levy must be given at least 120 days before notice of sale may be given. CCP §§700.015, 701.545. See §§3.71, 3.75. The contents of the notice of levy are specified in CCP §699.540.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.106 3. Form: Notice of Sale

§3.106 3. Form: Notice of Sale

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	**No.** _ _ _ _ _ _
vs	**NOTICE OF SALE**
_ _[*Name(s)*]_ _, **Defendant(s)**	

1. PLEASE TAKE NOTICE that the above-titled Court has ordered me, as levying officer, to sell the real property located in _ _ _ _ _ _ County, California, known as _ _[*state street address or other designation*]**_ _, and described as: _ _**[*Provide legal description*]**_ _.**

[*Add if property has no street address or other common designation*]

Directions to the location of the real property to be sold may be obtained from the undersigned on request.

[*Continue*]

2. The judgment of foreclosure of the deed of trust on the property and the order of sale were entered on _ _[*date*]**_ _, in the Judgment Book, Volume No. _ _ at page _ _ and recorded on _ _**[*date*]**_ _.**

3. The sale will begin on _ _[*date and time*]**_ _, at _ _**[*state full address, including county*]**_ _, California. The property will be sold to the highest bidder for cash or certified or cashier's check, except that, if the highest bid exceeds $5000, the highest bidder may elect to deposit either $5000 or 10 percent of the amount bid, whichever is greater, and within 10 days after the date of the sale must pay the balance due plus costs and interest accruing from the date of sale to the date of payment. As much of the property as is necessary will be sold to pay the expenses of sale and to satisfy the judgment. The judgment debt (secured indebtedness), including interest and costs through the date of sale, is _ _**[*dollar amount; see CCP §729.010(b)(1)*]**_ _.**

4. Prospective bidders should refer to Code of Civil Procedure §§701.510 to 701.680, inclusive, for the terms, conditions, and effect of the sale and the liability of defaulting bidders.

[*Add if deficiency judgment is not waived or prohibited*]

5. The property will be sold subject to the right of redemption under Code of Civil Procedure §§729.010-729.090, and the period within which to redeem the property is either 3 months (if the proceeds of the sale are sufficient to satisfy the indebtedness; CCP §729.030(a)) or 1 year (if the proceeds are not sufficient to satisfy the indebtedness; CCP §729.030(b)).

[*Continue*]

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
_ _[*Sheriff/court-appointed receiver*]_ _

Copies: Original (issued by levying officer and served on judgment debtor); one copy for court file; extra copies for sheriff's file; copies for other parties; office copies.

Comment: The notice of sale must comply with CCP §701.540. In addition to the legal description of the property, the notice must give its street address or other common designation. If the property has no street address or other common designation, the notice must state that directions to the property's location may be obtained from the levying

officer by an oral or written request. CCP §701.540(a). The language in ¶4 of the notice is required by CCP §701.547. The manner of posting, publishing, and mailing the notice of sale is set forth in CCP §701.540 (see §§3.74-3.76).

The notice of sale must always be preceded by (or served with) the notice of levy (see §§3.73, 3.105), but the time in which the notice of sale must be served after service of the notice of levy varies, depending on the nature of the judgment (see §§3.74-3.76). When the debtor has statutory postsale redemption rights (*i.e.,* when a deficiency judgment is neither waived nor prohibited), the notice of sale must state that the property is sold subject to the statutory right of redemption. CCP §729.010(b)(1). The debtor has either 3 months or 1 year to redeem the property after the foreclosure sale. CCP §729.030 (see §3.92). For discussion of presale common law redemption rights, see §3.63. For discussion of postsale redemption rights, see §§3.90-3.101.

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D. Postsale Forms

§3.107 1. Form: Certificate of Sale

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Recordation Requested By)
After Recordation Return To)
)
)
)
)
)
)

(Space above this line for recorder's use)

_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No. _ _ _ _ _ _**
	)	**CERTIFICATE OF SALE**
vs	)	
_ _[*Name(s)*]_ _, **Defendant(s)**	)	

I, _ _[*name of Sheriff/court-appointed receiver*]_ _, certify that I was appointed levying officer by the above-titled Court to sell the real property known as _ _[*state street address or other designation*]_ _ and described as _ _[*provide legal description*]_ _ and to apply the proceeds to the necessary expenses of sale, and to the judgment of _ _[*dollar amount*]_ _, plus interest and costs. The judgment of foreclosure of the deed of trust on the property and the order of sale were entered in favor of _ _[*name of creditor*]_ _, of _ _[*state address*]_ _, and against _ _[*name of debtor*]_ _, whose last known address is _ _[*state address*]_ _, on _ _[*date*]_ _, and entered on _ _[*date*]_ _, in the Judgment Book, Volume No. _ _ at page _ _.

The sale was advertised and conducted according to the Code of Civil Procedure. The sale took place on _ _[*date*]_ _. The real property consisted of _ _[*e.g., one lot/three parcels*]_ _, and the successful bid for _ _[*the/each*]_ _ _ _[*lot/parcel*]_ _ was _ _[*enumerate lot(s) or parcel(s) and successful bid(s)*]_ _, made by, and sold at auction to, _ _[*name(s) of successful bidder(s)*]_ _. The total price paid was _ _[*dollar amount*]_ _.

The real property was sold subject to the right of redemption under Code of Civil Procedure §§729.010-729.090 and may be redeemed within _ _[*3 months/1 year*]_ _ after the date of sale.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
_ _[*Sheriff/court-appointed receiver*]_ _

[*Acknowledgment*]

Copies: Original (recorded with county recorder; duplicate originals to record if property is situated in more than one county); copies for service (one for each attorney of record and unrepresented party); office copies.

Comment: When real property is sold at a judicially ordered foreclosure sale subject to the possibility of a deficiency judgment, postsale redemption rights under CCP §§729.010-729.090 apply and the levying officer gives the purchaser

a certificate of sale rather than a deed of sale. CCP §729.040. The required contents of a certificate of sale are prescribed by CCP §§701.670 and 729.040. See §3.85. Because a duplicate original of the certificate must be recorded, as well as executed and delivered to the purchaser (CCP §729.040(a)), the certificate should comply with recordation requirements.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.108 2. Form: Notice of Right of Redemption

§3.108 2. Form: Notice of Right of Redemption

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_ _[*Name(s)*]**_ _,** **Plaintiff(s)**	**No. _ _ _ _ _ _**
vs	**NOTICE OF RIGHT OF REDEMPTION**
_ _[*Name(s)*]**_ _,** **Defendant(s)**	

To _ _[*name of judgment debtor*]**_ _:**

PLEASE TAKE NOTICE that you have the right to redeem the real property described below from the foreclosure sale conducted by the undersigned under a writ of sale issued by the above-titled Court on the judgment of foreclosure entered in this action. The real property is described as follows:

[*Provide legal description*]

The real property was sold by the undersigned levying officer in accordance with the Code of Civil Procedure to _ _[*name of purchaser*]**_ _ for the sum of _ _**[*dollar amount*]**_ _ on _ _**[*date*]**_ _.**

The real property may be redeemed any time within _ _[*3 months/1 year*]**_ _ after the date of sale.**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
_ _[*Sheriff/court-appointed receiver*]_ _

Copies: Original for service on judgment debtor; one copy for each other party; copies for sheriff's file; office copies.

Comment: When real property is sold at a judicially ordered foreclosure sale subject to the possibility of a deficiency judgment, the levying officer must prepare and serve this redemption notice on the judgment debtor "promptly after the sale." CCP §729.050. For discussion of contents and other service requirements, see §3.85.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.109 3. Form: Report of Sheriff/Receiver and Account of Sale

§3.109 3. Form: Report of Sheriff/Receiver and Account of Sale

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**REPORT OF**
vs	)	**SHERIFF/RECEIVER**
	)	_ _[*name*]_ _ **AND ACCOUNT**
_ _[*Name(s)*]_ _, **Defendant(s)**	)	**OF SALE**
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____	)	**Trial completed:** _ _[*date*]_ _

I, _ _[*name*]_ _, am the _ _[*Sheriff/receiver*]_ _ appointed by this Court to conduct a sale of the real property known as _ _[*state street address or other designation*]_ _ and described as _ _[*provide legal description*]_ _ and to distribute the proceeds according to the Court's judgment entered in this action. This is my report and account of the sale.

1. The judgment of foreclosure of the deed of trust on the described property and the order of sale were entered on _ _[*date*]_ _, in the Judgment Book, Volume No. _ _ at page _ _.

2. I swore an oath to perform my duties according to law and _ _[*executed an undertaking/obtained a bond*]_ _ in the amount of _ _[*dollar amount*]_ _, as set and approved by the Court, _ _[*and supported by sufficient sureties*]_ _.

3. The sale was advertised and conducted in accordance with the Code of Civil Procedure. Written notice describing the property to be auctioned and the place of auction was posted on the property and in a public place on _ _[*date*]_ _. The notice was published weekly in a newspaper of general circulation in the _ _[*city/judicial district*]_ _ in which _ _[*all/part of*]_ _ the property is located. Posting and publication preceded the sale by at least 20 days. Affidavits of posting and publication in the described manner are attached as Exhibits _ _[*number*]_ _ and _ _[*number*]_ _.

4. The property was offered for sale at auction at the advertised time and place. The real property consisted of _ _[*e.g., one lot/three parcels*]_ _ and the highest bid for _ _[*the/each*]_ _ _ _[*lot/parcel*]_ _ was _ _[*enumerate lot(s) or parcel(s) and successful bid(s)*]_ _, made by _ _[*name(s)*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1: Deed of Sale*]

5. I gave _ _[*the/each*]_ _ purchaser a deed of sale and recorded a duplicate of _ _[*the/each*]_ _ deed in the office of the recorder of _ _ _ _ _ _ County.

[*Alternative 2: Certificate of Sale*]

5. I gave _ _[*the/each*]_ _ purchaser a certificate of sale and recorded a duplicate of _ _[*the/each*]_ _ certificate in the office of the recorder of _ _ _ _ _ _ County. The certificate of sale contained the following information:

a. The name of the Court in which judgment was entered and the name and number of the case;

b. The date of entry of judgment and any subsequent renewals, and notation of where judgment was entered in the Court's records;

c. The name and address of the judgment creditor and the name and last-known address of the judgment debtor;

d. A description of the property;

e. The date of sale;

f. The price paid for each lot or parcel sold subject to the right of redemption;

g. The total price paid; and

h. A statement that the property is sold subject to the right of redemption, indicating the applicable redemption period.

[*Continue*]

6. The expenses of the sale totaled _ _[*dollar amount*]**_ _ and consisted of the following items:**

[*Itemize expenses*]

This amount was deducted from _ _[*dollar amount*]**_ _, the proceeds of the sale, leaving a balance of _ _**[*dollar amount*]**_ _.**

7. In accordance with the judgment and order of sale, I disbursed _ _[*dollar amount*]**_ _ to _ _**[*name of plaintiff*]**_ _. A receipt for this amount is attached as Exhibit _ _**[*number*]**_ _.**

[*Add if there were surplus funds*]

8. After satisfying the judgment, as indicated in paragraph 7, a surplus of _ _[*dollar amount*]**_ _ remained, which I _ _**[*paid to defendant, _ _*[*name*]**_ _,/deposited with the court clerk*]**_ _ in accordance with the judgment. A receipt for the surplus is attached as Exhibit _ _**[*number*]**_ _.**

ACCOUNT

[9.]_ _[*Itemize Sheriff's accounting of details of sale and disbursal of funds.*]**_ _**

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Court-Appointed _ _[*Sheriff/Receiver*]**_ _**

Copies: Original (filed with court clerk with proof of service); copies for service (one for each attorney of record and unrepresented party); office copies.

Comment: This form is to be used by the person appointed to execute the writ of sale and may be modified if a receiver conducts the sale rather than the sheriff. See §3.67. If the sale is conducted by the sheriff, the sheriff will prepare the writ return and accounting in the same manner as for execution sales, using a locally prepared form declaration. See §3.83. The property should be identified both by its street address and its legal description. The buyer's name and address and the price paid for the property should be included. The accounting should list the expenses in detail, *e.g.,* cost of publishing notice of sale, costs of service. A deficiency or surplus in the sum realized should be noted.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.110 4. Form: Deed of Sale

§3.110 4. Form: Deed of Sale

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Recordation Requested By)
After Recordation Return To)
)
)
)
)
)
)

(Space above this line for recorder's use)

DEED OF SALE

I, _ _[*name*]_ _, having been appointed levying officer in this matter by the above-titled Court, grant to and confirm in _ _[*name and capacity of purchaser(s)*]_ _ the real property in _ _ _ _ _ _ County, California, known as _ _[*state street address or other designation*]_ _, and described as _ _[*provide legal description*]_ _.

This deed is given under the powers granted to me by the Court in its judgment of foreclosure of the _ _[*deed of trust/mortgage*]_ _ on the described property, which was entered in favor of _ _[*name of judgment creditor*]_ _, of _ _[*state address of judgment creditor*]_ _, and against _ _[*name of judgment debtor*]_ _, of _ _[*state last-known address of judgment debtor*]_ _, on _ _[*date*]_ _, and entered on _ _[*date*]_ _, in the Judgment Book, Volume No. _ _ at page _ _.

The sale was conducted according to the Code of Civil Procedure. The property was sold _ _[*, subject to redemption,*]_ _ at public auction on _ _[*date*]_ _, in _ _ _ _ _ _ County, California. The above-named grantee(s) _ _[*was/were*]_ _ the highest bidder(s) for the _ _[*lot/parcel*]_ _ and paid the successful bid in lawful currency of the United States.

[*Add if sale was subject to redemption rights*]

I issued a certificate of sale to the purchaser(s) and recorded a duplicate certificate on _ _[*date*]_ _, as instrument no. _ _[*number*]_ _ of the Official Records of _ _ _ _ _ _ County, California.

The time for redemption under the Code of Civil Procedure has now elapsed, and all rights of redemption have expired.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
_ _[*Sheriff/court-appointed receiver*]_ _

[*Acknowledgment*]

Copies: Original (filed with county recorder); duplicate originals to record if property is situated in more than one county; copies for service (one for each attorney of record and unrepresented party); office copies.

Comment: If the property is not subject to redemption after the foreclosure sale, the levying officer must execute and deliver a deed of sale to the purchaser. CCP §701.660. See §3.84. If the property is sold subject to redemption rights (*i.e.,* if a deficiency judgment is not waived or prohibited), the officer must first deliver to the purchaser a certificate of sale. CCP §729.040. See §§3.85-3.101. After the time for redemption has expired (see §3.92), if the property has not been redeemed, the officer must then execute and deliver a deed of sale to the purchaser. CCP §729.080(a).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/ E. Deficiency Judgment Forms/§3.111 1. Form: Notice of Motion for Deficiency Judgment

E. Deficiency Judgment Forms

§3.111 1. Form: Notice of Motion for Deficiency Judgment

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**NOTICE OF MOTION FOR DEFICIENCY JUDGMENT**
vs	)	
_ _[*Name(s)*]_ _, **Defendant(s)**	)	**Hearing:** _ _[*date; time*]_ _ **Dep't:** _ _[*number*]_ _ **Hearing judge:** _ _[*if known*]_ _ **Action filed:** _ _[*date*]_ _ **Trial completed:** _ _[*date*]_ _

To each party and attorney of record:

PLEASE TAKE NOTICE that on _ _[*date and time*]_ _, or as soon thereafter as the matter can be heard, in Department No. _ _ of the above-titled Court, plaintiff, _ _[*name*]_ _, will move for entry of a deficiency judgment in favor of plaintiff and against defendant, _ _[*name*]_ _.

This motion will be made on the ground that neither the proceeds from the foreclosure sale nor the fair value of the property is equal to the amount of the indebtedness with interest and costs. This motion is based on this notice, all pleadings, records, and files in this action, the attached supporting memorandum, and oral and documentary evidence to be presented at the hearing of the motion.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Copies: Original (filed with court clerk with proof of service); copies for service (one for each attorney of record and unrepresented party); office copies.

Comment: On time frame for making this motion, see §§3.86-3.87. Any additional facts needed to support the motion that are not contained in documents in the court file may be supplied by attaching a separate declaration of the plaintiff or the plaintiff's attorney or by testimony presented at the hearing. The most crucial facts are the fair value of the property (see §3.88) and the foreclosure sale price (see §§3.80-3.82). The sale price should be obtainable from the levying officer's certificate of sale (see §3.107), notice of right to redeem (see §3.108), or report and account of sale (see §3.109). The creditor's attorney should check local assignments and calendars to ascertain whether the judge who presided at the trial will preside at the deficiency hearing. The notice must be served 15 days before the hearing. CCP §726(b). See CCP §§1010-1013.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.112 2. Form: Application for Order and Order Appointing Referee to Appraise Property

§3.112 2. Form: Application for Order and Order Appointing Referee to Appraise Property

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**APPLICATION FOR ORDER**
vs	)	**AND ORDER APPOINTING**
	)	**REFEREE TO APPRAISE**
_ _[*Name(s)*]_ _, **Defendant(s)**	)	**PROPERTY**
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____	)	**Trial completed:** _ _[*date*]_ _

_ _[*Plaintiff/Defendant*]_ _, _ _[*name of party*]_ _, **declares:**

1. The above-titled Court entered its judgment of foreclosure of the deed of trust in this matter on _ _[*date*]_ _, decreed the amount of the debt owing to plaintiff to be _ _[*dollar amount*]_ _, together with interest and costs, and directed that the real property be sold by auction according to law. The Court retained jurisdiction to enter a deficiency judgment.

2. The property was sold on _ _[*date*]_ _, and the proceeds of the sale amounted to _ _[*dollar amount*]_ _. After deducting expenses, the net proceeds amounted to _ _[*dollar amount*]_ _.

3. The plaintiff in this matter applied to the Court for a deficiency judgment on _ _[*date*]_ _. The application is set for hearing on _ _[*date*]_ _.

4. _ _[*Plaintiff/Defendant*]_ _, _ _[*name of party*]_ _, hereby applies for an order appointing a probate referee to appraise the property as of the date of sale, _ _[*date*]_ _, and to file the appraisal with the court clerk, under Code of Civil Procedure §726(b).

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

ORDER

Good cause appearing from _ _[*name of party*]_ _'s application for an order appointing a probate referee,

IT IS ORDERED that _ _[*name*]_ _ is appointed to appraise the real property described as _ _[*provide legal description*]_ _ as of _ _[*date*]_ _, the date of sale. The referee will be paid _ _[*dollar amount*]_ _, plus costs and expenses, and is directed to file an appraisal, under oath, with the court clerk on or before _ _[*date*]_ _.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

Copies: Original (filed with court clerk with proof of service); copies for service (one for each attorney of record and unrepresented party); office copies.

Comment: This form is optional. Code of Civil Procedure §726(b) provides that any party may apply to the court at least 10 days before the date set for the deficiency hearing for appointment of a probate referee to appraise the property. It appears from the short notice period in §726(b) that the application may be made ex parte. For ex parte procedures, see Cal Rules of Ct 3.1200-3.1207. The court may also appoint a referee on its own motion at any time. As a practical matter, because of fair value limitations, the foreclosing creditor will need an appraisal even before the sale takes place. See §3.81.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/3 Judicial Foreclosure/§3.113 3. Form: Deficiency Judgment Following Foreclosure

§3.113 3. Form: Deficiency Judgment Following Foreclosure

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_ _[*Name(s)*]_ _,	)	**No.** _ _ _ _ _ _
Plaintiff(s)	)	
	)	**DEFICIENCY JUDGMENT**
vs	)	**FOLLOWING FORECLOSURE**
	)	
_ _[*Name(s)*]_ _,	)	**Dep't:** _ _[*number*]_ _
Defendant(s)	)	**Judge:** _ _[*if known*]_ _
_____	)	**Trial completed:** _ _[*date*]_ _

The plaintiff's application for a money judgment for a deficiency after sale of real property in this action for foreclosure of a deed of trust came on regularly for hearing on _ _[*date*]_ _, the Honorable _ _[*name of judge*]_ _ presiding. Plaintiff, _ _[*name*]_ _, appeared by attorney _ _[*name of attorney*]_ _; defendant, _ _[*name*]_ _, appeared by attorney _ _[*name of attorney*]_ _. The Court, having heard the testimony and considered the evidence, and

[*Add one of the following alternatives*]

[*Alternative 1: If statement of decision requested*]

having filed its statement of decision on _ _[*date*]_ _, makes the following findings and conclusions: _ _[*State factual and legal basis for decision; see CCP §632*]_ _, and

[*Alternative 2: If statement of decision not applicable*]

a statement of decision _ _[*not having been requested/not being applicable*]_ _,

[*Continue*]

HEREBY ADJUDGES, ORDERS, AND DECREES as follows:

Plaintiff, _ _[*name*]_ _, shall recover from defendant, _ _[*name*]_ _, the sum of _ _[*dollar amount*]_ _, with interest at the annual rate of _ _[*number*]_ _ percent from _ _[*date*]_ _, together with the sum of _ _[*dollar amount*]_ _ as costs.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

Entered on _ _[*date*]_ _, in the Judgment Book, Volume No. _ _ at page _ _.

Clerk
By _ _[*name*]_ _, Deputy

Copies: Original (submitted to judge for signature; then filed with court clerk); conformed copies for service (one for each attorney of record and unrepresented party); office copies.

Comment: This is a conventional money judgment, enforceable by all traditional means. It may, among other things, be recorded and thus become a lien on all property owned and later acquired by the judgment debtor. However, the deficiency judgment lien does not reattach to the foreclosed property if the debtor thereafter acquires it by postsale redemption. CCP §729.080(e). See §3.96; Dyer, *Judicial Foreclosure After the Revised Enforcement of Judgments Act,* 6 CEB Real Prop L Rep 53, 57 (Apr. 1983). (Before the enactment of §729.080(e), a deficiency judgment did become a lien on the originally mortgaged property if it was ever reacquired by the debtor. *Simpson v Castle* (1878) 52 C 644.)

On preparing judgment and serving notice of it, see CCP §664.5; California Trial Practice: Civil Procedure During Trial (3d ed Cal CEB 1995). On enforcing money judgment, see Debt Collection Practice in California (2d ed Cal CEB 1999).

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4

CCP §726(a): The One-Action Rule

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I. DEVELOPMENT OF CCP §726(a)

§4.1 A. Common Law Background

At common law, a mortgagee had three remedies available after a mortgagor defaulted:

- The mortgagee could bring a suit in equity to foreclose the mortgagor's right of redemption (initially, this was "strict" foreclosure, effectively transferring title from mortgagor to mortgagee without an auction sale);
- The mortgagee could bring an action at law on the debt and obtain a money judgment; or
- The mortgagee could bring an action at law for ejectment to obtain possession of the premises.

See in general Turner, *The English Mortgage of Land as a Security,* 20 Va L Rev 729 (1934).

This system was inconvenient for lenders, who frequently found it necessary to seek multiple remedies to obtain complete relief. Contrary to its general practices, equity would not take complete jurisdiction in the foreclosure action, thus forcing mortgagees back to the law for the additional monetary and possessory relief they required. 1 Nelson & Whitman, Real Estate Finance Law, chaps 1, 7 (5th ed 2007). See Skilton, *Developments in Mortgage Law and Practice,* 17 Temple U L Rev 315 (1943). Additionally, a later money judgment would reopen the foreclosure decree, compelling a common law mortgagee to obtain a money judgment before initiating a foreclosure and to accompany the foreclosure suit in equity with a simultaneous ejectment action at law because equity did not give the mortgagee that remedy. At that time, multiplicity of action was regarded as vexatious to the mortgagee rather than the mortgagor. See Tefft, *The Myth of Strict Foreclosure,* U Chi L Rev 573 (1937).

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§4.2 B. Enactment of CCP §726(a)

The original Field Code, adopted by New York in 1848, sought to remedy the preexisting artificial multiplicity of proceedings (see §4.1). It stated that

> the distinction between actions at law and suits in equity, and the forms of all such actions and suits heretofore existing, [are] abolished; and there shall be in this state but one form of action for the enforcement of protection of private rights and the redress of private wrongs, which shall be denominated a civil action.

Another New York Field Code provision proposed to require that a mortgagee seek all relief in one action rather than in separate actions on the debt and the security, but it did not compel any particular form of action, thus leaving an election of remedies in the creditor. Although New York did not enact this provision, California adopted it as §246 of the Civil Practice Act of 1851 and initially provided that "there shall be one action for the recovery of" a mortgage debt. In 1872 it was reenacted as CCP §726(a) and the wording was changed to "but one action." In 1933, the wording was changed from "but one action" to "but one form of action"; California courts have ascribed no significance to this revision (see Comment, *Mortgages and Trust Deeds: Foreclosure Sale of a Portion of the Mortgaged Premises: Remedies Open to the Mortgagee When the Security Is Valueless: Pleading the Existence of Security,* 25 Cal L Rev 469 (1937)).

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II. APPLICATION AND PURPOSES OF CCP §726(a)

§4.3 A. Application to Both Mortgages and Deeds of Trust

Historically, deeds of trust became the predominant security instrument in California because, until 1933, the lending industry believed that deeds of trust, unlike mortgages, were not subject to the one-action rule. This belief was based on the fact that CCP §726(a) refers only to "mortgages," which are defined in CC §2924(a) to expressly exclude transfers in trust. See *Koch v Briggs* (1859) 14 C 256; *Pierce v Robinson* (1859) 13 C 116. See also *Commercial Nat'l Bank v Catron* (10th Cir 1931) 50 F2d 1023 (one-action rule not applicable to deeds of trust); *Herbert Kraft Co. v Bryan* (1903) 140 C 73, 80, 73 P 745; *Bateman v Burr* (1881) 57 C 480. In 1933, however, the California Supreme Court held that a deed of trust serves precisely the same economic function as a mortgage and must therefore be treated as one, subject to all the rules restricting mortgage enforcement. *Bank of Italy Nat'l Trust & Sav. Ass'n v Bentley* (1933) 217 C 644, 20 P2d 940. Thus, the beneficiary of a deed of trust is not entitled to sue on its note without first foreclosing or showing that the security has become worthless. Hints in the opinion that the deed of trust might be rewritten to permit a waiver of CCP §726(a) were later rejected in *Winklemen v Sides* (1939) 31 CA2d 387, 88 P2d 147.

Code of Civil Procedure §725a makes §726(a) applicable to deeds of trust as well as to mortgages.

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B. Purposes of CCP §726(a)

§4.4 1. Antimultiplicity

The commonly ascribed purpose of CCP §726(a) is to protect a defaulting mortgagor from being harassed by a multiplicity of actions filed against it by the mortgagee. See *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7; *Savings Bank v Central Mkt. Co.* (1898) 122 C 28, 54 P 273; *Felton v West* (1894) 102 C 266, 36 P 676. As discussed in §4.1, however, multiplicity of actions was probably forced on creditors by the separation between law and equity, and it is unlikely that creditors found it in their interests to institute voluntary multiple proceedings to obtain a single recovery. Furthermore, pure multiplicity could generally have been avoided by a simple election-of-remedies doctrine, such as the New York statute initially contemplated. See §4.2. See also Comment, *Mortgages & Trust Deeds: Enforcement of a Secured Debt in California,* 31 Cal L Rev 429 (1943). Despite its lack of historic support, however, debtor protection against multiplicity is treated as the main purpose of §726(a), forcing the lender to elect either a judicial foreclosure (see chap 3) or a trustee sale (see chap 2). See *Bank of Italy Nat'l Trust & Sav. Ass'n v Bentley* (1933) 217 C 644, 20 P2d 940; *Ould v Stoddard* (1880) 54 C 613.

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§4.5 2. Consolidated Foreclosure and Deficiency Judgment

The first sentence of CCP §726(a) provides that the one action that is permitted "shall be in accordance with the provisions of this chapter." The second sentence states that in the allowed action "the court may, by its judgment, direct the sale of the encumbered real property … and the application of the proceeds of the sale to the payment of … the amount due plaintiff." When combined with the first sentence's reference to one action, judicial foreclosure becomes the beneficiary's exclusive remedy. Remedies generally available to unsecured creditors are unavailable to real property secured creditors. *Porter v Muller* (1884) 65 C 512, 4 P 531; *Winklemen v Sides* (1939) 31 CA2d 387, 402, 88 P2d 147.

In addition to prohibiting the beneficiary from bringing a simple money action to recover the debt, CCP §726(a) also proscribes the common law remedy of "strict foreclosure," which by decree vested title in the property in the mortgagee without a sale. Under strict foreclosure, when the mortgagor failed to make the payment, the mortgagor's right of redemption was barred. *Warner Bros. Co. v Freud* (1903) 138 C 651, 72 P 345. Under §726(a), the security is sold to produce proceeds that are used to satisfy the creditor's claim. Further monetary liability is then imposed only by a deficiency judgment if the foreclosure sale proceeds are insufficient to satisfy the debt. See chap 3. Similarly, §726(a) prohibits other forms of action (such as quiet title actions) that could terminate the debtor's equity of redemption without a sale. See *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897.

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III. EFFECTS OF CCP §726(a)

A. Security-First Rule

§4.6 1. Creditor May Be Required to Proceed Against Security First

The first major effect of CCP §726(a) is that it prevents a secured creditor from ignoring its security and suing on the underlying note or debt. A debtor who is confronted with such an action by the creditor may either successfully raise §726(a) as an affirmative defense (*Western Fuel Co. v Sanford G. Lewald Co.* (1922) 190 C 25, 210 P 419) or assert it later as a sanction (*Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897). Because the creditor must proceed against the security initially, this effect is variously labeled the "security-first," "security exhaustion," "collateral-first," or "primary fund" principle or rule. It is deemed violated when a secured creditor attempts—by judicial action or otherwise—to reach unpledged assets of the debtor before first exhausting the security. *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201; *Bank of America v Graves* (1996) 51 CA4th 607, 59 CR2d 288; *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298; *Bank of America v Daily* (1984) 152 CA3d 767, 199 CR 557. The security-first rule of §726(a) is the linchpin of California's antideficiency scheme, which is the reason it is distinguished in this chapter from the other antideficiency rules discussed in chaps 4-5. For further discussion of the security-first rule, see §§4.7, 4.10-4.15, 4.19, 4.21, 4.27, 4.48.

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§4.7 2. Makes Obligation Conditional

The security-first rule of CCP §726(a) (see §§4.6, 4.12-4.22) makes the debtor's promise to pay a conditional obligation. As a result, a secured note does not unconditionally obligate the maker to pay it—merely to pay any deficiency that remains if the foreclosure sale of the encumbered property does not satisfy the note and a deficiency judgment is then obtained. *Otto v Long* (1900) 127 C 471, 477, 59 P 895; *Commercial Bank v Kershner* (1898) 120 C 495, 52 P 848; *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298.

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B. One-Action Rule

§4.8 1. Prohibits Multiplicity of Actions

The other major effect of CCP §726(a) is that it prohibits a secured creditor from bringing more than one action to exhaust the security. Even a creditor that holds multiple security for a single obligation is limited by this "one-action" rule and must include all of its security in one foreclosure action. *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897. The omission of some of the security from that action may discharge the omitted security from liability for the obligation. Thus, both partial foreclosure actions and actions that ignore the security entirely (*e.g.,* actions on the underlying debt) violate §726(a).

The "one form of action" aspect of CCP §726(a) does not preclude the assertion of multiple causes of action within a single action if they are otherwise proper under §726. In *Scalese v Wong* (2000) 84 CA4th 863, 101 CR2d 40, an action for both judicial foreclosure and specific performance of the note obligation for the payment of money, the court permitted the successful creditor to elect specific performance because the debtor did not raise the security-first defense in CCP §726. See 24 CEB Real Prop L Rep 57 (Jan. 2001).

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§4.9 2. Not Applicable to Trustee Sales

A trustee sale is not considered an action, because no judicial involvement occurs. The antimultiplicity prohibition against judicial foreclosures does not apply to successive nonjudicial trustee sales. (Nor does the trustee sale violate the security-first principle, because it is directed solely at the security given to the creditor.) When a trustee sale is involved, the debtor has no opportunity for direct judicial review of the sale's propriety, but that purpose has never been treated by the courts as a goal of CCP §726(a). See §§2.1, 2.10, 4.17. See also §§2.18-2.20.

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§4.10 3. Combined Effect of One-Action and Antideficiency Rules

Code of Civil Procedure §726(a) not only compels a creditor to seek judicial foreclosure (see §§4.8, 4.13) but also restricts the creditor's ability to then obtain a deficiency judgment. See Leipziger, *Deficiency Judgments in California: The Supreme Court Tries Again,* 22 UCLA L Rev 753 (1975). Without the restrictions of §726(a), a secured creditor could avoid most of the statutory limitations on deficiency judgments by ignoring the security and obtaining a judgment on the note (and then perhaps executing on the same property). Such a strategy, however, is barred by §726(a) because any monetary recovery after foreclosure is classified as a deficiency judgment. See *James v P.C.S. Ginning Co.* (1969) 276 CA2d 19, 80 CR 457. The various antideficiency rules (see chap 5) become even more compelling because they cannot be circumvented by alternative forms of action. In situations in which those rules completely prohibit deficiency judgments, the effect of §726(a) and the antideficiency rules is to limit the beneficiary to the real property security; in those circumstances, it becomes a security-only rule as well as a security-first and one-action rule.

NOTE: Some commentators suggest that the reference to "one form of action" added in 1933 emphasizes a facet of CCP §726(a) that is less profound than the two discussed in §§4.6-4.9. It recognizes that judicial foreclosure is the only proper procedure under California law for judicially enforcing the beneficiary's interest in the real property security. Hansen, *Wielding the Two-Edged Sword: What Every Attorney Needs to Know About Real Property Secured Transactions* (2 Parts), 22 CEB Real Prop L Rep 117, 153 (July, Aug. 1999).

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§4.11 C. Affirmative Defense and Sanction Aspect of CCP §726(a)

The debtor may assert CCP §726(a) in two different contexts. First, when the creditor commences an action for damages against the debtor personally without first exhausting the security, the debtor may plead §726(a) as an affirmative defense (see §4.24). The debtor's failure to raise this affirmative defense during the action will result in a loss of the defense, and the creditor may elect the single remedy of a personal judgment against the debtor. See *Scalese v Wong* (2000) 84 CA4th 863, 869, 101 CR2d 40. Second, if the debtor fails to raise the affirmative defense, it may subsequently assert CCP §726(a) as a sanction, which bars the lender from further relief, including judicial foreclosure or selling the security under a power of sale even if the security has not been exhausted (see §§4.25-4.28).

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§4.12 IV. VIOLATIONS OF CCP §726(a)

A lender may violate CCP §726(a) if it seeks to

- use more than one judicial action to enforce the obligation;
- enforce a secured obligation by an action other than a judicial foreclosure action; or
- recover first from assets other than the secured assets.

For purposes of §726(a) an "action" is a civil proceeding under CCP §22 (*Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201), which is defined as

> an ordinary proceeding in a court of justice by which one party prosecutes another for the declaration, enforcement, or protection of a right, the redress or prevention of a wrong, or the punishment of a public offense.

This statutory definition clearly does not mention various self-help, extrajudicial activities a creditor may pursue, but the Supreme Court has held that even a "nonaction" may violate the security-first policy of CCP §726(a). See *Security Pac. Nat'l Bank v Wozab, supra* (bank offset triggered sanction effect of §726(a) (see §4.19) even though it did not constitute action under CCP §22). Thus the question of what is an action is driven as much by policy as by statutory language, heightening uncertainty in this area.

Sections 4.13-4.16 describe various violations of CCP §726(a).

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§4.13 A. Judicial Foreclosure Actions

A judicial foreclosure action (see chap 3) is an action for purposes of the one-action rule. A creditor may obtain a judgment in such a suit only once even if it holds multiple security for a single obligation. Thus, a creditor that brings a foreclosure naming only some of the security it holds may be subject to the debtor's affirmative CCP §726(a) defense that there should be no deficiency judgment entered until all of the security has been exhausted, whether or not it was identified in the complaint (see §4.24). When the debtor does not so protest, a deficiency judgment based on a partial sale is valid, but, as a sanction, the unincluded security is discharged and no longer secures the debt (see §§4.25-4.27). *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897. See §4.8. See also *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, aff'd without published opinion (9th Cir 1995) 46 F3d 1143; *Aplanalp v Forte* (1990) 225 CA3d 609, 275 CR 144; *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298. In that event, the creditor has in effect traded its unused security for a money judgment against the debtor, which is comparable to omitting all security from the action and suing only for debt. On piecemeal trustee sales of multiple security, see §4.17.

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§4.14 B. Cross-Complaints

A cross-complaint for monetary damages filed by a secured creditor in response to a debtor's complaint constitutes an action and is subject to CCP §726(a). To permit the creditor to assert a cause of action on its debt in this fashion, without having previously foreclosed, violates the security-first aspect of the statute. See *Pitzel v Maier Brewing Co.* (1912) 20 CA 737, 130 P 705. If the offset has already been allowed, the creditor may be deemed to have had its one action and is barred from any further recourse against the security. *Aplanalp v Forte* (1990) 225 CA3d 609, 275 CR 144. Conversely, a creditor that has already foreclosed and obtained a deficiency judgment may use that judgment to offset its putative liability to the debtor. *Nelson v Bank of America Nat'l Trust & Sav. Ass'n* (1946) 76 CA2d 501, 173 P2d 322. But see *Bidart Bros. v Elmo Farming Co.* (1973) 35 CA3d 248, 110 CR 819. See also *Birman v Loeb* (1998) 64 CA4th 502, 75 CR2d 294 (lender may not circumvent antideficiency laws by obtaining offset (against debtor's award for tort damages) for shortfall to lender resulting from trustee sale), discussed in Bernhardt, *Foreclosure Shortfalls,* 21 CEB Real Prop L Rep 144 (Aug. 1998).

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§4.15 C. Prejudgment Attachments on Nonpledged Assets

An improper prejudgment attachment on nonpledged assets owned by the debtor is an action for purposes of the one-action rule. It violates both the one-action and the security-first policies of CCP §726(a). In *Shin v Superior Court* (1994) 26 CA4th 542, 31 CR2d 587, a lender, who obtained an attachment of unpledged Korean real estate from a Korean court, was thereafter barred from bringing an action for judicial foreclosure of California land given as security. For more on this type of §726(a) violation, see Hetland & Hansen, *The "Mixed Collateral" Amendments to California's Commercial Code—Covert Repeal of California's Real Property Foreclosure and Antideficiency Provisions or Exercise in Futility?,* 75 Cal L Rev 185 (1987).

Even though the attachment in *Shin* afforded only provisional rather than final relief, the court stated that it gave the creditor the ability to deny the debtor access to assets that might be necessary to fund a legal defense. Because no hearing was held to determine whether the value of the California security was equal to the debt, the Korean attachment was improper and invoked the sanction effect of CCP §726(a). On the sanction aspects of §726(a), see §§4.11, 4.25-4.28. See also *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1997) 205 BR 427, aff'd (9th Cir 1999) 164 F3d 1214 (prejudgment attachment and levy on bank account). See also *Kirkpatrick v Westamerica Bank* (1998) 65 CA4th 982, 76 CR2d 876 (CCP §726(a) is violated when creditor conclusively elects to ignore its real property collateral by obtaining nondisclosure judgment or by taking action (such as prejudgment attachment on noncollateral assets) that estops it from arguing that it still intends to foreclose on the secured real property). On statutory exemption from §726(a) for attachments, see §4.20.

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§4.16 D. Money Actions

A suit for the recovery of the secured debt constitutes an action even if it does not seek foreclosure of the security underlying the debt (including not only simple money claims on the debt but creative claims for breach of the secured covenants of the note or deed of trust). See, *e.g., Kirkpatrick v Westamerica Bank* (1998) 65 CA4th 982, 76 CR2d 876. Thus, CCP §726(a) may be asserted in the action itself as an affirmative defense (see §4.24) or subsequently as a sanction defense if the lender later attempts to reach the former security (see §4.25).

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E. Proceedings Not Constituting Action

§4.17 1. Trustee Sale

A trustee sale is not an action within the meaning of CCP §22 or §726(a), because it does not involve or require a court proceeding. A creditor holding multiple security may conduct multiple separate trustee sales as long as each sale only partially satisfies the debt. *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 120 P2d 869. See *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29 (creditor may underbid in seriatim trustee sales of multiple security without violating antideficiency laws). See also §§2.10, 5.30, 9.5-9.8.

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§4.18 2. Interlocutory Proceedings

The mere filing of a complaint does not constitute an action for CCP §726(a) purposes. Using election of remedies principles, courts have held that there is no action until the suit leads to a judgment or other coercive relief and that the mere entry of a default is insufficient to invoke the §726(a) sanction. *Madigan v Potrans Int'l, Inc. (In re Madigan)* (BAP 9th Cir 1991) 122 BR 103 (action on debt); *Tidrick v General Bank (In re Tidrick*) (Bankr CD Cal 1989) 105 BR 584 (action to foreclose deed of trust). See also *Brice v Walker* (1920) 50 CA 49, 194 P 721. But see *Shin v Superior Court* (1994) 26 CA4th 542, 31 CR2d 587, discussed in §4.20. Even a partial summary judgment on a monetary claim does not invoke the sanction if the complaint is timely amended to add a count for judicial foreclosure. *Kirkpatrick v Westamerica Bank* (1998) 65 CA4th 982, 76 CR2d 876 (§726(a) is not violated until creditor conclusively elects to ignore its collateral). Thus, the secured lender who has improvidently sought the wrong form of relief may escape the sanction effect of CCP §726(a) by either dismissing or amending the complaint prior to judgment.

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§4.19 3. Self-Help Remedies (Bankers' Liens and Offsets)

Self-help remedies directed against the debtor personally or its general assets, such as banker's liens and offsets, are not considered actions under CCP §726(a), because they do not constitute a judicial proceeding (see §4.12), but they do violate the security-first rule of this statute. *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201. If a bank is the secured lender and the debtor is both a borrower and a bank customer, the bank is often both creditor and the holder of valuable assets owned by the debtor. In this situation, the bank may be tempted to offset the account against the borrower's delinquent loan balance.

A banker's lien arises by operation of law and applies to "all property in [the banker's] hands belonging to a customer." CC §3054(a). For example, the lien attaches to "securities such as commercial paper deposited with the bank by the customer in the course of business." *Kruger v Wells Fargo Bank* (1974) 11 C3d 352, 357, 113 CR 449. As a matter of banking law, a bank holding a defaulted mortgage may exercise its banker's lien to reach such securities and offset them against its mortgage.

Although a banker's lien does not apply to general deposit accounts that a debtor has with the bank (*Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 996 n3, 275 CR 201; *Gonsalves v Bank of America Nat'l Trust & Sav. Ass'n* (1940) 16 C2d 169, 105 P2d 118), the account does represent a debt from the bank to the depositor in which the bank has an equitable right of offset. This debt permits the bank to offset what it owes its depositor (via the account) against what it is owed on its mortgage. The distinction between the banker's lien and the banker's right to offset is not always clearly maintained. See *Woodruff v California Republic Bank* (1977) 75 CA3d 108, 141 CR 915 (offset characterized as banker's lien). The distinction is not important for §726(a) purposes.

A bank that invades its debtor's assets to satisfy a defaulted mortgage obligation violates the security-first rule of CCP §726(a) even though the banker's lien or banker's offset is exercised without an action. *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201. Any kind of creditor activity that seeks to appropriate unpledged assets of the debtor to retire the debt before the security itself has been first exhausted violates §726(a). *Security Pac. Nat'l Bank v Wozab*, *supra* (banker's offset); *McKean v German-American Sav. Bank* (1897) 118 C 334, 50 P 656 (banker's lien). But see *Woodruff v California Republic Bank, supra*.

PRACTICE TIP: It is possible in California for a creditor to take a personal property security interest in a bank account. Com C §§9102(a)(2), 9104. Consequently, it may be possible for the bank, if it has taken an express pledge of the bank account or a broadly worded security interest in debts and accounts, to argue that, in offsetting a deposit account, it was engaged in a private resort to its security based on a consensual Commercial Code security interest. For a similar argument in a different context, see *Resolution Trust Corp. v Bayside Developers* (ND Cal 1993) 817 F Supp 822, aff'd (9th Cir 1995) 43 F3d 1230.

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§4.20 4. Statutory Exception for Pursuing Attachment

Before 1977, a secured creditor could attach only a debtor's unsecured assets if, by no fault of the creditor, the security became worthless. See former CCP §483.010. In 1977, CCP §483.010(b) was amended to permit attachment if the security's value had decreased to less than the amount owed on the claim. The 1997 amendments to §483.010 retained this provision. Stats 1997, ch 222, §1. On prejudgment attachment, see Debt Collection Practice in California, chap 6 (2d ed Cal CEB 1999).

Undersecured creditors holding real property security have always been leery of using prejudgment attachment lest such efforts be treated as actions, thus prohibiting all further relief (including foreclosure on the real estate). See, *e.g., Shin v Superior Court* (1994) 26 CA4th 542, 31 CR2d 587 (attachment of foreign real estate through foreign proceedings constituted an action under CCP §726(a) and extinguished the California deed of trust); *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1997) 205 BR 427, aff'd (9th Cir 1999) 164 F3d 1214 (local attachment). On security-first violations in *Shin*, see §4.15.

In 1997, CCP §483.012 was enacted, which provides that "pursuit of any remedy provided by this title shall not constitute an action for the recovery of a debt for purposes of" CCP §726(a). This wording gives scant comfort to an undersecured creditor. Pursuing a remedy is not the same as obtaining the remedy. See *Madigan v Potrans Int'l, Inc. (In re Madigan)* (BAP 9th Cir 1991) 122 BR 103; *Tidrick v General Bank (In re Tidrick)* (Bankr CD Cal 1989) 105 BR 584. Thus, real property secured creditors must worry that, even though they are entitled under the attachment statute to pursue other debtor assets, success in that enterprise may violate §726(a). See also *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord), supra* (narrowly interpreting CCP §483.012 to limit protection afforded to creditors to actions to foreclose deed of trust and not to actions on personal guaranties).

It is unclear what the effect of the issuance of a writ of attachment would be after a proper fair value hearing. See Bernhardt, *Is Attachment Once Again Safe?,* 21 CEB Real Prop L Rep 51 (Mar. 1998).

WARNING: Practitioners should not assume that CCP §§483.010 and 483.012 make attachment either broadly available to secured creditors or entirely safe. Section 483.012 expressly protects against CCP §726(a) sanctions for attachments "provided by this title" (*i.e.,* attachments permitted by §483.010). The implication may be that attachments not provided by CCP §§481.010-493.060 are vulnerable to sanctions under §726(a).

For an attachment on a claim originally secured by real property to fit within §483.010, it must have these characteristics:

- Be based on a contract claim for money;
- Exceed $500;
- Involve a debt that is either unsecured or undersecured without any act of the secured party;
- Be only for the amount that is undersecured through no fault of the creditor;
- Arise from the defendant's "trade, business, or profession," if the defendant is a natural person; and
- Not arise from a transaction "primarily for personal, family, or household purposes."

PRACTICE TIP: Even if all the requirements are clearly met, counsel for the secured creditor must be careful not to overattach and, by so doing, step outside *any* sanctuary provided by CCP §483.010. This need for restraint runs contrary to instinct in the heat of an attachment battle and should caution the secured creditor to obtain a reliable appraisal at the outset of a foreclosure proceeding.

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§4.21 F. Other Creditor Activity Not Constituting Action

Based on the current judicial interpretation of the security-first policy of CCP §726(a), California courts will likely hold that the creditor's creation of an involuntary lien against or appropriation of any of the debtor's unpledged assets before completing the foreclosure action constitutes an "action" in violation of §726(a). See *Carnation Co. v Lampi (In re Kristal)* (9th Cir 1985) 758 F2d 454. Any additional assets that have been pledged as security may be reached through a single or multiple trustee sales without violating §726(a). See §4.17. If a judicial foreclosure action is brought, all securities must be included to avoid the sanction effect of §726(a) (see §§4.25-4.26), which dictates that the unincluded assets are no longer security for the obligation. If mixed collateral is involved, Com C §9604(a)(2) declares that the one-action policy does not apply to a proceeding solely against the personal property security (see §4.22).

Accepting "adequate protection" payments in a bankruptcy proceeding does not constitute an action by the lender, because the lender is not entitled to reject such funds. See *Metropolitan Life Ins. Co. v Sunnymead Shopping Ctr. (In re Sunnymead Shopping Ctr.)* (BAP 9th Cir 1995) 178 BR 809, cited in §7.110. Similarly, a lender's refusal to endorse the proceeds of a joint insurance check to the borrower does not violate CCP §726(a) even if the lender is not entitled to retain any of the funds involved. *Ziello v Superior Court* (1995) 36 CA4th 321, 42 CR2d 251. On effect of §726(a) on collecting rents, see §6.41. On actions affecting one of two codebtors, see *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, aff'd without published opinion (9th Cir 1995) 46 F3d 1143.

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§4.22 G. Distinguishing Monetary and Nonmonetary Judgments

In the mixed collateral context, Com C §9604(a)(5)-(6) describes an action seeking a "monetary judgment on the debt" as one seeking recovery of principal and interest and distinguishes it from a "judgment which provides only for other relief," thus permitting a monetary judgment to follow a nonmonetary judgment despite CCP §726(a). The same distinction will also likely apply to pure real estate collateral, permitting some other forms of creditor relief to be granted without invoking the sanction effect of CCP §726(a) (see §§4.25-4.26). See *Tidrick v General Bank (In re Tidrick)* (Bankr CD Cal 1989) 105 BR 584. A bankruptcy court held that a motion for relief from the automatic stay (see §7.99) constituted the creditor's one action (see *McReynolds v Rivers (In re Rivers)* (Bankr CD Cal 1984) 39 BR 608), but the decision was reversed on appeal (see *McReynolds v Rivers (In re Rivers)* (Bankr CD Cal 1984) 55 BR 699).

NOTE: Some practitioners believe that the decision in *Florio v Lau* (1998) 68 CA4th 637, 80 CR2d 409, casts doubts on the extent to which §726(a) applies to mixed collateral transactions in light of Com C §9604 (operative July 1, 2001). Although the strict holding in *Florio* deals with the applicability of CCP §726(b) to mixed collateral transactions (see §§5.13, 9.21), the court's reasoning may raise questions about the applicability of aspects of §726(a) (*e.g.,* the security-first and one-action rules) to mixed collateral transactions. But see *Sherwood-Trimble Med. Group v 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 89 CR2d 533. For more on the issue of mixed real and personal property security under the Commercial Code, see chap 9. For an introduction to the 2001 revisions to UCC Article 9, see Weise, *An Introduction to Revised UCC Article 9,* 22 CEB Cal Bus L Rep 4 (July 2000).

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§4.23 V. INVOKING CCP §726(a)

The debtor has two ways to assert CCP §726(a) protections. Initially, the debtor may raise an affirmative defense to a lender's attempt to circumvent this statute (see §4.24). Failing this, the debtor may later invoke the sanction effect of §726(a) (see §§4.25-4.26).

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§4.24 A. As Affirmative Defense

When the creditor commences an action for monetary relief, the debtor may plead CCP §726(a) as an affirmative defense in order to bar the relief sought by the creditor. For example, see *Western Fuel Co. v Sanford G. Lewald Co.* (1922) 190 C 25, 210 P 419; *Barbieri v Ramelli* (1890) 84 C 154, 23 P 1086 (creditors holding mortgages cannot bring actions on their notes if debtors plead §726(a)); conversely, see *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7 (debtor's failure to affirmatively plead §726(a) allows creditor to obtain money judgment without first exhausting security). If the debtor asserts the affirmative defense, the creditor must amend its complaint to seek the proper relief or to include the omitted security.

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§4.25 B. As Sanction

The scope and effect of the CCP §726(a) sanction defense are complicated and did not fully emerge until 1974, in *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897. The courts have never explained how the pre-1974 holdings apply to what constitutes an action in the context of the sanction aspect of §726(a) rather than the affirmative defense.

The sanction aspect of §726(a) is more significant than the affirmative defense. A debtor that fails to raise the affirmative defense may invoke §726(a) as a sanction, barring from any further relief a secured creditor that has had its one action, even though the security may not have been exhausted. Thus, a creditor that obtains a money judgment in an action based solely on the note because the debtor failed to plead §726(a) as an affirmative defense may then lose its security because of the sanction effect of §726(a). See *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7; *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, aff'd without published opinion (9th Cir 1995) 46 F3d 1143.

Similarly, a foreclosing creditor that has not included all of the security in a single foreclosure action may obtain a deficiency judgment after the sale of the included security, but the sanction aspect of §726(a) will act to release the unincluded security from the lien of the deed of trust. See *Walker v Community Bank, supra*. See also *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 598 n6, 5 CR2d 712; *DiSalvo v DiSalvo (In re DiSalvo)* (BAP 9th Cir 1998) 221 BR 769, rev'd on other grounds at (9th Cir 2000) 219 F3d 1035.

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§4.26 1. Triggering the Sanction

Before a creditor's action will trigger a CCP §726(a) sanction, any action taken by it should have proceeded either to judgment (at which point the creditor is said to have made an election of remedies) or to some other form of prejudgment coercive relief. The following are a few examples of how the sanction may be triggered.

EXAMPLE 1: The simple entry of a stipulated judgment against one of multiple debtors, with no enforcement activity, triggers the sanction involving loss of the security. *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, aff'd without published opinion (9th Cir 1995) 46 F3d 1143.

EXAMPLE 2: Prejudgment conduct in the course of a lawsuit may trigger the sanction. *Shin v Superior Court* (1994) 26 CA4th 542, 31 CR2d 587 (prejudgment attachment triggers sanction); *Aplanalp v Forte* (1990) 225 CA3d 609, 275 CR 144 (judicial offset of verdict in favor of borrower against debt owed to lender violates §726(a)). But see *Kirkpatrick v Westamerica Bank* (1998) 65 CA4th 982, 76 CR2d 876 (sanction not triggered, because creditor amended its complaint to seek foreclosure before final judgment).

EXAMPLE 3: A judicial offset is the equivalent of a deficiency and violates the purchase money antideficiency statute CCP §580b. *Birman v Loeb* (1998) 64 CA4th 502, 75 CR2d 294.

Little guidance is available on the more difficult issue of whether final judgment constitutes the creditor's one permissible action if the judgment is for the debtor-defendant. *Kirkpatrick v Westamerica Bank, supra.*

WARNING: Even though the reported cases provide little guidance, the type of nonjudgment conduct during an action that may trigger a CCP §726(a) sanction is probably not limited to offsets and attachments. Prejudgment actions that may trigger the sanction include contempt proceedings and the prejudgment liquidation of property. Creditors may also run afoul of §726(a) by engaging in improper conduct after entry of judgment but before a deficiency is obtained. See, *e.g., Carnation Co. v Lampi (In re Kristal)* (9th Cir 1985) 758 F2d 454, also discussed in §§3.68, 3.88, 4.21, 7.99. The creditor may also violate §726(a) by obtaining a stipulated judgment on the secured debt while retaining the consensual security interest. See *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712 (junior secured creditors are within the class who may object to such an arrangement under §726(a)). Counsel for the secured party needs to carefully evaluate the risk of any conduct that may involve a multiplicity of actions, may not be in the proper form of action (*e.g.,* judicial foreclosure), or constitutes a resort to the debtor or its general assets outside of the narrow judicial foreclosure/deficiency judgment procedure.

See Muñoz, *Demystifying the One Action Goblin: Current Developments Under CCP §726(a),* 22 CEB Real Prop L Rep 73 (Apr. 1999) for an in-depth discussion of the severity-of-sanctions issue.

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§4.27 2. Extent of Sanction: What Rights Are Forfeited?

In cases of both judicial and nonjudicial violations of CCP §726(a), the exact nature and extent of the *rights forfeited* raises many questions, including whether the creditor loses only the remaining security or both the remaining security and the debt.

Some older cases declared that a creditor that lost its security could not thereafter proceed on the underlying debt, but such statements generally arose in peculiar contexts. In other earlier cases, the courts either imposed no sanction (*McKean v German-American Sav. Bank* (1897) 118 C 334, 50 P 656 (creditor forced to return funds improperly offset before foreclosure)) or imposed a sanction with a fairly minor impact (*Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7 (creditor's money judgment replaced its previous security interest); *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897 (creditor obtained deficiency judgment following only partial sale of security)). Later cases generally permit the secured creditor to retain assets obtained through a judicial action violating §726(a) because the lender obtained a valid judgment that could have been—but was not—averted by the debtor's invocation of the affirmative defense under §726(a). Rather than make the creditor surrender the gain, courts focused on the creditor's forfeiture of rights omitted from the judgment. See, *e.g., Walker v Community Bank, supra*. (The same sanction analysis is used in nonjudicial violations of the security-first rule of §726(a). Thus, a bank that has successfully taken a nonjudicial banker's offset (see §4.19) may keep the funds recovered by the offset, but it will lose some or all of its remaining rights.)

Security Pac. Nat'l Bank v Wozab (1990) 51 C3d 991, 275 CR 201, suggests several alternative sanctions, depending on the parties' behavior after a wrongful action has been taken. In *Wozab*, the bank improperly offset $3000 from the obligor's bank account, which the obligor claimed entirely eliminated the bank's right to recover its $1 million loan made to the debtor's company. The supreme court first suggested that, if the offset was inadvertent and the funds were promptly restored to the obligor, then interest and possibly special damages would be adequate compensation. If the offset was deliberate or if funds were not promptly restored, both compensatory damages and loss of both the security and the debt constitute the appropriate sanction. The extreme sanction of losing the underlying obligation applies only if the debtor demands return of the offset funds and the bank refuses.

The scope of the *Wozab* court's holding is complicated by the fact that the bank in *Wozab* voluntarily reconveyed the deed of trust to the debtors in response to their claim that the security was waived by the offset. See *DiSalvo v DiSalvo (In re DiSalvo)* (BAP 9th Cir 1998) 221 BR 769, rev'd on other grounds at (9th Cir 2000) 219 F3d 1035 (by electing to pursue debtor personally, creditor elected her remedy and lost her security but did not lose right to collect debt when debtor did not raise one-action rule as defense to plaintiff's actions).

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§4.28 3. *Wozab* Letters

One method by which the debtor may demand a return of improperly offset funds has come to be known as a *"Wozab* letter*"* or "*Wozab* demand." See §4.27. It also demands that the creditor proceed against the encumbered property before attempting to recover on the underlying debt.

Before sending a *Wozab* letter, the client should understand that, in response, the creditor may elect to return the funds improperly offset, thus avoiding loss of the security. This possibility may make it imprudent to send a *Wozab* letter when the obligation is nonrecourse. See *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1997) 205 BR 427, aff'd (9th Cir 1999) 164 F3d 1214 (successful invocation of loss-of-security sanction in context of purchase money obligation constituted de facto waiver of purchase money antideficiency protection under CCP §580b). See also discussion of *Wozab* in *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1998) 223 BR 203, aff'd (9th Cir 2000) 234 F3d 1108. But see *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292, stating that §580b is not contractually waivable even after default. See also *Cadle Co. II v Harvey* (2000) 83 CA4th 927, 100 CR2d 150.

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VI. ADDITIONAL IMPACTS OF CCP §726(a)

A. Parties

§4.29 1. Guarantors

Code of Civil Procedure §726(a) is said to be for the principal debtor's benefit only and is inapplicable to parties who are "merely" secondarily liable, such as guarantors. *Murphy v Hellman Commercial Trust & Sav. Bank* (1919) 43 CA 579, 185 P 485. It has also been asserted that a guarantor is outside the one-action rule because the guaranty agreement is separate and distinct from the deed of trust (see, *e.g., Adams v Wallace* (1897) 119 C 67, 51 P 14). The 1939 assimilation of surety and guarantor defenses, however, appears to make that distinction irrelevant and to cast doubt on the proposition that an independent guarantor's promise to pay a debt is independent and not subject to the rules affecting the debtor's promise. See *Mead v Sanwa Bank Cal.* (1998) 61 CA4th 561, 71 CR2d 625; *American Guar. Corp. v Stoody* (1964) 230 CA2d 390, 41 CR 69.

The Nevada Supreme Court, applying California law, has held that the 1939 abolition of the surety-guarantor distinction gave guarantors the protection of the California one-action rule. *Component Sys. Corp. v Eighth Judicial Dist. Court* (Nev 1985) 692 P2d 1296. No California case, however, has yet made a reference to that decision.

If a guarantor secures its guaranty with a deed of trust encumbering California real property, then, for purposes of such deed of trust, the guarantor has the same one-action protection as any other trustor. On guarantors, see §§9.89-9.112.

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§4.30 2. Codebtors

Codebtors (more than one person principally liable on the debt), even those who do not post security, are also protected by the one-action rule. Thus, in *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298, the creditor's reconveyance of the security to the trustor-codebtor gave the nontrustor-codebtor a one-action defense because he had lost the protection of having the security exhausted by foreclosure before being exposed to personal liability. See also *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, aff'd without published opinion (9th Cir 1995) 46 F3d 1143, holding that a stipulated judgment against a nontrustor-codebtor released the other trustor-codebtor and the security from the lien of the deed of trust.

In *Shin v Superior Court* (1994) 26 CA4th 542, 31 CR2d 587, a wrongful attachment against one codebtor's unpledged property was held to discharge not only the property securing the debt and its owner but also that of the other codebtors. For further discussion of *Shin*, see §4.15.

Schwenke and other similar codebtor cases (see *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897; *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712) were distinguished in the Ninth Circuit decision *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1998) 223 BR 203, aff'd (9th Cir 2000) 234 F3d 1108, a case involving application of the sanction aspect of CCP §726 to a creditor's obtaining of an illicit attachment on a sham guaranty. Although it did not dispute the single-sanction loss of the security for a §726 violation, the *Prestige* court rejected the application of a "double sanction" (loss of both security and debt). 234 F3d at 1115.

On effect of §726 on codebtors when there are multiple obligations, see §4.66.

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§4.31 3. Junior Secured Creditors

A creditor holding a junior lien on the same security is clearly benefited when the senior lien is lost as a result of the sanction effect of CCP §726(a) and may invoke that sanction in proper cases. See *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712. Even if the previous senior's actions generate a valid money judgment in its favor, any execution on the former security will relate back only to the date of judgment, not to the earlier date of execution of the original deed of trust. *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7; *Valley Title Co. v Parish Egg Basket, Inc.* (1973) 31 CA3d 776, 107 CR 717.

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B. Transactions

§4.32 1. Installment Land Sale Contracts

An installment land sale contract functions so similarly to a purchase money mortgage as to be subject to the same one-action and antideficiency restrictions (see §§1.59-1.65; on antideficiency statutes and land sale contracts, see §§5.45-5.50). Although the seller has the theoretical choice of seeking either to enforce the contract and claim damages or to rescind it and seek rental value, both measures of relief apply only to the question of how much of the money already received by the seller may be retained following a breach. *Honey v Henry's Franchise Leasing Corp.* (1966) 64 C2d 801, 52 CR 18. See California Real Property Sales Transactions §§9.14-9.17 (4th ed Cal CEB 2007); California Real Property Remedies and Damages, chap 4 (2d ed Cal CEB 2002). A direct monetary action against the purchaser is clearly barred by both CCP §§726(a) and 580b because an installment land contract is inevitably a purchase money transaction. See *Powell v Alber* (1967) 250 CA2d 485, 58 CR 657; *Venable v Harmon* (1965) 233 CA2d 297, 43 CR 490. The common law remedy of quieting title against a defaulting buyer is also probably prohibited by §726(a) because quieting title would constitute a strict foreclosure if allowed.

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§4.33 2. Hidden Security Instruments

Once a court finds that an instrument serves a security function and should therefore be treated as a mortgage, the instrument becomes subject to CCP §726(a) and the remedies normally available under the nominal transaction are preempted. For example, see *Kaiser Indus. Corp. v Taylor* (1971) 17 CA3d 346, 94 CR 773 (agreement found to be mortgage must be foreclosed as equitable mortgage). See §5.51 for other hidden security devices.

WARNING: Hidden security devices present particular risks under CCP §726(a). The creditor may not follow the proper remedial procedures because it mistakenly believes that the transaction is not a mortgage or not subject to normal one-action and antideficiency rules. Such instruments commonly lack any power of sale clause, so once their true status is unmasked, judicial foreclosure becomes the creditor's only available remedy.

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§4.34 3. Unsecured and Partially Secured Notes: Fractionalizing Debt

An unsecured note is not governed by CCP §726(a) or any other antideficiency rule. *Childs v Hunt* (1970) 9 CA3d 276, 88 CR 34. Because there is no security to exhaust, the payee of an unsecured note may bring an action on it at any time, even if the note is given as part of the purchase price of real property.

If an obligation is divided into separate secured and unsecured notes, a creditor may have the dual benefits of a foreclosure and a money action, but only for separate components of the obligation. *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873. In no event do the benefits of one component apply to the other. The security protects only the secured note, even if the security has value above the face amount of the note. There is a clear trade-off, but it is one that may be valuable if the security value does not match the amount of the loan and if the debtor is a good collection target.

The trade-off between secured and unsecured notes may not be evaded by having the notes overlap (*i.e.,* both state the entire amount) rather than apportioning the obligation between them. *Freedland v Greco* (1955) 45 C2d 462, 289 P2d 463; *Nevin v Salk* (1975) 45 CA3d 331, 342, 119 CR 370; *Christopherson v Allen* (1961) 190 CA2d 848, 12 CR 658. A provision in the loan documents declaring that the security covers only a fraction of the note will also be unavailing because the security nevertheless "floats" as the note is retired, securing the entire payment of the note. *Loretz v Cal-Coast Dev. Corp.* (1967) 249 CA2d 176, 179, 57 CR 188. A partial release clause is likely to have the same effect.

PRACTICE TIP: Before splitting the obligation into secured and unsecured segments, the lender should carefully calculate the value of the security. For example, if the security value is $120,000, it would be unwise to take a $100,000 secured note and a $30,000 unsecured note because any surplus arising from a foreclosure sale under the secured note may go to junior lienholders or prior judgment creditors rather than to the unsecured note. Of course, loan-to-value ratio calculations may dictate lending only $100,000 on the basis of the $120,000 security.

On fractionalization and effect of antideficiency statutes, see §§5.12, 5.53.

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§4.35 C. Secured Money Judgments

A judgment creditor who accepts a note and deed of trust in the amount of the judgment is subject to CCP §726(a) and can no longer pursue its former remedies as a judgment creditor. *DiSalvo v DiSalvo (In re DiSalvo)* (BAP 9th Cir 1998) 221 BR 769, rev'd on other grounds at (9th Cir 2000) 219 F3d 1035 (execution on divorce court judgment secured by deed of trust violates §726(a)); *Rettner v Shepherd* (1991) 231 CA3d 943, 282 CR 687 (CCP §§726(a) and 580d barred further recovery following trustee sale under deed of trust).

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VII. WORTHLESS SECURITY EXCEPTION

§4.36 A. Legally Worthless Security

Code of Civil Procedure §726(a) does not apply when the creditor's security is legally worthless, *e.g.,* when the real property is nonexistent (see *Dyer Law & Collection Co. v Abbott* (1921) 52 CA 545, 199 P 340), nonmortgageable (see *Republic Truck Sales Corp. v Peak* (1924) 194 C 492, 515, 229 P 331), not owned by the mortgagor or trustor (see *Otto v Long* (1900) 127 C 471, 59 P 895), or not subject to being validly encumbered by the debtor (see *Curtin v Salmon River Hydraulic Gold Mining & Ditch Co.* (1903) 141 C 308, 74 P 851; *Powell v Patison* (1893) 100 C 236, 34 P 677). See *McPhee v Townsend* (1903) 139 C 638, 73 P 584. In such situations, foreclosure would be meaningless, so the courts permit the creditor to proceed directly on its note without first obtaining a deficiency judgment for the entire debt. *Otto v Long, supra*.

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§4.37 B. Economically Worthless Security

The worthless security exception does not apply if the security is valueless for economic rather than legal reasons. *Barbieri v Ramelli* (1890) 84 C 154, 23 P 1086; *Giandeini v Ramirez* (1936) 11 CA2d 469, 54 P2d 91. The beneficiary cannot justify avoiding foreclosure because it erred in its valuation of the security at the time the security was taken. Some cases justified the rule on the ground that the best way to resolve the question of value is by a foreclosure sale rather than by a court's substituting its opinion of value for that of the marketplace. *Security-First Nat'l Bank v Chapman* (1939) 31 CA2d 182, 87 P2d 724; *Giandeini v Ramirez, supra*. See also *Bartlett v Cottle* (1883) 63 C 366; *DiSalvo v DiSalvo (In re DiSalvo)* (BAP 9th Cir 1998) 221 BR 769, rev'd on other grounds at (9th Cir 2000) 219 F3d 1035. This rationale, however, appears inconsistent with the fair value restrictions on deficiency judgments, which derive their validity from the assumption that foreclosure sales do not produce market prices. Moreover, presale value hearings now appear necessary whenever an undersecured creditor seeks to attach other security under the attachment provisions. See CCP §483.010(b). But see discussion of environmentally impaired property in §§4.54-4.57, 5.60.

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§4.38 C. Partially Worthless Security

Under CCP §483.010(b), an undersecured creditor may attach other assets of the debtor even if its security is not entirely worthless. It is unclear what effect this attachment rule has on the applicability of CCP §726(a). See §4.20. Partial worthlessness probably does not justify noncompliance with the one-action rule, so a foreclosure action must still be brought. The effect of a presale attachment is likely to be limited to permitting the creditor to reach and execute on the attached assets only to satisfy a deficiency obtained after a judicial foreclosure sale. Because CCP §483.012 provides that the right to attach is subject to CCP §§580b and 580d, the creditor could reach and execute the attached assets only if the loan was not purchase money and if the foreclosure was not by trustee sale.

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D. Subsequently Worthless Security

§4.39 1. Destruction of Security

When the security is destroyed *after* execution of the deed of trust, the beneficiary may sue on its note and need not foreclose first. See *Cohen v Marshall* (1925) 197 C 117, 122, 239 P 1050 (mortgaged crops destroyed by rain and insects); *Toby v Oregon Pac. R.R.* (1893) 98 C 490, 33 P 550 (dictum on mortgaged ship lost at sea). The source of this exception is a section of California's attachment law that originally provided that attachment would issue either on a suit on an unsecured note or on a note for which the security had "without any act of the plaintiff … become valueless." Former CCP §537 (earlier wording). The current CCP §483.010(b) adds "or has decreased in value to less than the amount then owing on the claim." These provisions from the original attachment statute have been read into CCP §726(a), so that a beneficiary whose security becomes valueless may not only attach other assets of the debtor but also sue the debtor directly on the note without foreclosing first. *Barbieri v Ramelli* (1890) 84 C 154, 23 P 1086.

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§4.40 2. Decline in Value of Security

No court has yet applied the worthless security exception (CCP §483.010(b)) to security that merely declined in value to a point where the creditor believed it to be valueless. When an opinion of worth is required, the creditor must foreclose, allowing the market to establish worth. *Bartlett v Cottle* (1883) 63 C 366; *Security-First Nat'l Bank v Chapman* (1939) 31 CA2d 182, 87 P2d 724; *Giandeini v Ramirez* (1936) 11 CA2d 469, 54 P2d 91. See §§4.51-4.53, 5.57-5.59 on security impaired by waste.

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§4.41 3. Without Act or Fault of Creditor

The attachment provision for worthless security applies only if the security became worthless "without any act of the plaintiff or the person to whom the security was given." CCP §483.010(b). Thus, the attachment rule and the worthless security exception do not apply if the lender makes the security worthless. Although security is elsewhere regarded as something that is strictly for the creditor's benefit and therefore can be ignored if it becomes inconvenient, CCP §726(a) does not permit a creditor to unilaterally divest its security and instead proceed on the underlying obligation. *Western Fuel Co. v Sanford G. Lewald Co.* (1922) 190 C 25, 210 P 419; *Commercial Bank v Kershner* (1898) 120 C 495, 52 P 848. Only if the debtor consents may a creditor dispense with its security and proceed directly on the note. See CC §3513; *Martin v Becker* (1915) 169 C 301, 146 P 665; *Hibernia Sav. & Loan Soc'y v Thornton* (1895) 109 C 427, 42 P 447. See also *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7. Thus, a creditor that loses its security through its own voluntary act does not come within the worthless security exception to CCP §726(a). See *Hibernia Sav. & Loan Soc'y v Thornton, supra* (security discharged by improper probate proceedings by mortgagee); *Page v Latham* (1883) 63 C 75 (statute of limitations barred relief on security); *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298 (release of security to one debtor gives codebtor CCP §726(a) defense even though second debtor was not trustor under deed of trust); *Cooper v Burch* (1906) 3 CA 470, 86 P 719 (mortgagee released security of record).

If the former security has been irretrievably relinquished, arguably the creditor may lose both the right to use the security and the right to recover on the note because §726(a) allows the debtor to demand that the creditor exhaust the security before obtaining monetary recovery of the debt. See authorities cited in §4.6.

If the security is lost inadvertently because the trustee mistakenly reconveys it to the debtor and the debtor is probably aware of the mistake, the lender may sue for restitution from the proceeds of a subsequent sale by the debtor, despite CCP §726(a) and the other antideficiency laws. *First Nationwide Sav. v Perry* (1992) 11 CA4th 1657, 15 CR2d 173. See *Ghirardo v Antonioli* (1996) 14 C4th 39, 57 CR2d 687 (lender entitled to unrecovered portion of debt erroneously omitted from payoff demand). See CC §2943(d)(3) for statutory authority covering the situation in which the creditor has reconveyed the security based on an erroneous and understated payoff demand.

Although a lender may be able to sue for unjust enrichment following a mistaken reconveyance, there remain several possible hurdles to such claims. As indicated in *FDIC v Dintino* (2008) 167 CA4th 333, 84 CR3d 38, CCP §726 and other antideficiency rules may preclude an action on the secured debt or contract obligation following a mistaken reconveyance, leaving the creditor to rely on theories of unjust enrichment, implied and constructive contract, or common count. Such equitable theories may involve a need to prove additional elements (such as that the enrichment is unjust) and may also involve limitations periods shorter than the typical 4 years on a written contract and 6 years on a negotiable instrument. Although the court in *Dintino* agreed with the debtor that the 3-year limitations period of CCP §338 applied to the creditor's unjust enrichment claims, the creditor in *Dintino* prevailed because of the court's application of the delayed discovery rule. On delayed discovery rule, see §12.5. See also California Real Property Remedies and Damages §§3.62, 3.77 (2d ed Cal CEB 2002).

PRACTICE TIP: Different facts may make the delayed discovery argument difficult or impossible, and a lender in a mistaken reconveyance situation should bring its money lent and unjust enrichment claims promptly on discovery of the mistake. See analysis of *Dintino* and practice advice in Bernhardt, *The Editor's Take,* 31 CEB Real Prop L Rep 208 (Nov. 2008).

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§4.42 E. Sold-Out Junior Creditor

Changes in market conditions and property values affect the holder of a junior deed of trust far more than the senior lienholder. When the senior lien is large in relation to the total value of the property, a slight decline in property value may render the junior's security partially or even totally worthless.

EXAMPLE: On a house worth $600,000, if the first deed of trust secures a loan of $500,000 and the second deed of trust secures a $40,000 loan, the junior's $40,000 debt is secured by $100,000 of value remaining in the property. If prices fall 15 percent, however, reducing the total value of the house by $90,000 to $510,000, then the junior's $40,000 claim is secured by only $10,000 of remaining value in the house and the junior is clearly undersecured. A decline in values of 20 percent leaves the junior entirely unsecured and the security effectively worthless.

A decline in value does not by itself permit an unpaid junior to ignore the security and proceed against the trustor directly. *Barbieri v Ramelli* (1890) 84 C 154, 23 P 1086; *Giandeini v Ramirez* (1936) 11 CA2d 469, 54 P2d 91. Following the trustor's default, a junior who believes that the security has no value because of the amount of the senior lien(s) may not use that as an excuse to bypass CCP §726(a). The junior must first foreclose judicially and sell the property subject to the paramount lien(s). If the junior is correct about the property's value, the sale will not produce sufficient proceeds to pay the junior obligation, and the junior may then obtain a deficiency judgment for the entire amount of the debt.

The situation changes if, after the trustor's default, the senior lienholder forecloses its lien. A senior foreclosure sale conveys the property free of all junior liens (see §§2.99, 3.32). Thus, the junior no longer has a lien on the property, and the security has been entirely destroyed. The security has thus become valueless and the junior may then sue directly on its note, subject to the antideficiency rules (see chap 5) and any nonrecourse provisions in it.

The sold-out junior creditor is a common phenomenon. A defaulting trustor is likely to default on both the senior and junior notes, and a foreclosing senior beneficiary has no motivation to bid more than the amount owed on the first deed of trust. The junior creditor's ability to file a separate action means that the trustor may become subject to two separate proceedings: (1) a foreclosure by the senior and (2) a court action by the sold-out junior on the second note. Section 726(a) thus fails to protect the trustor from a multiplicity of actions if the property is subject to two deeds of trust. The sold-out junior may sue on its note whether the senior foreclosure is judicial or nonjudicial, meaning that the debtor may be named as a defendant in two separate actions. More important, because an action on the note also bypasses many of California's antideficiency rules, the sold-out junior exception also strips the trustor of many antideficiency protections. See §§5.14-5.15, 5.39-5.44.

PRACTICE TIP: Although the worthless security exception (see §4.36) entitles the junior to ignore a senior sale, if the value of the security clearly exceeds the amount owed to the senior creditor and if the solvency of the debtor is in doubt, the junior should consider bidding at the senior sale. Cash is required at the sale because the junior cannot make a credit bid (even for the overage) at a sale not conducted by it, but the amount bid in excess of the senior lien will be returned as surplus to the junior (see §§2.76-2.79, 2.83). If the property's value exceeds the amount of the senior lien and the debtor is otherwise insolvent, the junior should consider reinstating the loan and either conducting its own trustee sale (see chap 2) or seeking a judicial foreclosure sale (see chap 3) so that it may acquire the property by credit bidding rather than by paying cash. If the junior lender succeeds in purchasing the property, the fair value limitation of CCP §§726(b) and 580a applies in calculating the size of any deficiency judgment sought after a judicial foreclosure. On full credit bids and underbidding strategies, see §§2.84-2.87. On credit bidding in judicial foreclosure, see §§3.76, 3.80-3.81.

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§4.43 1. Participation in Senior Sale

Because the worthless security exception applies only if the creditor is not at fault with regard to loss of the security, a sold-out junior must also show that its actions did not cause the loss. Early cases rejected the contention that the junior was at fault when it failed to appear at the senior's foreclosure action, despite the evident consideration that the antimultiplicity policy of CCP §726(a) should favor a single consolidated action in preference to separate and multiple actions against a debtor who has two creditors. *Savings Bank v Central Mkt. Co.* (1898) 122 C 28, 54 P 273. In a judicial foreclosure action brought by the first lienholder, the second lienholder will inevitably be named as a defendant to validate and perfect the foreclosure sale. See §3.32. Under the general rules of pleading, a cross-complaint by the junior for foreclosure of its lien would be proper. See *Hibernia Sav. & Loan Soc'y v London & Lancashire Fire Ins. Co.* (1903) 138 C 257, 71 P 334 (judgment lienor); *Stockton Sav. & Loan Soc'y v Harrold* (1900) 127 C 612, 60 P 165. Had the junior creditor been obliged to join in any senior foreclosure action, it would also have foreclosed its own deed of trust in the same action and claimed the surplus proceeds from the sale. In these circumstances, a junior that failed to participate should be treated as having made its security worthless by its own inaction, thus rendering itself ineligible for relief. *Hibernia Sav. & Loan Soc'y v Thornton* (1895) 109 C 427, 42 P 447, discussed in §§4.41, 4.62.

The law, however, developed otherwise. If a junior cross-complains to foreclose its own deed of trust, it loses the right to redeem from the senior sale (under an earlier rule permitting junior redemption from senior sales as long as the junior lien was not itself foreclosed). *San Jose Water Co. v Lyndon* (1899) 124 C 518, 57 P 481. See *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873. See also §3.87. On postsale redemption, see §§3.90-3.101. Thus, there is no incentive for a junior to participate in senior foreclosure actions, even when named as a party, and the worthless security exception has eliminated the potentially dangerous sanction effect of CCP §726(a) in such cases. A junior lender may even interrupt and delay its own sale to permit a senior sale to go first, which would result in the junior security's becoming worthless. *Bank of America v Graves* (1996) 51 CA4th 607, 59 CR2d 288. Such an affirmative delay is not regarded as fault. See Bernhardt, *One Action or One Exception,* 20 CEB Real Prop L Rep 200 (Aug. 1977).

A junior that completes a junior sale cannot claim sold-out junior status following a later sale by the senior merely because it failed to obtain or record a trustee's deed at its own junior sale. *Ballengee v Sadlier* (1986) 179 CA3d 1, 224 CR 301. The sale itself eliminated the former junior lien, and the junior's further relief is only by way of a deficiency judgment, if allowable.

On mistaken release of security, see §4.41.

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§4.44 2. Junior Also Senior Lienholder

A single lender may hold both first and subordinate liens on the same security. If the first lien is to be sold in the secondary market, it will have greater value if the riskier aspect of the loan is carved off and allocated to the junior lien, as in the following examples:

- An "equity line" of credit may be carried in a junior secured position by the same lender holding the debtor's first mortgage (often called "kangaroo loans").
- The junior loan may be an additional advance by the senior lender, which was not accorded the same priority as the first loan because it was considered "optional" rather than "obligatory" or "protective" (see §§9.59-9.73).
- As part of a workout, defaulted back interest may be capitalized into a second mortgage to earn interest.
- Frequent transfers in secondary markets may also lead to temporary holdings of both interests by the same lender.

The one-action rule of CCP §726(a) is raised when the lender forecloses on its senior lien—selling out its junior position—and then seeks to sue under the sold-out junior exception on its junior note. See *Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549 (dragnet clause in junior deed of trust meant that two liens were merged; CCP §580d barred any further monetary recovery following foreclosure); *Simon v Superior Court* (1992) 4 CA4th 63, 5 CR2d 428 (same result when positions held by same lender even though no dragnet clauses). But see *National Enters., Inc. v Woods* (2001) 94 CA4th 1217, 115 CR2d 37 (antideficiency provisions, including CCP §726, do not bar judgment by junior creditor sold out in senior judicial foreclosure sale when two loan positions were originally held and made by same lender but later sold to separate entities and senior loan did not contain broad dragnet provisions found in *Wendland*). For further discussion of sold-out juniors who are also senior lienholders, see §5.12; on dragnet clauses, see §§9.59-9.73.

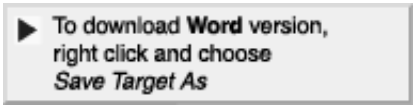
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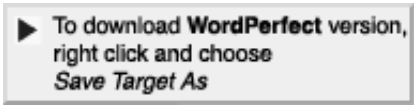
§4.45 3. Complaint

Because the courts permit a junior to sue directly on the note when the senior has foreclosed (see §4.42), the complaint may take the form of a simple action to collect on an unsecured note. To eliminate the prospect of the debtor's raising CCP §726(a) as a defense, however, the complaint should include an allegation that the security is worthless (see §4.46).

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§4.46 4. Form Provision: Allegation of Worthless Security





The note was originally secured by a deed of trust executed by defendant and delivered to plaintiff. The security interest created by the deed of trust has become valueless without any act or fault of plaintiff, because the property encumbered by the deed of trust has been foreclosed on and sold under a deed of trust senior and paramount to the deed of trust given to plaintiff. _ _[*No portion of the proceeds from the senior sale was available for the satisfaction of plaintiff's note./*_ _[*Dollar amount*]_ _ *was received from the senior sale, providing only partial satisfaction of plaintiff's note, leaving a balance of* _ _[*dollar amount*]_ _ *due and unpaid.*]_ _

Comment: This allegation should be used in the complaint when a sold-out junior lienholder sues directly on the note. See §§4.36, 4.42, 4.45. Some practitioners prefer to delete the phrase "without any act or fault of plaintiff" in the second sentence because they believe that by making this allegation they may be compelled to prove an unnecessary fact, thus shifting the burden of proof. Other practitioners argue that the mere pleading of ultimate facts in a complaint does not shift the burden of proof.

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§4.47 VIII. PROCEEDINGS NOT BARRED BY CCP §726(a)

A cause of action arising within the context of the lender-debtor relationship but not based on the obligation itself is not subject to CCP §726(a). Such causes of action may include the following:

- Fraud (see §4.48);
- Rent skimming (see §4.49);
- Mistake (see §4.50);
- Waste (see §§4.51-4.53); and
- Environmental impairment (see §§4.54-4.57).

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§4.48 A. Fraud

A creditor may bring an action for damages for fraud against a borrower despite CCP §726(a) and other antideficiency rules (see §5.55). This exemption is limited to loans that (CCP §726(a), (f)-(h); Fin C §§7459-7460)

- are made by institutional lenders and loan brokers;
- exceed $150,000 (adjusted for inflation after 1987); and
- are not secured by owner-occupied, single-family residences.

Courts have created the same general exemption without including the special statutory restrictions. These decisions, however, all involve deficiency judgment protections other than CCP §726(a). See §§4.6-4.10.

Code of Civil Procedure §726(f), (h) and Fin C §§7459-7460 clearly provide that a monetary fraud action may be brought despite CCP §726(a), but it is unclear whether this rule is intended to eliminate both the security-first and the antimultiplicity policies of §726(a). A court could apply the security-first policy only to prohibit a lender from seeking damages from a trustor for fraud until *after* completion of the foreclosure of the security. If a court rendered a judgment for damages in a prior fraud action, it would need to also decide how such recovery should affect the size of the remaining obligation when foreclosure is later sought. This issue should not arise when the defendant is a third party rather than the trustor-borrower, in which case there is no reason to prohibit a prior fraud action, although the question of crediting the award against the debt (or the security against the damages) will remain. See *Hardin v Gianni (In re King St. Invs.)* (BAP 9th Cir 1998) 219 BR 848 (lender who accepted deed in lieu of foreclosure may sue third party nonborrower who solicited loan for borrower for misrepresenting value of security). But see *Michelson v Camp* (1999) 72 CA4th 955, 85 CR2d 539 (lender could not recover against appraiser for fraud because amount of credit bid at foreclosure sale was greater than all fraud- and loan-related damages).

See §§2.121-2.126 on effect of full credit bid on fraud claims.

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§4.49 B. Rent Skimming

Civil Code §891(g) provides that an action for damages for the purchaser's "rent skimming" (pocketing rents collected rather than applying them to the obligations) is subject to neither CCP §726(a) nor any of the other statutory deficiency prohibitions. As with fraud (see §4.48), there is a similar issue regarding when to bring a rent-skimming action. Because the statute permits damages of treble the amount of the rent skimmed in multiple acts of rent skimming, if that action precedes foreclosure, the court in the foreclosure action would have to decide whether all or merely one third of the previous recovery should be applied to the debt.

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§4.50 C. Mistake

Under CC §2943(d)(3), a lender is bound by any incorrect beneficiary statement it issues, but any amounts omitted from the statement survive as a recoverable unsecured claim. The statute merely codifies the equitable principles of unjust enrichment, mistake, and estoppel when the beneficiary suffers a loss because of an inadvertently incorrect payoff demand. *Ghirardo v Antonioli* (1996) 14 C4th 39, 57 CR2d 687. A later action for the omitted part of the debt is not subject to CCP §726(a), because the relief sought is not for a deficiency judgment (because recovery is not for the balance of the debt but only for the amount omitted from its payoff demand).

See §2.84 for mistaken full credit bids. On antideficiency rules and unjust enrichment, see §5.54.

NOTE: Not every writing from the creditor that purports to state the balance of the secured obligation will constitute a statutory payoff demand under CC §2943. Thus, in *California Nat'l Bank v Havis* (2004) 120 CA4th 1122, 16 CR3d 245, the court held that a lender's use of the term "payoff funds" in a letter to escrow acknowledging the unanticipated receipt of a check outside of escrow that had not yet cleared did not constitute a statutory payoff demand under CC §2943.

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D. Waste

1. Waste by Trustor

§4.51 a. Impairment of Security

Civil Code §2929 imposes on the trustor a duty not to "substantially impair the mortgagee's security," which is commonly referred to as "the duty to avoid waste." Most deeds of trust amplify this requirement by requiring the trustor to do the following:

- Keep the secured property in good condition and repair;
- Refrain from removing improvements;
- Restore damaged improvements promptly;
- Pay all construction claims when due;
- Comply with all laws affecting the property; and
- Avoid waste.

Like the statute, this type of provision is described as prohibiting waste, although technically it instead protects the beneficiary against impairment of security. *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557. See *Easton v Ash* (1941) 18 C2d 530, 116 P2d 433; *Southern Pac. Land Co. v Kiggins* (1930) 110 CA 56, 293 P 708. True waste recovery, such as a landlord may have against a tenant, is not limited by the size of the secured obligation or by CCP §726(a) considerations, as is true for impaired security. See *People ex rel Dep't of Transp. v Redwood Baseline, Ltd.* (1978) 84 CA3d 662, 149 CR 11.

A covenant against waste in the deed of trust may not protect the lender as well as CC §2929 does, because, unlike §2929, such a covenant does not bind nonassuming successor owners and cannot support a personal money judgment against them. *Cornelison v Kornbluth, supra*. All successors nevertheless do take subject to the covenant (along with all other provisions of the deed of trust) so that breach may be a ground for declaring a default and foreclosing against their interests. *Braun v Crew* (1920) 183 C 728, 192 P 531. See §§3.24, 9.127.

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§4.52 b. Timing of Waste Action

Despite old case law declaring that a mortgagee may bring an action for damages for waste against the mortgagor (*Lavenson v Standard Soap Co.* (1889) 80 C 245, 22 P 184; *Robinson v Russell* (1864) 24 C 467), it is unlikely that the current interpretation of CCP §726(a) will permit a damage action to be filed before completion of the foreclosure sale. See *American Sav. & Loan Ass'n v Leeds* (1968) 68 C2d 611, 68 CR 453; *Osuna v Albertson* (1982) 134 CA3d 71, 184 CR 338; *Krone v Goff* (1975) 53 CA3d 191, 127 CR 390.

In *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, the supreme court stated that a judgment for waste is similar to a deficiency judgment. To maintain that equivalence, the judgment for waste may have to be entered after—not before—the foreclosure sale. As a practical matter, it is difficult to know whether there has been any impairment of security until after the property is sold and the proceeds applied to the debt. Conversely, if the "bad faith" exception in CCP §§580b and 580d cases for waste (see §§5.57-5.58) applies to §726(a) issues, it may permit a beneficiary who can prove that the waste is being committed in bad faith to sue at once, without foreclosing first. For discussion of what constitutes bad faith waste, see *Osuna v Albertson* (1982) 134 CA3d 71, 184 CR 338; *Hickman v Mulder* (1976) 58 CA3d 900, 130 CR 304; *Mills v Sdrawde Titleholders, Inc. (In re Mills)* (9th Cir 1988) 841 F2d 902. See also §§2.119-2.120.

If the security-first principle prohibits recovery of damages for waste until after foreclosure, then the beneficiary will probably be permitted to foreclose even when the obligation is not otherwise in default if waste has been committed. Civil Code §2929, however, does not provide for foreclosure for waste, allowing monetary or injunctive relief instead. See *Easton v Ash* (1941) 18 C2d 530, 116 P2d 433; *Conde v Sweeney* (1911) 16 CA 157, 116 P 319. Under CCP §564(b)(2), the beneficiary may have a receiver appointed to prevent waste, but only incident to a judicial foreclosure proceeding. Foreclosure may therefore be the only sensible remedy if waste is committed by a debtor who has not defaulted on the note or if the loan documents provide that waste by the borrower is an event of default. If the trustor disputes the claim of waste, it may do so either as a defense to a judicial foreclosure (see chap 3) or in an action to enjoin a trustee sale (see chap 7).

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§4.53 2. Third Party Waste

If waste is committed by a third party, CC §2929 does not apply and the beneficiary's rights against the third party are analyzed under general tort principles. *United States Fin. v Sullivan* (1974) 37 CA3d 5, 112 CR 18. Because the defendant is neither the debtor nor a successor owner in such cases, neither the protections of CCP §726(a) nor those of §§580b and 580d apply (see §§5.5, 5.58), and the beneficiary may sue for impairment of the security without first foreclosing. Because any damage recovery will be applied to the debt, the trustor is benefited by the third party tort action proceeding first. If the waste is the result of joint actions of the trustor and a third party, as in *Lavenson v Standard Soap Co.* (1889) 80 C 245, 22 P 184, timing problems arise for which no simple solution is available.

Waste by a third party may be actionable at the instance of the trustor as well as the beneficiary. *American Sav. & Loan Ass'n v Leeds* (1968) 68 C2d 611, 68 CR 453; *Duarte v Lake Gregory Land & Water Co.* (1974) 39 CA3d 101, 113 CR 893. Nothing in a standard deed of trust prohibits the trustor from suing third parties for damage to the real property or permits the beneficiary to demand any part of an award made to the trustor.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/4 CCP §726(a): The One-Action Rule/§4.54 E. Environmentally Impaired Property

§4.54 E. Environmentally Impaired Property

When real property is contaminated, federal and state laws require the owner or operator to remediate the situation and incur the necessary response costs of restoring the property to its precontamination state. See, *e.g.,* Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675). Such potential cleanup liability presents special fears to secured real estate lenders for the following reasons:

- If the cleanup costs exceed the value of the borrower's equity in the property, the borrower may decide to stop servicing the loan;
- If the property is sold at foreclosure, other bidders will subtract anticipated cleanup costs from their bids because they will be deemed owners or operators on acquisition of the property; and
- If the lender acquires the title itself, or if it is otherwise deemed a potentially responsible party, it may find that not only has its loan gone unpaid but that it must also pay to remediate the property.

For further discussion, see §§12.151-12.153. On antideficiency and contamination issues, see §5.60.

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§4.55 1. Election to Waive

Despite the one-action rule, CCP §726.5(a) permits a lender securing property that is "environmentally impaired" to waive its security and exercise the rights of an unsecured creditor, including obtaining a money judgment. (The lien may also be waived for any "affected parcel," *i.e.,* one close to the environmentally impaired parcel. CCP §726.5(e)(1).) To take advantage of this section, the following factors must be present:

- The property must be large (commercial or over 15 residential units) (CCP §726.5(e)(5));
- The borrower must know of or have caused the impairment (CCP §726.5(d)(1); see also CCP §726.5(e)(3));
- The lender must first sue and prove the impairment (CCP §726.5(b));
- The lender must foreclose on any other collateral it holds (CCP §726.5(c)); and
- The secured obligations must have been made, renewed, or modified on or after January 1992 (CCP §726.5(g)).

"Environmentally impaired" property is defined as property that sustains a release or threatened release of hazardous substances not disclosed to, or actually known by, the lender before the loan is made if the cleanup or remediation costs exceed 25 percent of the fair market value of *all* security for the loan. CCP §726.5(e)(3). An additional category of environmentally impaired property is property included on the National Priorities List under 42 USC §9605 or on a similar state list under Health & S C §25356(b)(1) and (c). CCP §726.5(e)(3).

The definition of "borrower" appears to require the trustor or its successor to be obligated on the secured obligation, whether that is a note or a guaranty. CC §2929.5(e)(1); CCP §§564(e)(1), 726.5(e)(2), 736(f)(1). Thus, CCP §726.5 may not apply if a third party gives a suretyship deed of trust to secure another's loan or guaranty.

Section 726.5 requires the lender to proceed against the other collateral first, and it also subjects any further recovery to fair value and trustee sale antideficiency rules. A lender holding nonpurchase money paper must, therefore, foreclose judicially, determine the fair value of the property sold, and proceed under this section within 3 months.

PRACTICE TIP: The CCP §726.5 exception to the exhaustion of security rule has not been widely used because of the delay and expense of litigating the preliminary issue of environmental impairment. Using the procedure may make sense only if the debtor and junior creditors agree to stipulate that the property is "environmentally impaired" or if the creditor is confident that such impairment can be established quickly and efficiently, *e.g.,* by summary adjudication.

On waiver and other antideficiency statutes, see §§5.64-5.70.

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§4.56 2. Environmental Indemnities

A secured lender may bring an action for money or to enforce any "environmental provision" made by a trustor, and that action "shall not constitute an action within the meaning of" CCP §726(a). CCP §736(a). An "environmental provision" is the trustor's written representation or covenant that relates to hazardous substances, made in connection with the origination, renewal, or modification of a secured loan. CCP §736(f)(2). The provision may be secured or unsecured, and it may be contained in the deed of trust or elsewhere. If in a deed of trust, it continues in effect even after the deed of trust has been reconveyed or foreclosed.

The value of securing such an indemnity by the same property that secures the loan, however, is problematic at best. If contamination reduces its value below the loan balance, it affords no economic security for the indemnity agreement, leaving the lender to seek relief for cleanup costs as an unsecured creditor. The statute does not explicitly say whether the indemnity may be secured by different collateral, although it does seem to contemplate that situation. The advantage to a lender of using other collateral of the debtor to secure the indemnity, rather than as mere additional security for the loan itself, is that the cleanup cost recovery on the indemnity represents a categorically different loss from nonpayment of the loan. The combination of security may permit the lender to acquire the basic property (for default on the loan) and to acquire the collateral property (for failure to clean up the basic property). (Note that the lender may elect to waive its security on the basic property that is environmentally impaired.) It is also possible to take an unsecured environmental indemnity when the debtor is solvent enough to make that step worthwhile. See Cooper, *Unsecured Environmental Indemnity Agreements,* 12 CEB Real Prop L Rep 95, 98 (Apr. 1989).

Much like CCP §726.5, CCP §736 applies only if the following factors are present:

- The property is large (commercial or over 15 residential units);
- The obligation exceeds $200,000;
- The borrower caused the impairment; and
- The secured obligation to which the indemnity relates was made, renewed, or modified after 1991 (CCP §726.5(g)).

Unlike §726.5, however, the lender is not required to sue first and prove the impairment or to foreclose first on any other collateral it holds.

A lender may recover cleanup costs, including response costs demanded by government (rather than the unpaid balance of the loan, which is recoverable under CCP §726.5). CCP §736(b)(1)-(2). Recoverable cleanup costs are those ordered by a government agency or, in the absence of a governmental mandate, those that are reasonable and made in good faith. CCP §736(b)(1)-(2). Damages include attorney fees and costs relating to the breach (CCP §736(b)(4)), but they do not include any part of the secured obligation (except for amounts advanced to cure or mitigate the breach of the environmental provision) (CCP §736(b)(1)). An action for an injunction or specific performance of the environmental provision may be brought only while the loan is still unpaid and only against a trustor who still owns the real property security. CCP §736(a). An action for damages is not subject to these restrictions and may therefore be brought. CCP §736(a).

A lender may also sue for indemnification of its liability to third parties for damages not caused by it and incurred while the defendant trustor owned or operated the property. CCP §736(b)(3).

NOTE: The trustor also has an innocent-owner defense: The trustor is not liable if it did not cause the release of a hazardous substance and was ignorant of the problem or had disclosed the problem to the lender (or the lender knew of it) at the time the loan originated, was modified, or was renewed. CCP §726.5(d).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/4 CCP §726(a): The One-Action Rule/§4.57 3. Right to Enter and Inspect; Appointment of Receiver

§4.57 3. Right to Enter and Inspect; Appointment of Receiver

Civil Code §2929.5(a) permits a secured lender to enter and inspect property to look for a release or threatened release of a hazardous substance. The entry

- must be based on a reasonable belief in the existence of a previously undisclosed hazardous substance (CC §2929.5(a)(1)); or
- may be made before or during a judicial or nonjudicial foreclosure action (CC §2929.5(a)(2)); and
- may not be abused or used to harass the occupant (CC §2929.5(b)); and
- must be preceded by reasonable notice (CC §2929.5(b)).

If such entry or inspection is denied, the lender may petition a court for enforcement. This petition is not an action covered by CCP §726(a). CC §2929.5(d). Even without this provision, courts are unlikely to hold that a nonmonetary claim, similar to a restraining waste action, constituted a lender's single action. For further discussion of CC §2929.5, see §5.60.

Also exempt from §726(a) is an action to appoint a receiver to enforce the creditor's inspection rights under CC §2929.5. CCP §564(c)-(d). Code of Civil Procedure §564 is confusing because it treats the lender, not the receiver, as the party making the inspection. CCP §564(c).

NOTE: The various environmental sections described in §§4.54-4.56 do not have identical scope of application. The exclusions in CC §2929.5(e)(3) and CCP §564(e)(3) on right of entry and appointment of a receiver are limited to 1 to 15 dwelling units located on parcels of one acre or less. The exclusions in CCP §§726.5(e)(5) and 736(f)(4) on waiver of lien and remedies for environmentally impaired property do not have a size limit on the parcels and cover property that is also used for incidental agricultural or commercial purposes.

For more detailed analysis, see Ferguson, Weir, Brody & Louie, *Assembly Bill 1735: New Rights for Lenders Holding Contaminated Real Property Security,* 15 CEB Real Prop L Rep 1 (Jan. 1992).

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IX. CHOICE OF LAW

§4.58 A. Location of Secured Property

Code of Civil Procedure §726(a) applies only if the real property serving as security is in California. *First-Trust Joint Stock Land Bank v Meredith* (1936) 5 C2d 214, 53 P2d 958; *Felton v West* (1894) 102 C 266, 36 P 676. Thus, a creditor holding non-California real property as security may sue on its note in California without foreclosing first, assuming that the state in which the property is located does not have a one-action rule (if it does, California would probably enforce the sister-state rule, particularly if the parties had agreed to a choice of law provision designating the sister state's law as the law of choice). Restatement (Second) of Conflict of Laws §229 (1971) suggests, however, that the security-first rule of CCP §726(a) should still apply (even though the one-action rule would not) under the principle that local law applies to foreclosure procedures but not to substantive rights of the debtor. The Restatement rule permits the creditor to bring a separate action for a deficiency judgment, but only after the foreclosure. See *Younker v Reseda Manor* (1967) 255 CA2d 431, 63 CR 197. For a similar analysis, applying the "substantive" provisions of CCP §580b to foreclosure of a debt secured by Nevada property, see *Kish v Bay Counties Title Guar. Co.* (1967) 254 CA2d 725, 62 CR 494.

When the security is located out of state, a California debtor may be protected if the loan documents specify that California law applies and the other jurisdiction enforces that provision, *i.e.,* requires the creditor to foreclose first in California. Under CC §1646.5, such an agreement is enforceable if the transaction is at least $250,000, even though it bears no reasonable relation to California. Even if the security is in California, however, the documents may provide for application of the law of some other jurisdiction. See *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330; *Guardian Sav. & Loan Ass'n v MD Assocs.* (1998) 64 CA4th 309, 75 CR2d 151 (when all significant contacts are with Texas, Texas choice of law clause permits California deficiency judgment despite CCP §580b).

It remains to be seen whether CCP §726(a) may be evaded by a boilerplate provision declaring a contact with some other jurisdiction and providing for application of that foreign jurisdiction's law. The argument that California statutes embodying "fundamental" public policy cannot be defeated by a contractual choice of law provision gained support in *ABF Capital Corp. v Grove Props. Co.* (2005) 126 CA4th 204, 23 CR3d 803. The *ABF* case involved an assumption of liabilities contract containing a choice of law clause specifying New York law. The clause contained a one-sided attorney fee provision that contradicted the fee reciprocity policy embodied in CC §1717. Conceding that New York law otherwise controls interpretation of the contract, the court nevertheless ruled that CC §1717 represents too basic and fundamental a policy statement to be evaded by way of a choice of law provision. But see *ABF Capital Corp. v Berglass* (2005) 130 CA4th 825, 838, 30 CR3d 588, for a diametrically opposite holding (with similar facts, parties, and contract) that "California's interest is not materially greater than New York's." There is authority describing CCP §726 and the other antideficiency protections as "fundamental" and grounded in public policy. See, *e.g*., California Supreme Court cases cited in §§4.3-4.8.

On issues concerning conflict of laws and California antideficiency rules, see Comment, *Application of California's Antideficiency Statutes in Conflict of Laws Contexts,* 73 Cal L Rev 1332 (1985).

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§4.59 B. Application of Federal Law

When federal agencies, such as the Federal Housing Administration (FHA) or Veterans Administration (VA), insure or guarantee loans (see, *e.g.,* 38 CFR §36.4323(e)), their collection efforts are subject to federal rather than state law. See *Carter v Derwinsk*i (9th Cir 1993) 987 F2d 611 (VA subject to state antideficiency rules only if it sues via subrogation rather than indemnity). State law is otherwise followed only if it furthers the policy behind the federal loan program in question or if the government has waived its federal rights and consented to state regulation of enforcement on default. *U.S. v Ellis* (9th Cir 1983) 714 F2d 953; *U.S. v Stewart* (9th Cir 1975) 523 F2d 1070. Both the Multifamily and Single Family Mortgage Foreclosure Acts permit the federal agency to sue on its note without having to foreclose first. 12 USC §§3705, 3755.

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§4.60 X. WAIVERS

A borrower may not waive CCP §726(a) protection "in connection with the making of or renewing of" a secured loan. CC §2953. A waiver of CCP §726(a) would purport to permit the secured creditor to immediately sue on its note as an alternative to first foreclosing. See *Winklemen v Sides* (1939) 31 CA2d 387, 88 P2d 147. See §§5.64-5.70 on waiver of the antideficiency rules.

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§4.61 A. Disguised Waivers

The proscription against waivers and attempted waivers of the antideficiency protections is not limited to explicit waivers included in the note or security instrument. The courts will invalidate a transaction if they perceive that it was structured with the underlying purpose of depriving the debtor of antideficiency or one-action protections:

- A deed in lieu of foreclosure given to the creditor contemporaneously with the mortgage or deed of trust is invalid as an attempt to make the debtor waive the right of redemption and the right to have the property sold at a public sale after default. *Hamud v Hawthorne* (1959) 52 C2d 78, 338 P2d 387.
- A deed absolute that is intended as a mortgage is subject to all foreclosure rules. See *Byrne v Hudson* (1899) 127 C 254, 59 P 597.
- A covenant against encumbrances, which arguably permitted the creditor to claim that it constituted an equitable mortgage or a negative pledge, was treated by the courts as a disguised waiver, and the courts gave the debtor, rather than the creditor, the election. *Tahoe Nat'l Bank v Phillips* (1971) 4 C3d 11, 92 CR 704. See §§3.44, 8.9-8.10.
- For many years, use of a deed of trust was used to deprive the debtor of the protection of CCP §726(a) on the ground that a deed of trust was not a mortgage. However, the supreme court's decision in *Bank of Italy Nat'l Trust & Sav. Ass'n v Bentley* (1933) 217 C 644, 20 P2d 940, that both instruments have the same economic effect, subjected deeds of trust to §726(a). See §1.35.
- In contrast, even though a power of sale provision clearly constitutes a waiver of the judicial foreclosure requirement of CCP §726(a), it has always been permitted. *Fogarty v Sawyer* (1861) 17 C 589. Considering that it took nearly 75 years for the courts to recognize that a deed of trust should not be permitted to accomplish a waiver of §726(a) (from 1859 (*Koch v Briggs* (1859) 14 C 256) until 1933 (*Bank of Italy Nat'l Trust & Sav. Ass'n v Bentley, supra*)), it is possible, albeit extremely unlikely, that the power of sale clause will someday suffer a similar fate. On disguised waivers of other antideficiency provisions, see §5.65.

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§4.62 B. Unilateral Waivers by Creditor

A valid waiver requires an act of the debtor. The creditor alone cannot waive the debtor-protection rules or shed the security and its attendant restrictions. Although creditors holding worthless security are exempt from several of the debtor-protection rules (see §§4.36-4.46, 5.10-5.12, 5.40-5.44), these exemptions do not apply when the creditor is personally responsible for loss of the security. See *Hibernia Sav. & Loan Soc'y v Thornton* (1895) 109 C 427, 42 P 447. Thus, a beneficiary may not cancel its security to sue on its note as an unsecured creditor. *Merced Sec. Sav. Bank v Casaccia* (1894) 103 C 641, 37 P 648; *Barbieri v Ramelli* (1890) 84 C 154, 23 P 1086. The beneficiary may release the security, but all obligors must join in the release for it to have the effect of entirely waiving CCP §726(a) and the other antideficiency rules. See also *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298 (release of security gives unconsenting obligor complete defense to debt based on creditor's inability to exhaust and apply security).

A unilateral release does not exempt the transaction from debtors' antideficiency protections. See *Crisman v Lanterman* (1906) 149 C 647, 87 P 89. In one case, the court suggested that a mortgagee that releases part of its security may still obtain a deficiency judgment by first crediting the mortgagor with the full value of the released portion (see *Woodward v Brown* (1897) 119 C 283, 51 P 542), but there is a greater likelihood that the release of even part of the security without the trustor's consent may totally bar a deficiency judgment if the trustor makes a timely objection to the release (see §9.5). Even when a waiver and release is valid against the trustor, it may be ineffective against nonconsenting rival lienors. *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712.

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§4.63 C. Waivers Contemporaneous With Making of Loan

A waiver of any antideficiency protection that is made contemporaneously with the making of the loan is invalid. California courts take the view that, to obtain a loan, a necessitous borrower will always waive all its rights at the creditor's insistence. See *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7. Thus, a provision in the loan documents entitling the beneficiary to sue on the note without first foreclosing on the security is invalid. *Winklemen v Sides* (1939) 31 CA2d 387, 88 P2d 147. A provision found in many current deeds of trust permitting the beneficiary to reconvey any part of the security without affecting the trustor's liability is not likely to be judicially construed to violate CCP §726(a), and it would surely be held invalid if it were so read. On contemporaneous waivers of other antideficiency protection, see §5.67.

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§4.64 D. Subsequent Waivers

In contrast to the rule invalidating contemporaneous waivers of CCP §726(a) (see §§4.61-4.63), some California courts have upheld "subsequent" waivers, *i.e.,* certain waivers made by the trustor after the deed of trust was executed. See, *e.g., Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7. But see *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712, questioning and disallowing conduct that constituted a subsequent waiver. The CC §2953 prohibition against waiving CCP §726(a) or related code sections (see §4.60) is limited to waivers made in conjunction with the making or renewing of a loan, but not at other times. *Morello v Metzenbaum* (1944) 25 C2d 494, 154 P2d 670 (waiver made at time of loan extension).

Whether a loan that has been modified by the parties as part of a workout agreement is considered "made" or "renewed" is unclear. There is no statutory or clear judicial definition of that phrase in CC §2953 prohibiting waivers "in connection with the making of or renewing of" a secured loan (see *Russell v Roberts* (1974) 39 CA3d 390, 114 CR 305, disapproved on other grounds in *DeBerard Props. v Lim* (1999) 20 C4th 659, 662, 85 CR2d 292; *Morello v Metzenbaum, supra*), and a loan extension may conceivably be treated as a renewal, meaning that waivers given by the debtor as consideration for it are invalid.

PRACTICE TIP: Drafting and labeling the workout agreement as a forbearance of the original loan—rather than as an extension or renegotiation of it—may increase the validity of waivers accompanying it. If more is involved, however (*i.e.,* changes in amounts, rates of interest, or deadlines), the forbearance label may not help. The new terms may be enforceable, but the debtor's waivers may be unenforceable. On problem loan workouts, see chap 10.

Waiver by inaction has always been more common than contractual waiver. When a beneficiary brings an action on the note, the trustor may plead CCP §726(a) as an affirmative defense, contending that the beneficiary must foreclose on the security instead. See *Western Fuel Co. v Sanford G. Lewald Co.* (1922) 190 C 25, 210 P 419; *Barbieri v Ramelli* (1890) 84 C 154, 23 P 1086. See also §4.24. Because it is an affirmative rather than a jurisdictional defense, if the trustor does not so plead it, the action will proceed and the beneficiary may obtain a money judgment on the note. See *Salter v Ulrich, supra*. Failure of the trustor to affirmatively plead CCP §726(a) thus results in its waiver (although the debtor may still assert the §726(a) sanction). On executory waivers, see §4.65. See *Spector v National Pictures Corp.* (1962) 201 CA2d 217, 20 CR 307.

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§4.65 E. Executory Waivers

In addition to the distinction between contemporaneous and subsequent waivers, the rules of waiver are muddied by a second distinction affecting their validity, which is seldom articulated clearly: the difference between immediate and executory waivers.

An immediate (or completed) waiver of CCP §726(a) occurs when the secured creditor sues on its note and the debtor fails to plead §726(a) as an affirmative defense, as occurred in *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7. In such circumstances, the waiver is fully effective, and the creditor essentially trades its security for a judgment. An executory or contractual waiver, however, occurs when the debtor agrees—during the existence of the loan—not to assert §726(a) as an affirmative defense if the secured creditor later elects to sue on its note rather than to foreclose on its security.

Such a waiver may avoid the prohibition against contemporaneous waivers, but it does not automatically guarantee its effectiveness. If the consideration given to the debtor for executing such a waiver is forbearance on the debt, *i.e.,* an agreement to overlook a current default, then the waiver agreement is little more than an additional mortgage on the debtor's reinstatement rights. The debtor in effect says to the creditor: If you will give me more time to pay my debt, I will give you the right to avoid the foreclosure rules if I do not pay within the extended time. Thus, elsewhere in the country, an executory deed in lieu of foreclosure, even though subsequent and fair, remains merely a mortgage and must be foreclosed despite its language. See *Guam Hakubotan, Inc. v Furusawa Inv. Corp.* (9th Cir 1991) 947 F2d 398. In California, however, after a default on the loan, the lender may enforce such an arrangement. See *Bradbury v Davenport* (1898) 120 C 152, 52 P 301. See also discussion of validity of deeds in lieu executed after loan default in §7.11.

The distinction in California between contemporaneous and subsequent waivers is based on the assumption that any duress that might compel a borrower to waive rights vanishes once the loan is made. See *Hamud v Hawthorne* (1959) 52 C2d 78, 338 P2d 387; *Salter v Ulrich, supra*. However, a debtor who has received loan funds but is unable to pay them back may be in even greater distress than one whose original decision to borrow was merely elective. See *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292; *Ghirardo v Antonioli* (1996) 14 C4th 39, 57 CR2d 687; *Palm v Schilling* (1988) 199 CA3d 63, 244 CR 600. See also *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712 (subsequent waiver of CCP §726(a) might be invalid). Consequently, while failure to plead §726(a) when the creditor sues for money is effective, it does not automatically guarantee the validity of the debtor's agreement not to make such a defense later if the creditor forgoes foreclosing for the time being. For further discussion of *DeBerard Props., Ltd. v Lim, supra,* see §§4.28, 5.43, 5.70-5.71, 6.71, 7.7, 7.82.

WARNING: Some commentators note that the *DeBerard* court's rejection of executory contractual waivers of CCP §580b in a postdefault setting, together with the doubt expressed in *O'Neil v General Sec. Corp.*, *supra,* about the validity of postdefault waivers of §726(a), suggests that creditors should be cautious and skeptical about the validity of executory waivers of antideficiency protection, regardless of when they were obtained. For discussion of *DeBerard* and its implications for borrowers and lenders, see Mastromonaco, DeBerard Properties, Ltd. v Lim: *Are Borrowers Helped or Hurt?,* 22 CEB Real Prop L Rep 166 (Aug. 1999).

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§4.66 F. Sanction Effect of CCP §726(a)

A trustor does not completely waive CCP §726(a) protection by failing to assert it as an affirmative defense if the beneficiary has first pursued an action directly on its note instead of foreclosing. As well as being an affirmative defense, CCP §726(a) has a "sanction" aspect. See *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897. If the beneficiary ignores its security and proceeds to obtain a judgment solely on the note, it loses any advantage the security would have given it, effectively waiving its right to foreclose on the security. The beneficiary may then deal with the property only as an unsecured execution creditor and loses any priority over other creditors that its former consensual security interest afforded. *James v P.C.S. Ginning Co.* (1969) 276 CA2d 19, 80 CR 457. See also *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7.

In multiple-security cases, the beneficiary's omission of part of the security leads to loss of the lien on the omitted part, but it apparently does not prohibit the beneficiary from obtaining a deficiency judgment after the sale of the security that was included. *Walker v Community Bank*, *supra*. See §4.25. If the trustor prefers that all the security be included (to reduce the size of any deficiency), this point must be raised defensively at the appropriate time in the proceedings and before the foreclosure sale. *United Cal. Bank v Tijerina* (1972) 25 CA3d 963, 102 CR 234. See §§4.11, 4.24, 9.6.

In multiple-debtor cases, a personal judgment against one of the debtors that was obtained on an obligation independent of the secured obligation does not automatically constitute a violation of CCP §726(a). *Williams v Reed* (1957) 48 C2d 57, 307 P2d 353. In *Williams*, the judgment debtor's failure to plead §726(a) in the personal action against him on an extension agreement did not trigger the sanction effect of §726(a) on the secured loan and therefore did not preclude the creditor from foreclosing on the interests in the chattel security belonging to the other debtors who had cosigned the loan. See §§4.23, 9.5-9.6. On codebtors, see §4.30. But see *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, aff'd without published opinion (9th Cir 1995) 46 F3d 1143 (entry of stipulated judgment against one debtor triggers loss of all security). Regarding the effect on other lienholders, see *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712.

For further discussion of sanction and defense aspects of §726(a), see §§4.24-4.28.

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The Antideficiency Rules

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§5.1 I. BACKGROUND AND HISTORY OF ANTIDEFICIENCY LEGISLATION

Although cautious real estate lenders generally attempt to oversecure their loans by demanding security valued significantly more than the amount lent, real estate values may nevertheless fall as well as rise over time. Security that may have exceeded 150 percent of the loan amount when the loan was made may—when the loan goes into default—cover only 75 percent of the unpaid loan balance.

At common law, the absence of a one-action rule gave the undersecured creditor the option of first foreclosing against the security before going after other assets of the debtor or, instead, proceeding directly on its note to recover the loan without attempting to foreclose on the security. Given the comparative value of the security against other assets of the debtor, an action on the note (combined with an attachment of the nonsecured assets) might be a superior collection strategy. Code of Civil Procedure §726(a) eliminated the creditor's ability to collect the debt without first foreclosing on the security (see chap 4). Thus, any monetary recovery exceeding the amount of the foreclosure sale proceeds is confined to a deficiency judgment (*i.e.,* a judgment rendered against the debtor after a foreclosure sale) to compensate the creditor for the discrepancy between what it was owed and what it collected at the foreclosure sale. On deficiency judgments, see §5.3. See also §§3.1, 3.4, 3.35, 3.62, 3.86-3.89, 3.111-3.113, 9.7-9.8, 9.102-9.105.

During the Great Depression of the 1930s, the collapse in real estate values was so dramatic that foreclosure sale prices were just pennies on the dollar, and debtors who had lost their previously valuable security were exposed to large deficiency judgment liability. The California Legislature, in response, enacted a series of antideficiency prohibitions, which survive today despite the radical change of American economic conditions since the Depression.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/5 The Antideficiency Rules/§5.2 A. Antideficiency Rules

§5.2 A. Antideficiency Rules

In addition to CCP §726(a) (discussed in chap 4), there are four distinct antideficiency rules in California:

- The private-sale bar (CCP §580d; see §§5.4-5.12);
- The 3-month time limit (CCP §580a; see §§5.13-5.15);
- The fair value limitations (CCP §§580a, 726(b); see §§5.16-5.23); and
- The purchase money prohibition (CCP §580b; see §§5.24-5.44).

The statutory regulation of postsale redemption after a judicial foreclosure sale serves a similar antideficiency purpose (CCP §§729.010-729.090; see §§5.9, 3.90-3.101).

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§5.3 B. "Deficiency Judgment" Defined

A deficiency judgment is a judgment against the trustor for the difference between the unpaid balance of the secured debt (plus expenses) and the amount produced by the sale or the fair value of the security, whichever is greater. CCP §726(b). After the sale price is reported to the court, the court enters a personal judgment against the debtor for whatever liability remains to the creditor after a fair value hearing. *Toby v Oregon Pac. R.R.* (1893) 98 C 490, 33 P 550. See §§3.86-3.89.

Because California's statutory protections apply only in the context of deficiency judgments, it has been necessary for the courts (and the legislature) to determine what kinds of monetary relief should be treated as deficiency judgments.

In *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425, the California Supreme Court held that a sold-out junior lienholder's action for the entire unpaid balance of her debt constituted a claim for a deficiency judgment even though she had never held a foreclosure sale of the security (because her junior lien had been eliminated by a senior sale). Before *Brown*, it was generally assumed that a deficiency judgment would arise only after there had been a foreclosure sale by the plaintiff creditor. The court's rejection of that rule indicated that the issue of the scope of the antideficiency rules was to be one of policy rather than technical definition and that the meaning of "deficiency judgment" was to be somewhat elastic.

In *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, the supreme court held that an action for waste brought by a lender against a borrower after a foreclosure sale was sufficiently similar to an action for a deficiency judgment as to be subject to antideficiency protection unless the waste had been committed in bad faith.

In *Birman v Loeb* (1998) 64 CA4th 502, 75 CR2d 294, a court of appeal held that a seller who had a $2.2 million shortfall following a trustee sale of the security could not offset any part of that against a $300,000 judgment in the buyer's favor if a deficiency judgment would be prohibited under CCP §580b, because the offset would be "equivalent to" a deficiency judgment. See Bernhardt, *Foreclosure Shortfalls,* 21 CEB Real Prop L Rep 144 (Aug. 1998). For a similarly expansive definition of deficiency judgment in the CCP §580b context, see *Frangipani v Boecker* (1998) 64 CA4th 860, 75 CR2d 407, discussed in §§5.37, 9.124-9.125, 9.132.

For purposes of the fair value antideficiency rule embodied in CCP §580a, the supreme court reaffirmed the distinction between the pursuit of a deficiency judgment (*i.e.*, a personal money judgment against the debtor) and the resort to additional consensual security or collateral. In so doing, the court held that the latter does not constitute the pursuit of a deficiency judgment. See *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/5 The Antideficiency Rules/§5.4 II. PRIVATE SALE DEFICIENCY PROHIBITION (CCP §580d)

§5.4 II. PRIVATE SALE DEFICIENCY PROHIBITION (CCP §580d)

Code of Civil Procedure §580d, the last of California's Depression-era mortgagor-protection legislation, became effective in 1941, providing the following:

> No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property … hereafter executed in any case in which the real property … has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.

The section completely bars any deficiency judgment when the mortgagee or beneficiary elects to foreclose by power of sale rather than judicially. Regardless of the inadequacy of the foreclosure sale proceeds to cover the debt, there is no further recovery.

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§5.5 A. Purpose of CCP §580d: Equalize Judicial and Nonjudicial Foreclosures

Code of Civil Procedure §580d bars deficiency judgments following nonjudicial foreclosures only—not judgments following judicial foreclosures. Judicial foreclosure sales, however, are subject to the trustor's redemption rights following the sale when a deficiency judgment is permitted. See §§3.90-3.101. Thus, according to the courts, the purpose of §580d is to equalize judicial and nonjudicial foreclosure sales by burdening them, respectively, with the roughly equivalent disadvantages of redemption (after a judicial sale) or a categorical deficiency bar (after a trustee sale). The beneficiary who seeks a deficiency judgment must conduct a sale that is subject to redemption. The beneficiary who wants to make a nonredeemable sale must forgo a deficiency judgment. *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873.

Although both forms of sale have drawbacks, the deterrents are clearly different, and the beneficiary may choose which device to use (see §§2.10-2.19, 3.4-3.11). Consequently, the impact of the limitations is considerably lessened. If the value of the property equals or exceeds the debt still due or if the debtor is insolvent, the creditor will usually choose a private sale, which will both pay off the entire debt and cut off the debtor's right of redemption. If the property's value is not enough to substantially repay the debt, the creditor may seek a judicial sale and deficiency judgment. Section 580d provides only that the creditor cannot both conduct a nonredeemable sale and hold its debtor subject to a deficiency judgment.

NOTE: The impact of CCP §580d does not arise until a trustee sale is completed. *Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090. Lenders sometimes commence both judicial and nonjudicial foreclosures simultaneously and wait until the last moment to choose which one to follow, depending on such factors as an appraisal or a marketing analysis. On choosing between foreclosure methods, see chaps 2-3.

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§5.6 B. Deterrence to Underbidding

According to the courts, the purpose of the deficiency bar in trustee sales (CCP §580d) and the right of redemption in judicial sales (CCP §§729.010-729.090) is to deter underbidding at the sale. *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873. The techniques used are quite different, however, and lead to differing results. See §§5.7-5.8.

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§5.7 1. Judicial Foreclosures and Postsale Redemption

Postsale redemption is designed to deter underbidding by making underbids subject to nullification through later redemption. For a complete discussion of postsale redemption rights, see §§3.90-3.101.

EXAMPLE: If the market value of the property is $600,000, the beneficiary is owed $600,000, and if the beneficiary bids $600,000 at the sale, then the trustor is unlikely to redeem the property. But if the beneficiary bids only $500,000 for the property, the trustor may be motivated to redeem and acquire a $600,000 property for only $500,000. It is considerably easier to raise the necessary additional funds if $500,000 will pay for property worth $600,000. In this situation, the beneficiary may suffer by its own strategy: Its hoped-for deficiency judgment (based on a bid of only $500,000 on a $600,000 debt) may be frustrated by a fair value determination of the security at above that number, thus reducing or entirely eliminating any such recovery but not affecting the redemption cost. Thus, if a court determined that the fair value of the property was $600,000 and the debtor redeemed, the beneficiary would be denied any deficiency judgment and would receive only $500,000 of its $600,000 debt even though the property had an additional $100,000 of value in it.

To minimize the redemption risk, a beneficiary will often bid an amount equal to the value of the property (see §3.81), at least to the extent of the debt (although there may still be an incentive to underbid in some cases; see §§5.8, 9.7).

The prospect of postsale redemption, however, appears to have reduced rather than raised bidding prices. Potential purchasers reduce their bids on properties that can be redeemed and in which the debtor remains in possession during the postsale redemption period. Thus, the federal courts have refused to apply postsale redemption in federal foreclosure proceedings, and California appraisers are instructed to ignore the "price-reducing" effect of redemption in estimating fair values of foreclosed property. See, *e.g., San Paolo U.S. Holding Co. v 816 S. Figueroa Co.* (1998) 62 CA4th 1010, 73 CR2d 272. For further discussion of *San Paolo*, see Bernhardt, *Fair Value,* 21 CEB Real Prop L Rep 100 (May 1998).

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§5.8 2. Nonjudicial Foreclosures and the Ban on Deficiency Judgments

In nonjudicial foreclosure sales, there is no postsale redemption right. Neither the trustor nor junior lienholders have redemption rights once the sale is concluded. See §§1.33, 2.73. Although the ability to sell a nonredeemable title should encourage more competitive bidding, it has not always done so. During the Great Depression, the absence of capital and rival bidders at foreclosure sales allowed many properties to be sold to their creditors for only nominal bids, followed by large deficiency judgments. Code of Civil Procedure §580d was enacted to rectify this situation.

Section 580d does not so much discourage underbidding as make it irrelevant. The total ban on deficiency judgments nullifies the prospective windfall from an underbid. A beneficiary conducting a trustee sale of the property is, in one sense, treated as having bid the full amount of its debt, and no actual bid for a lesser sum will make any difference as far as deficiency judgments are concerned. There may be reasons to underbid at a private sale, but a deficiency judgment is not one of them. See Johnson & Smith, *The Case Against the Full Value Bid,* 12 CEB Real Prop L Rep 141 (July 1989); Crocker, *Beneficiary's Underbid—A Neglected Tool,* 44 LA B Bull 295 (1969).

Under CCP §483.010(b) of the California attachment statute, an undersecured creditor can attach the debtor's property, but this right is subject to the restrictions of CCP §580d (and CCP §580b). CCP §483.012. This rule appears to mean that any creditor seeking attachment must pursue a judicial foreclosure rather than a trustee sale (to reach other assets after the foreclosure sale). A court would probably treat any attachment that violated this provision as sanctionable under CCP §726(a). See *Shin v Superior Court* (1994) 26 CA4th 542, 31 CR2d 587. For further discussion of attachment and §726(a), see chap 4.

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§5.9 3. Effectiveness of Protection of Redemption Statutes

The redemption statutes (CCP §§729.010-729.090) and CCP §580d operate effectively only when the market value of the property is less than the debt. If the property's value exceeds the debt, these provisions do not fully protect the debtor against underbidding.

EXAMPLE: Assume that real property is worth $600,000, with a debt of $500,000. If the sale is private, the beneficiary has no inducement to bid over $500,000. (If there is competitive bidding, the beneficiary may wish to enter into the auction to outbid others, but it is then acting as a purchaser, not as a creditor; as a pure creditor, the beneficiary is completely satisfied the moment someone bids the full amount owed to it, and after that takes no interest in the sale.) Although CCP §580d eliminates the possibility of a profit from bidding less than $500,000 (because no deficiency judgment will ensue), it creates no incentive to bid more than $500,000, because it regulates deficiencies and not surpluses.

A similar situation occurs in the judicial sale. The beneficiary who is owed $500,000 is discouraged from bidding less than $500,000 but is not encouraged to bid more than $500,000. Although property worth $600,000 is more likely to be redeemed if it sold for $500,000 than if it sold for $600,000, there is no motivation for the beneficiary to bid more than $500,000. Every dollar bid by the beneficiary over what it is owed must be in the form of cash and will be turned over to the trustor or to junior creditors. A more expensive redemption thus returns to the beneficiary only what it has previously paid at the sale. If the beneficiary prefers to have cash rather than to hold land, it will bid only $500,000, hoping that this low figure will encourage someone else to bid.

Because neither system protects the trustor from underbidding when the property is worth more than the debt, the combined effect leads a beneficiary into making a choice, usually to the debtor's detriment.

If the property is worth more than the debt, the beneficiary will foreclose by power of sale; the bid will be less than the market value of the property; the sale will be nonredeemable; and there will be no surplus for the debtor or junior lienholders.

If the property is worth less than the debt, the beneficiary will foreclose judicially and make a credit bid at close to the market value; the trustor's right of redemption will be of little value; and the beneficiary may obtain a deficiency judgment.

On bankruptcy courts' treatment of foreclosure sales as fraudulent transfers when the amount bid was not reasonably equivalent to the market value of the property, see §§7.109-7.114, 11.86.

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§5.10 C. Sold-Out Juniors

A junior whose security is rendered worthless by virtue of a senior foreclosure sale is permitted to file suit on its note without going through a meaningless foreclosure sale of its lost security. See §§5.39-5.44. But such an action, even though permitted despite CCP §726(a) (see §§4.42-4.46), is still an action for a deficiency judgment and therefore potentially subject to CCP §§580a, 580b, and 580d. *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425. But see *California Cent. Trust Bankcorp v Been (In re Been)* (9th Cir 1998) 153 F3d 1034 (sold-out junior's judgment does not arise from mortgage foreclosure for lien avoidance purposes).

Application of a CCP §580d defense to a sold-out junior's action on its note would mean that such action is permitted only when the senior sale was judicial rather than nonjudicial. A trustee sale by the senior would bar not only the senior but also the junior from a subsequent deficiency claim. However, the California Supreme Court held that the junior's rights should not depend on the senior's choice of sale and consequently permitted the sold-out junior creditor to bring an action directly on the note despite the fact that the senior foreclosure was nonjudicial. See *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873. Application of §580d is limited to the creditor conducting the sale as the party who chose that form of sale.

This rule benefits the junior at the expense of the trustor, who thus faces the prospect of both losing the property in a nonredeemable sale (the senior trustee sale) *and* remaining subject to personal liability on the junior note. This rule appears to thwart the basic policy of CCP §580d (*i.e.,* that there should be deficiency liability only when there is a right to redeem, as stated in *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64, and *Roseleaf Corp. v Chierighino, supra*). The senior lienholder has no incentive to bid more than what it is owed on its senior lien, which makes any surplus for the junior extremely unlikely unless it bids at the senior sale. The junior is then entitled to obtain a personal judgment against the trustor, even if the property was worth enough to pay off both liens.

EXAMPLE: Property worth $600,000 is subject to a first mortgage of $500,000 and a second (nonpurchase money) mortgage of $40,000. At a senior trustee sale, the senior's bid will probably not exceed $500,000—the amount that it is owed. The senior then obtains irredeemable title to the property. After the sale, the junior may recover a money judgment of $40,000 from the trustor. The trustor has lost the property absolutely (because the foreclosure was nonjudicial) and is now subject to a $40,000 liability rather than being the beneficiary of a $60,000 equity in the property.

If the junior elects to foreclose its lien by trustee sale rather than judicial action before the senior foreclosure, CCP §580d bars the junior from any deficiency recovery despite the fact that it later becomes a sold-out junior. *Ballengee v Sadlier* (1986) 179 CA3d 1, 224 CR 301. See also *Marriage of Oropallo* (1998) 68 CA4th 997, 80 CR2d 669 (junior holding second deeds of trust on six parcels of land who elected to sell four of them by trustee sale (instead of judicial foreclosure) after senior foreclosure sale eliminated her liens on the other two parcels was thereafter barred from deficiency judgment).

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§5.11 1. High-Bidding Sold-Out Junior

A sold-out junior does not lose its right to recover a money judgment following a senior trustee sale merely because it was the successful bidder at the senior sale. *Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 221 CR 425. See also *Citrus State Bank v McKendrick* (1989) 215 CA3d 941, 263 CR 781. This gives the junior creditor the previously unpermitted double benefit of a nonredeemable title and the right to a money judgment, but the courts reason that to do otherwise would penalize the junior for a choice made by the senior. That reasoning does not seem to consider the junior's opportunity to cure the senior default, thus reinstating the senior loan and entitling the junior to proceed with a junior foreclosure, either judicial or nonjudicial, at its election. If the junior is next in priority after the senior, the junior is entitled to the subsequent return of the cash portion of its bid as surplus if the senior entered a full credit bid. *Pacific Loan Mgmt. Corp. v Superior Court* (1987) 196 CA3d 1485, 242 CR 547.

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§5.12 2. When Senior and Junior Lienholders Are the Same

If the junior lienholder is also the holder of the senior lien, and if a dragnet clause (see §§9.59-9.67) or other form of cross-collateralization in one or both of the two instruments links the two loans together, they will be treated as one loan for CCP §580d purposes, and the creditor who conducts a trustee sale on the senior lien may not then sue for money as a sold-out junior lienholder. *Union Bank v Wendland* (1976) 54 CA3d 393, 398, 126 CR 549. But see *National Enters., Inc. v Woods* (2001) 94 CA4th 1217, 115 CR2d 37, distinguishing and questioning the precedential value of *Wendland*. The possibility that this result could be avoided by more careful loan drafting was rendered less likely when *Simon v Superior Court* (1992) 4 CA4th 63, 5 CR2d 428, reached the same result even though no dragnet clauses connected the loans. Because this rule treats a junior loan made by the senior differently from a junior loan made by anyone else, there is bound to be considerable controversy over this rule's scope and wisdom. See §9.28.

In *Evans v California Trailer Court, Inc.* (1994) 28 CA4th 540, 33 CR2d 646, the court held that a holder of both first and second deeds of trust on the same property may sue the debtor in tort (for waste or fraud) following a nonjudicial foreclosure on the senior deed of trust. The *Evans* court also expressed doubt about the applicability of the CCP §580d merger-of-liens doctrine if the two liens are separated by an intervening lien. Also unknown is whether and how this doctrine would affect "kangaroo" loans, *i.e.*, when the senior lender supplies the trustor with a line of credit secured by a second mortgage on the same property.

No case provides guidance on the creditor's ability to eliminate the CCP §580d consequences of two such related loans by transferring one of the loans to a third party lender. It is also unknown whether the merger doctrine would apply if the same lender temporarily acquired the beneficiary interest in a junior and senior loan secured by the same property because of secondary market transactions. See §4.44. On the antideficiency consequences of lenders fractionalizing their loans into secured and unsecured components, see §5.53.

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III. TIME LIMIT ON SEEKING DEFICIENCY JUDGMENT

§5.13 A. General Rule (CCP §726(b))

Although CCP §580d bars deficiency judgments following nonjudicial foreclosures, it does not prohibit deficiency judgments following judicial foreclosures. See §§5.4-5.5. Any judicially foreclosing creditor seeking a deficiency judgment must apply to the court that rendered the initial foreclosure decree within 3 months after the foreclosure sale. CCP §726(b). On applying to the court for a deficiency judgment, see chap 3. Although it is not explicitly stated in the statute, the courts treat this time period as a statute of limitation, barring actions and other proceedings not commenced within the requisite time. See, *e.g., Life Savs. Bank v Wilhelm* (2000) 84 CA4th 174, 100 CR2d 657. Thus, while judicial foreclosure of a deed of trust may be delayed for up to 4 years after a default (CCP §337, which applies generally to actions on written contracts), collection against the debtor's general assets must be commenced promptly (*i.e.,* within 3 months) after the security has been sold.

No similar time compulsion is imposed by the Uniform Commercial Code (or the California Commercial Code) on creditors secured by purely personal property. With mixed collateral, however (*i.e.,* combined real and personal property securing the same loan), Com C §9604 generally attempts to apply real estate rules to the real property and UCC rules to the personal property. See chap 9. In the context of mixed security, the court of appeal held in *Florio v Lau* (1998) 68 CA4th 637, 80 CR2d 409, that the 3-month time limit did not apply and that a creditor was not required to seek a deficiency within 3 months after a sale of the security, real or personal. The court rejected the alternative of imposing the time limit immediately after the sale of the real property even though the personal property remained unsold. It also rejected the trial court's logic of not starting the countdown until the last personal property had been sold. See also *Paykar Constr. v Bedrosian* (1999) 71 CA4th 803, 84 CR2d 135 (3-month period begins when highest bid is made at sheriff's auction, not when sheriff's certificate of sale is recorded).

NOTE: A similar 3-month time limit is imposed after a nonjudicial trustee sale by CCP §580a, but the section has only limited application because CCP §580d constitutes a categorical bar to deficiency judgments after foreclosure by trustee sale (see §§5.4-5.5).

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B. Sold-Out Juniors

§5.14 1. When 3-Month Period Does Not Apply

A junior that seeks monetary relief from the trustor after its security has been lost because of a senior sale deals with CCP §580a rather than CCP §726 because its claim requires the filing of an independent action. A question arises whether the deficiency time limitations of CCP §580a or §726(b) compel it to bring its action within 3 months after the senior sale (whether judicial or nonjudicial). The California Supreme Court has held that the sold-out junior is generally not subject to the 3-month constraint. In *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873, the court permitted a junior whose security was lost at a senior trustee sale to bring its own action on its note more than 3 months after the senior sale was completed. According to the opinion, a contrary result "would unnecessarily compel acceleration of the junior obligation to the detriment of the debtor," which presumably means that a debtor is worse off under a short statute of limitations because the creditor will then file suit sooner rather than later. That assertion raises the obvious question of why the same time frame is not also imposed on the senior creditor. Enacted in California (and many other states) during the Depression, the short limitations period was originally conceived as a rule helping debtors by enabling them to get back on their feet more rapidly. But if a 3-month window is viewed as beneficial to the debtor against a senior creditor, and if the absence of such a window is viewed as beneficial against a junior creditor, it becomes truly impossible to predict outcomes in other situations, because the same policy can be used opportunistically to justify entirely contradictory results.

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§5.15 2. When 3-Month Period Does Apply

The rules change dramatically when the sold-out junior acquires the property at the foreclosing senior sale. The sold-out junior who is the high bidder at the senior sale is subject to the 3-month limit of CCP §580a. In *Citrus State Bank v McKendrick* (1989) 215 CA3d 941, 950 n12, 263 CR 781, the court stated that there would be an "anomalous inequity" if a purchasing junior were given both the title as well as a 4-year period to seek a deficiency. The holding in *Citrus State Bank* is probably best explained as one based on an extrapolation of the holding in *Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 221 CR 425, in which the court applied the fair value aspect of the same statute, CCP §580a, to the purchasing sold-out junior.

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§5.16 IV. FAIR VALUE LIMITATIONS (CCP §§726(b), 580a)

Code of Civil Procedure §726(b) provides that a deficiency judgment is limited to

> the amount by which the amount of the indebtedness … exceeds the fair value of the real property … as of the date of sale. [Provided, however, that in] no event shall the amount of the judgment … exceed the difference between the amount for which the real property … was sold and the entire amount of the indebtedness.

Code of Civil Procedure §580a imposes a similar limitation on any deficiency judgment sought after a trustee sale rather than a judicial foreclosure sale. But see Note in §5.13; §5.20.

A deficiency judgment is not calculated merely by subtracting the amount bid at the sale from the unpaid balance of the debt (plus interest and costs). Rather, to determine the amount of the deficiency in a judicial foreclosure, CCP §726(b) requires the following:

- The creditor must return to court within 3 months after the date of the judicial foreclosure sale to apply for a fair value determination and a deficiency judgment (*Life Savs. Bank v Wilhelm* (2000) 84 CA4th 174, 100 CR2d 657; *Paykar Constr. v Bedrosian* (1999) 71 CA4th 803, 84 CR2d 135) (see §§3.86-3.87);
- The court will conduct a hearing and take evidence of the fair value of the property sold at foreclosure (see §3.88); and
- A money judgment for any deficiency will be limited by the fair value of the property unless the amount bid at the sale exceeds that value (see §§3.88-3.89, 5.18).

In a nonjudicial foreclosure sale, CCP §580a provides that the creditor must file a complaint within the 3-month period and that a similar hearing and determination of fair market value must be held (see §5.20).

EXAMPLE: If the foreclosing beneficiary is owed $600,000 at the time of sale and the high bid at its judicial foreclosure sale is $500,000, the beneficiary would have been able to obtain a deficiency judgment for $100,000 at common law. Now, in California, if the court finds that the fair value of the property at the time of sale was $520,000, the deficiency judgment is limited to $80,000, the difference between the debt and the fair value. If the fair value were found to be $475,000, the deficiency judgment would not be $125,000 but would be limited to $100,000, which is the difference between the debt and the amount bid. The higher of the fair value or the amount bid is subtracted from the balance owed to calculate the allowable deficiency judgment.

On court procedures for determining fair value, see §§3.86-3.89. On the effectiveness of fair value rules on bidding behavior, see §§3.81, 5.8, 5.19, 9.7. On nonapplication of the fair value limitations to at least some bankruptcy sales made "free and clear of any interest in such property" under 11 USC §363(f), see *Coppola v Superior Court* (1989) 211 CA3d 848, 259 CR 811. Compare *Coppola* with *Vista Del Mar Assocs. v West Coast Land Fund (In re Vista Del Mar Assocs.)* (BAP 9th Cir 1995) 181 BR 422 (holding that sale without right of redemption is tantamount to trustee sale).

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§5.17 A. Rationale

The fair value provisions of CCP §§726(b) and 580a were enacted in 1933 when it became apparent that the traditional debtor-protection mechanisms were no longer working. It had previously been assumed that a defaulting trustor could expect that the property would be sold for a reasonable price because

- the foreclosure sale would be by public auction; and
- there was a right of redemption following the sale, and the trustor or junior creditors would repurchase the property if it were underbid.

The Depression so depleted cash and credit, however, that only the beneficiary typically bid at its foreclosure sale, and neither the junior creditor nor the trustor had the means to redeem, even when redemption was a bargain. (The beneficiary could afford to bid at the sale because it was allowed to credit bid the debt owed to it and thus did not need cash.) On postsale redemption, see §§3.90-3.101.

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§5.18 B. Definition of "Fair Value"

"Fair value" as used in CCP §726(b) has been a troublesome phrase not made any clearer by the legislature's apparent inconsistent use of "fair market value" in the parallel provisions of CCP §580a. In *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873, the court used the terms interchangeably, but that indifference was characterized as improvident dicta by the decision in *Rainer Mortgage v Silverwood, Ltd.* (1985) 163 CA3d 359, 366 n5, 209 CR 294. Originally, CCP §726(b) used the term "fair market value," but the statute was amended in 1937 to refer only to "fair value." A proposal was made at that time to use "intrinsic value," but that term was not enacted. Most other jurisdictions that have such a limitation use "fair market value" or "fair and reasonable value," but others use "fair value." See Restatement (Third) of Property: Mortgages §8.4, comment c (1997).

Rainer Mortgage v Silverwood, Ltd., *supra,* held that fair value was not necessarily equivalent to fair market value and adopted the concept of intrinsic or underlying value, with market value merely a factor to consider in making the calculation. The court of appeal in *San Paolo U.S. Holding Co. v 816 S. Figueroa Co.* (1998) 62 CA4th 1010, 1026, 73 CR2d 272, rejected so dramatic a definition and restricted the notion to the fair market value of the property without reducing it further because of the price-reducing effects of the foreclosure sale and the subsequent right of redemption. See also *Citicorp Real Estate, Inc. v Smith* (9th Cir 1998) 155 F3d 1097 (discussing issues of market value as of foreclosure date).

The difference between the fair market and intrinsic value approaches is marked. If the *San Paolo* fair value standard is used, an expert may testify about what a willing buyer would pay a willing seller in an arm's-length transaction, unreduced even though the sale is by forced foreclosure auction rather than by voluntary negotiation. This is the conventional valuation approach, which appraisers and real estate brokers best understand and can most easily explain on the witness stand. In contrast, if "intrinsic value" is the standard, the witness is free to express an opinion of the property's "real worth," even though no one might be willing to pay it. (In *San Paolo,* the trustor's appraiser sought to ignore the current (1996) market value of the property and to base his opinion on its much higher 1986 market value because he thought that the earlier value was the "intrinsic" one.) Such a standard imposes on the creditor the consequences of any postloan deflation of property values to the creditor, whereas the *San Paolo* fair value standard allocates only the loss from underbidding on the creditor. See Bernhardt, *Fair Value,* 21 CEB Real Prop L Rep 100 (May 1998).

As to other factors, the court in *Nelson v Orosco* (1981) 117 CA3d 73, 172 CR 457, held that it was proper to consider the fact that the property was subject to a lis pendens at the time of sale in setting its fair value. In *Luther Burbank Sav. & Loan Ass'n v Community Constr., Inc.* (1998) 64 CA4th 652, 75 CR2d 367, the court held that prior liens should be considered and deducted from the estimated fair market value because any bidder-purchaser must independently satisfy them and include them, therefore, in its own bidding calculations. *Citicorp Real Estate, Inc. v Smith, supra,* upheld a fair value determination based on the nature and zoning of the property, the condition of the real estate market, financing potential, and similar factors.

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§5.19 C. Limits Deficiency Judgments Only

The fair value provisions of CCP §§726(b) and 580a limit only deficiency judgments. Thus, when no deficiency judgment is sought, no fair value hearing need be held. This means that a trustor is protected against any bid that is both below the value of the property and below the amount owed on the debt, but it is not protected against a bid that equals or exceeds the debt, even if it is below the value of the property. In this respect, the fair value provisions have an effect similar to that of CCP §580d: They do not protect debtors against a forfeiture of their equity, if any, in the security. See §§2.79, 2.102.

EXAMPLE: If the unpaid balance of the note is $500,000 and the property has a market value of $600,000, then the fair value provisions will prohibit entry of a deficiency judgment no matter how little is bid. But nothing in those provisions requires or even encourages the creditor (or anyone else) to bid more than $500,000 (the amount owed) even though the property is worth $100,000 more. The $500,000 bid satisfies the claim and eliminates any possibility of a deficiency judgment or its attendant fair value hearing. The fair value standard is not the equivalent of judicial establishment of an upset price or official approval of the sale price. Because most loans are made at less than the current market value of the security, the value of the foreclosed property may easily exceed the remaining debt, and the fair value provisions do nothing to ensure a fair bid. See also §§5.16-5.18.

On effect of fair value on sold-out junior creditor, see §§5.22-5.23.

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§5.20 D. Continuing Viability of CCP §580a

For 8 years, between 1933 (when CCP §580a was enacted) and 1941 (when CCP §580d became effective), §580a limited the size of money judgments following nonjudicial foreclosure sales, which then were not otherwise prohibited. The enactment of §580d, however, created a complete bar to a deficiency judgment after a private sale, preempting §580a in most situations, thus creating an anomalous situation in which the same deficiency is limited (and seemingly validated) by §580a while simultaneously prohibited by §580d.

The legislature, however, not only never repealed CCP §580a but also amended it several times since 1941. The continued existence of the statute requires that it be given some role in the foreclosure system. It is not applied to most sold-out junior creditors (see §5.22), but it does apply if the sold-out junior is the successful bidder at the senior lienholder's sale (see §5.23). Eventually it may be applied to guarantors (see §§9.89, 9.98) and in multiple-security cases (see §§9.7, 9.21). Because §580a refers to "the balance due upon an obligation," while §580d mentions only a "note," there is the possibility that §580a would be called into play in private foreclosure sales of any nonnote obligations to which §580d does not apply. See *Willys of Marin County v Pierce* (1956) 140 CA2d 826, 296 P2d 25.

The California Supreme Court held that fair value principles (based on §580a or notions of good faith and fair dealing) do not prevent a secured creditor from using underbids in sequential trustee sales against multiple security without first determining fair value. *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29.

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§5.21 E. Fair Value and CCP §726(a)

Without the limitations of CCP §726(a), a secured creditor could easily avoid the restrictions of the fair value provisions of CCP §§726(b) and 580a by merely filing an action on the note, obtaining a personal judgment, and levying on the same property (and on any other property). See *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7; *James v P.C.S. Ginning Co.* (1969) 276 CA2d 19, 80 CR 457. Because there is no provision for a fair value hearing at an execution sale, any amount bid that was less than the amount of the judgment would leave its remainder unsatisfied. See CCP §701.570; *Rauer v Hertweck* (1917) 175 C 278, 165 P 946; *Winbigler v Sherman* (1917) 175 C 270, 165 P 943; *Central Pac. R.R. v Creed* (1886) 70 C 497, 11 P 772; *Smith v Randall* (1856) 6 C 47. But because §726(a) forces real estate secured creditors to foreclose first, it propels them into a fair value hearing when they seek more than the value of their security. For complete discussion of CCP §726(a), see chap 4.

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§5.22 1. Not Binding on Nonselling Junior Creditors

A nonselling junior creditor is not bound by the fair value provisions of CCP §§580a and 726(b) (see §§5.16-5.20). *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873. The California Supreme Court's treatment of the fair value provisions is thus analogous to its treatment of the 3-month time period and CCP §580d, *i.e.*, none of these restrictions applies to junior deeds of trust following senior foreclosures (see §5.10). The *Roseleaf* court's rationale was that the intent of the fair value provisions was to influence only the selling creditor who is able to credit-bid the amount of its debt (although the statute contains no language to this effect). To hold the junior responsible for a fair selling price at a senior sale would compel the junior to bid cash (up to and in excess of the senior's credit bid), which, according to the court, the trustor can do equally well. Thus, a junior who brings an action against the trustor on the junior note is not required to prove the fairness of the price bid at the previous senior sale, and the trustor is not permitted the defense that the property was undersold at the senior sale. *Roseleaf Corp. v Chierighino, supra*.

EXAMPLE: If the security was worth $600,000 and the first and second loans were for $500,000 and $40,000, respectively, the trustor has an equity of $60,000. If the senior bids only $500,000 (or less) at its trustee sale, however, and the junior is then permitted to obtain a $40,000 money judgment against the trustor, that $60,000 asset is converted into a $40,000 liability by application of the fair value rules.

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§5.23 2. Binding on Junior Creditor Who Purchases at Senior Sale

The fair value rule does apply when the junior is the high bidder at the senior sale. Any subsequent money judgment for the balance due on the junior note is then limited to the difference between the fair value of the property (or its selling price, if greater) and the combined total of the junior and senior debts. *Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 221 CR 425; *Bank of Hemet v U.S.* (9th Cir 1981) 643 F2d 661. Otherwise, the junior would gain the double advantage of a successful underbid and the equivalent of a deficiency judgment based on the underbid.

EXAMPLE 1: Property is encumbered with a first deed of trust for $500,000 and a second deed of trust for $40,000. If the senior forecloses and sells to itself, the junior may recover a money judgment against the trustor for $40,000 despite the fact that the security should have been able to cover both obligations. If, however, the junior acquires the title at the senior sale by bidding $510,000 ($10,000 of which will be returned to the junior as surplus), leaving it with $30,000 remaining unpaid, the junior's right to a money judgment for that amount will be subject to a fair value determination. If a court finds the fair value to be $600,000, no judgment will be allowed, because the junior has already profited by paying only $510,000 for an asset worth $600,000. The bargain of $90,000 offsets the junior's loss of $30,000. See §§5.16-5.20 on fair value determination.

EXAMPLE 2: If the amounts of the two debts were $500,000 and $40,000 and the junior's high bid was $510,000 (still leaving $30,000 unpaid) but the court found that the fair value of the property was $518,000, then the junior money judgment would be set at $22,000 because the rest of the debt loss had been regained by the bargain purchase.

This fair value limitation on high-bidding sold-out junior creditors is true whether the senior sale is judicial or nonjudicial. It thus constitutes a rare situation in which CCP §580a does apply (see §§5.19-5.20).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/5 The Antideficiency Rules/ V. PURCHASE MONEY PROHIBITION (CCP §580b)/§5.24 A. Basic Rule

V. PURCHASE MONEY PROHIBITION (CCP §580b)

§5.24 A. Basic Rule

In its present form, CCP §580b provides the following:

> No deficiency judgment shall lie in any event after a sale of real property … for failure of the purchaser to complete his or her contract of sale, or 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 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.
>
> 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 no deficiency judgment would lie under the deed of trust or mortgage on the real property….

This statute was first enacted in 1933, although some provisions were added later. The reference to contracts of sale in the first paragraph was added in 1935; the entire second paragraph, dealing with combined real and personal property security, was added in 1949; and the distinction between vendor and third party financing was added in 1963.

The basic rule of CCP §580b may be stated simply: Deficiency judgments are prohibited after the foreclosure sale of real property that secures a purchase money loan. Purchase money, as presently used in §580b, means either

- credit extended to the buyer by the seller to finance the purchase of real property, which is secured by that property, or
- funds lent to the buyer by a third party if those funds are used to pay all or part of the purchase price of, and are secured by, a dwelling of four units or less occupied at least in part by the purchaser.

See §§5.26-5.28 on "standard transaction" falling within scope of §580b.

NOTE: The basic rule has been far more difficult in its application than its recitation would appear. It has caused the bar considerable uncertainty in advising clients on whether a particular loan will be enforced according to its terms or denied recourse status because of the purchase money antideficiency prohibition.

For similar purchase money restrictions for mobile and floating homes, see Health & S C §18038.7 and CC §2983.8. See also *Security Pac. Nat'l Bank v Casavant* (1988) 205 CA3d 127, 252 CR 175; *Bank of Sonoma County v Dorries* (1986) 185 CA3d 1291, 230 CR 459.

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§5.25 B. Comparison of CCP §580b With Other Antideficiency Rules

Code of Civil Procedure §580b operates within a different frame of reference than do CCP §§580a, 580d, and 726, which relate to the process of collection after default and do not apply to predefault events. Section 580b is independent of the postdefault collection process. Its application depends on the original nature of the secured transaction, *i.e.,* whether the loan was initially made for the purpose of purchasing the real property security. Subsequent events generally do not alter the effect of §580b. *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425; *Costanzo v Ganguly* (1993) 12 CA4th 1085, 16 CR2d 55; *Paramount Sav. & Loan Ass'n v Barber* (1968) 263 CA2d 166, 69 CR 390. On purposes of §580b, see §§5.31-5.35.

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C. Scope of CCP §580b

§5.26 1. Applicable to Standard Transactions

According to the California Supreme Court, CCP §580b applies only to "standard" purchase money transactions. Variations on the standard transaction are covered only if they are found to advance the policy purposes of §580b. *Spangler v Memel* (1972) 7 C3d 603, 102 CR 807; *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873.

If a transaction constitutes a "standard" transaction, CCP §580b automatically applies to prohibit any deficiency judgment against the purchaser, regardless of the foreclosure method used. This apparently means that no arguments by the creditor based either on equity or policy will change the result. To avoid the unrebuttable impact of the section, the creditor must first show that the transaction is nonstandard. Only if successful in that assertion may the creditor undertake to demonstrate that recovery of a deficiency judgment would not violate the "purposes" of §580b. *Lawler v Jacobs* (2000) 83 CA4th 723, 100 CR2d 52.

There are currently two basic standard transactions, seller (or vendor) financing (see §5.27) and certain residential third party financing (see §5.28).

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§5.27 a. Seller Financing

In a standard two-party transaction, the seller accepts a note from the buyer for part of the purchase price and secures the note with a deed of trust on the property sold. If the seller holds a first deed of trust, the transaction clearly comes under CCP §580b. If the deed of trust is a second, it still fits within the notion of a "standard" purchase money transaction, at least if the senior deed of trust secures a conventional first loan on the property. *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425. On application of §580b if the property is subsequently conveyed to new owners, see §§9.133-9.135.

Courts have broadly construed the term "vendor" to include both those who are literally sellers and those who the courts deem serve a seller-like function and facilitate the sale. See, *e.g., Sherwood-Trimble Med. Group v 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 89 CR2d 533 (seller of personal property who with seller of real property took back single purchase money promissory note secured by deed of trust and security agreement is vendor); *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518 (in sale of two properties, with purchase money note given for purchase of one property secured by deed of trust lien on second property, plaintiff, even though not sole owner, was vendor because he marketed and sold the property and financed its sale); *Costanzo v Ganguly* (1993) 12 CA4th 1085, 16 CR2d 55 (lienholder who sold and financed original sale of property and who participated in subsequent sale by extending loan to new purchaser to protect its security interest was vendor); *Jackson v Taylor* (1969) 272 CA2d 1, 76 CR 891 (seller-lender who agreed to cancel original note and deed of trust as part of subsequent sale in exchange for new note and deed of trust remained vendor). See cases cited in *Costanzo*.

On methods of structuring transactions so as to avoid §580b, see §5.37.

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§5.28 b. Third Party Financing

Until 1963, CCP §580b did not define what kinds of loans qualified as "purchase money." Early commentators, looking at other states, interpreted the phrase to refer only to seller financing. See Currie & Lieberman, *Purchase-Money Mortgages and State Lines: A Study in Conflict-of-Laws Method,* 1960 Duke LJ 1; 1 Nelson & Whitman, Real Estate Finance Law §1.1 (5th ed 2007). Some old supreme court dicta suggested that third party lenders would be considered purchase money creditors (see *Stockton Sav. & Loan Bank v Massanet* (1941) 18 C2d 200, 114 P2d 592), but one appellate court held that third party loans were not purchase money loans (*Peterson v Wilson* (1948) 88 CA2d 617, 199 P2d 757). Only credit extended by the seller was generally considered to be purchase money.

When the underlying purposes of purchase money protection were first announced in *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873 (see §§5.31-5.35), it was unclear whether they applied only to seller financing or also to third party financing. With respect to the overvaluation policy, third party lenders do not set prices, although the extent of their willingness to make "generous" loans may have a significant impact on the prices established by the parties. The statute's antidepression policy, however, clearly seems to apply with equal force to both sellers and lenders.

Three weeks after *Roseleaf,* the supreme court ruled that third parties who advance funds to enable buyers to purchase property do come within CCP §580b and are barred from obtaining deficiency judgments. *Bargioni v Hill* (1963) 59 C2d 121, 28 CR 321 (disapproving *Peterson v Wilson, supra*). In response, the legislature amended CCP §580b (in 1963). The statute as amended makes buyer antideficiency protection depend on the nature of the property purchased. Residential property of 1 to 4 units, on which the buyer will reside, has complete §580b protection against the third party lender as well as the seller. *Prunty v Bank of America* (1974) 37 CA3d 430, 441, 112 CR 370. "Commercial property" (residential property of over 4 units or commercial development or raw land) has no deficiency protection against a third party lender, although there is such protection against the seller. This distinction between residential and commercial property is thus relevant only to third party loans, not to vendor financing. The vendor who secures the carry-back financing with the property sold cannot have a deficiency judgment, regardless of the kind of property involved (see §§5.26-5.27).

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§5.29 2. Nonstandard Transactions That Meet Purposes of CCP §580b

In transactions that are within the scope of CCP §580b but are deemed "nonstandard," application of §580b depends on whether the statute's purposes will be met by giving or refusing deficiency protection to the purchaser. *Spangler v Memel* (1972) 7 C3d 603, 613, 102 CR 807; *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 41, 27 CR 873; *Webber v Inland Empire Invs., Inc.* (1999) 74 CA4th 884, 88 CR2d 594.

A natural attack for any beneficiary seeking a deficiency judgment is to contend the following:

- The particular transaction before the court is a variant rather than a standard transaction (see §5.30); and
- It does not fall within the purposes of §580b (see §§5.31-5.36).

See *Clayton Dev. Co. v Falvey* (1988) 206 CA3d 438, 253 CR 609 (defective mortgage); *Allstate Sav. & Loan Ass'n v Murphy* (1979) 98 CA3d 761, 159 CR 663 (loan to finance swimming pool). For further discussion of *Clayton* and its ramifications, see Little & Anscher, *Avoiding the Equitable Mortgage Trap,* 12 CEB Real Prop L Rep 193 (Oct. 1989).

In *Crookall v Davis, Punelli, Keathley & Willard* (1998) 65 CA4th 1048, 77 CR2d 250, a malpractice action against the borrower's attorney, the purchase money loan was subject to an executory provision, subordinating the purchase money loan to a construction loan. In a prior judicial foreclosure action on the purchase money loan, the court had rejected the borrower's CCP §580b objection at the hearing on the deficiency judgment because borrower's counsel had failed to timely plead that defense in the answer. The court in *Crookall,* on reviewing summary judgment, had to examine the applicability of §580b to determine if malpractice might have occurred. The court held that the transaction was not nonstandard, because the subordination had not been exercised (and, consequently, had not altered the standard risks). The court also concluded that in this situation, failure to plead §580b could constitute malpractice.

WARNING: Even if the transaction is nonstandard on its face, a lesson from the *Crookall* decision is that it would be wise to plead §580b as a defense because a nonstandard transaction is not automatically free from the statute's application.

On effect of refinancing purchase money loans, see §5.71; on sold-out junior creditors, see §§5.39-5.44.

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§5.30 3. Nonstandard Transactions Not Subject to CCP §580b

The "nonstandard" doctrine is often used as a safety valve that permits courts to avoid applying CCP §580b in unfair situations. This is particularly true for sold-out junior creditors who have no other remedy and who have not taken on extra risks because of the structure of the transaction. See *Spangler v Memel* (1972) 7 C3d 603, 613, 102 CR 807; *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425; *Barash v Wood* (1969) 3 CA3d 248, 83 CR 153. The following are other situations held to be outside the scope of §580b:

- An unsecured note, even if given for the purchase price of real property, is not subject to CCP §580b and is fully recoverable despite its purchase money character (*Van Vleck Realty v Gaunt* (1967) 250 CA2d 81, 58 CR 246; see §§5.52-5.53);
- An action against the guarantor of a purchase money note or the issuer of a letter of credit is also outside the scope of §580b (see *Heckes v Sapp* (1964) 229 CA2d 549, 40 CR 485);
- Seriatim nonjudicial foreclosures of multiple security do not violate either §580b or §580d (see *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29; *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 120 P2d 869); and
- If the buyer purchases a corporation's stock to acquire the corporation's real property rather than purchase the property directly, §580b does not apply (*Union Bank v Anderson* (1991) 232 CA3d 941, 283 CR 823; see chap 9).

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§5.31 D. Purposes of CCP §580b

There is no significant legislative history on the enactment of CCP §580b. There is, however, a good deal of judicial explanation of its purposes, much of it circular or contradictory. In *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425, the first case to ascribe purposes to §580b, the supreme court stated that the statute was intended to ensure that the lender could look only to the security for recovery of a purchase money debt, because the seller who takes back a deed of trust knows the value of the security and, therefore, assumes the risk that it will become inadequate. Ten years later, however, the supreme court effectively rejected this rationale, stating in *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873, that the *Brown* decision described the effect of the rule (if other recourse is barred, then by definition the security is the only recourse) but not a reason for it. The *Roseleaf* court also rejected the suggestion in *Brown* that the rule is based on the seller's superior knowledge of property values, finding it doubtful that the legislature intended this to be a controlling consideration.

The *Roseleaf* court declared instead that placing the risk of inadequate security on the vendor discourages the vendor from overvaluing the security. 59 C2d at 42. This is also said to discourage precarious land promotion schemes, because the security value of the land gives purchasers an idea of its true market value. The *Roseleaf* court further reasoned that, if inadequacy of the security results not from overvaluing but from a decline in property values during a general or local economic depression, §580b prevents the aggravation of the downturn that would result if defaulting purchasers were burdened with large personal liability. Section 580b thus is said to serve as a stabilizing factor in land sales.

These two purposes of CCP §580b—preventing overvaluation and stabilizing property values—are analyzed at length in §§5.32-5.35. Because the courts subject all but standard transactions to an analysis of whether the purposes of §580b will be met by granting a deficiency judgment (see §§5.26-5.30), a full understanding of both concepts is necessary.

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§5.32 1. Overvaluation of Property

The courts state that the legislative intent of CCP §580b was to prevent overvaluation of real property by placing the risk of inadequate security on the seller. See, *e.g*., *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873, and authorities in §5.31. Application of the statute generally appears to produce the opposite result.

Despite the statements in *Roseleaf* that §580b was intended to discourage a seller from asking too high a price for property, nothing in the operation of the statute encourages the seller to take less than the maximum amount it can demand: If the note is paid, the seller is better off; if not, the seller is no worse off and can enter a greater credit bid at the foreclosure sale. A purchase money note has no value beyond the worth of the property, but a larger note is no worse and probably marginally better than a smaller one, even if each is uncollectible. Instead of discouraging sellers from taking second deeds of trust, §580b often leads sellers to raise prices to compensate for the risk of the uncollectibility of their second deeds of trust, and buyers have been no less willing to accept these higher asking prices, which may later be disavowed because of §580b protection.

A purchaser, knowing that it will be immune from personal liability for any default on the purchase price, is likely to offer more rather than less for the property. If the market rises, a profit is realized; if the market falls, the loss is cushioned or completely avoided by §580b.

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§5.33 a. Residential Construction

Overvaluation is analyzed differently in the construction field. One court of appeal held that CCP §580b protection should be applied to property owners borrowing funds to build their personal residence, because this protection would "discourage construction borrowing which is 'unsound' because the financed construction is overvalued." *Prunty v Bank of America* (1974) 37 CA3d 430, 441, 112 CR 370. In *Spangler v Memel* (1972) 7 C3d 603, 102 CR 807, however, the supreme court held that purchasers of raw land who gave a first deed of trust to their construction lender and a second, subordinated deed of trust to the seller were not protected against a personal judgment in the seller's favor following a senior foreclosure sale, on the ground that denial of protection to the purchaser is the best way to deter overvaluation in that context. Because lenders always lend cautiously if the loan is nonrecourse, and because borrowers always borrow cautiously if there is no antideficiency protection, the *Prunty* and *Spangler* decisions allow a court to allocate the risk of overvaluation (and attendant deficiency exposure or protection) as it pleases, with authority for supporting either choice. For further discussion of *Spangler*, see §§5.34, 5.41, 9.134. This judicial inconsistency, of course, makes predicting future results difficult. See *Boyle v Sweeney* (1989) 207 CA3d 998, 255 CR 153.

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§5.34 b. Commercial Construction

A construction loan on commercial property is not subject to CCP §580b, because the funds come from a third party and do not involve a personal dwelling. Thus, the commercial construction lender is clearly not barred from a deficiency recovery. Furthermore, the decision in *Spangler v Memel* (1972) 7 C3d 603, 614 n9, 102 CR 807, holds that a seller of land who subordinates a purchase money deed of trust to a construction loan for commercial development may recover a deficiency judgment despite §580b. For further discussion of *Spangler*, see §5.41.

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§5.35 2. Stabilization of Economy

Another legislative intent of CCP §580b is to prevent "the aggravation of the downturn that would result if defaulting purchasers were burdened with large personal liability." *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 42, 27 CR 873. Overvaluation (see §§5.32-5.34) and stabilization are supposed to operate in complementary situations. The overvaluation mechanism, on one hand, is intended to function when the initial selling price is so unrealistically high as to guarantee that a deficiency judgment would follow any foreclosure sale because the value of the property will never equal the amount of the debt. The stabilization mechanism, on the other hand, is intended to apply when the initial selling price is proper but later market declines have so reduced the value of the property that it can no longer cover the debt. *Roseleaf Corp. v Chierighino, supra*.

The stabilization policy described in *Roseleaf* appears not to be directed at protecting the immediate parties but at slowing a downward economic spiral. The assumption seems to be that a trustor who loses the security is more likely to default on its other obligations if also faced with a deficiency judgment, and this domino effect hurts others. This policy bears some resemblance to the "fresh start" policies underpinning the bankruptcy laws.

The stabilization policy has been as difficult to justify as the overvaluation policy. Assuming that depressions are fueled by mortgage defaults, they can be more effectively ameliorated by giving all borrowers, not just purchase money borrowers, antideficiency protection. There seems no benefit to the economy in denying such protection to borrowers who obtain acquisition financing from third party lenders on commercial projects, as CCP §580b has done since 1963 (the same year in which the supreme court announced the statute's antidepression policy). Furthermore, denial of a deficiency judgment in an otherwise proper case (*i.e.,* when the property is truly worth less than the debt) does not eliminate a loss; it merely shifts the loss from the borrower to the lender. If the lender then becomes the party who is likely to default, the economic downturn is no less aggravated. See *Spangler v Memel* (1972) 7 C3d 603, 614, 102 CR 807.

Regarding the construction field, the court in *Prunty v Bank of America* (1974) 37 CA3d 430, 441, 112 CR 370, stated that the stabilization policy covers natural disasters (*e.g.,* landslides) as well as economic ones on the theory that the construction lender is able to bear such risks because of its control of the entire construction process and its ability to purchase insurance against physical risks.

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§5.36 3. Application of CCP §580b to Third Party Loans

The legislative standards for third party lenders (see §5.28) make rational application of the judicial policies of overvaluation and stabilization all the more difficult. A policy against overvaluation may have some effect in the third party loan context because some third party lenders will lend only as much as the property is worth if antideficiency rules prohibit recourse beyond the security. In such circumstances, CCP §580b may lead to more cautious lending. This policy has had very little effect in subprime market and securitized lending industries. (Even without §580b, institutional lenders may be restricted by loan-to-value ratio requirements from lending more than a stated percentage of the property's appraised value. See, *e.g.,* Fin C §§1227 (state banks), 7509 (state savings and loan associations); Interagency Guidelines for Real Estate Lending Policies (12 CFR §§560.100-560.101 and App to §560.101 (federal savings and loan associations).) The amount that a third party is willing to lend may furnish the parties with a clue to the value of the property, and it may encourage a realistic selling price. *Spangler v Memel* (1972) 7 C3d 603, 102 CR 807. See Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes,* 17 UCLA L Rev 245 (1969).

When commercial property is involved, the third party lender is not bound by CCP §580b and has recourse against the buyer-borrower for a deficiency. Consequently, such a lender is not dependent on a proper valuation of the property as long as the borrower remains solvent, even though a seller-financer who sets the price is not motivated to keep it low merely because the seller is subject to §580b. A serious overvaluation approach, *i.e.,* one intended to stop overpriced sales, would possibly reverse this arrangement, subject the lender to §580b, and not bar the seller by it.

The inability to match either of the judicially declared policies with the mechanics of the legislative mandate makes it exceedingly hard for attorneys to know in advance whether loans involving their clients are covered by or exempt from §580b.

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§5.37 E. Structuring Transactions to Avoid CCP §580b

Code of Civil Procedure §580b gives protection in some cases and denies it in others (see §§5.26-5.30); therefore, it is not surprising that parties structure transactions to try to avoid the statute's debtor protections. The courts have been erratic in deciding which arrangements permissibly avoid §580b and which do not. The basic principle, of course, should be that courts look beyond form and into the substance of transactions. See *Bank of Italy Nat'l Trust & Sav. Ass'n v Bentley* (1933) 217 C 644, 20 P2d 940. Instead, some decisions appear to hold out hope to lenders that the proper form will avoid application of §580b.

Shortly after setting forth the policies it believed underlay CCP §580b (see *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873; see also §§5.31-5.35), the California Supreme Court permitted a transparent avoidance device to succeed. In *Kistler v Vasi* (1969) 71 C2d 261, 78 CR 170, a purchaser of raw land paid part of the price in the form of a note and deed of trust to the seller's broker. (The transaction was an exchange, but it is best understood as involving a purchaser, a note secured by a deed of trust to the seller, and a note to the seller's broker covering the commission the seller owed his broker.) Because the note covered the seller's liability to his broker, the substance of the transaction was no different from the buyer giving the second note to the seller (to cover the balance he owed the seller on the price) and the seller then turning the note over to the broker (to cover his obligation to the broker for a commission).

The substance of the transaction, therefore, should have subjected the loan to §580b protection. Rather than reject that characterization, the supreme court held that the parties were free to structure the transaction either way and to choose whether to give or withhold deficiency protection to the buyer. Moreover, the court added, the buyer presumably paid a lower price in return for executing an unprotected note, which makes it appear that §580b generates rather than discourages overvaluation. Because form triumphed over substance, lenders have taken some comfort in the prospect of regaining control over the loans they make, but they have little confidence that such an approach will always work on a consistent or predictable basis.

Conversely, in *Ziegler v Barnes* (1988) 200 CA3d 224, 246 CR 69, the court held that a similar arrangement did not escape CCP §580b protection. In *Ziegler,* the true seller had the buyer execute a note to a third party (as part of the ostensible acquisition of a different parcel, which was then traded to the true seller as part of a tax-deferred exchange). Without reference to *Kistler v Vasi, supra,* the court refused to allow the form of the transaction to override its substance, *i.e.,* that the buyer gave a note to the true seller for the property ultimately acquired by the buyer. On the effect of partially secured loans, see §5.53.

Giving priority to substance over form does not, however, necessarily guarantee predictability. In *BMP Prop. Dev. v Melvin* (1988) 198 CA3d 526, 243 CR 715, the seller exchanged property with the buyers and also lent them $80,000 to cover cash-flow and for nonpurchase purposes. Although the loan of cash from a seller to a buyer for nonpurchase purposes hardly appears to constitute a transaction under CCP §580b, the court held that it was necessary to the sale (because the buyers could not have afforded the transaction otherwise) and was therefore subject to the statute. Because the loan was made through a separate escrow after the sale was completed, it was not in the form of a purchase money loan and the outcome was made to depend solely on the court's view of the substance of the transaction.

PRACTICE TIP: A purchase money seller or lender can reduce its risks by requiring additional security over and above a deed of trust on the property sold. On multiple security, see chap 9.

Lenders structure transactions in many ways, sometimes in an attempt to circumvent CCP §580b. The following are examples of structures to which the court applied §580b:

- In *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518, a vendor group sold one property for all cash and later a different parcel to the same buyer, taking back a security interest in the first property. The offer to purchase, however, made acceptance contingent on the sale of both properties. The parties opened simultaneous escrows. Thus, although the transactions did not fit the literal terms of the vendor-financing

provisions of §580b, the court applied the purchase money antideficiency statute broadly to cover this situation. But see *Kurtz v Calv*o (1999) 75 CA4th 191, 89 CR2d 99 (declining to apply §580b to different facts). For further discussion of *Conley*, see Bernhardt, *Changing Course,* 20 CEB Real Prop L Rep 260 (Nov. 1997).

- In *Frangipani v Boecker* (1998) 64 CA4th 860, 75 CR2d 407, the buyer took title subject to two deeds of trust. The buyer failed to make payments on the junior deed of trust, and the seller made a protective advance to stave off a senior foreclosure. The court applied §580b to preclude the seller's recovery from the buyer of this advance, holding that allowing such a recovery would frustrate the policy purposes of §580b.
- In *Birman v Loeb* (1998) 64 CA4th 502, 511, 75 CR2d 294, the court applied §580b to prevent a judicial setoff, although admitting that the setoff would not constitute a literal deficiency and was, at most, analogous to or "the functional equivalent of a deficiency judgment." For further discussion of *Birman*, see Bernhardt, *Foreclosure Shortfalls,* 21 CEB Real Prop L Rep 144 (Aug. 1998).

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§5.38 F. Effect of Attachment Statute

Under CCP §483.010(b) of the California attachment statute, an undersecured creditor can attach the debtor's property, but CCP §483.012 subjects this right to the restrictions of CCP §580b (and CCP §580d; see §5.8). The reference to §580b appears to mean that a purchase money creditor (who is by definition barred from any deficiency judgment) may not attach other assets no matter how undersecured its claim is. An improper attachment by a purchase money junior may eliminate the security as well as any monetary claim the junior previously had. For further discussion of attachment, see chap 4.

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G. Sold-Out Junior Creditors

§5.39 1. Standard Transaction: Loan Secured by Property Purchased

Except for special cases, the sold-out junior creditor is barred from bringing a personal action against the trustor when the junior lien secures a purchase money loan. Thus, unlike CCP §726(a) (see §§4.42-4.46) and CCP §580d (see §§5.10-5.15), CCP §580b applies to a sold-out junior creditor. See *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425. See also *Mortgage Guar. Co. v Sampsell* (1942) 51 CA2d 180, 124 P2d 353. A junior creditor who holds a recourse nonpurchase money note is permitted to sue on it following a senior foreclosure sale. The formal basis for the *Brown* holding was the assertion that a sold-out junior suing on the note is seeking a deficiency judgment. Technically, such an action is not for a deficiency, because the junior has not held a previous foreclosure sale. In *Brown,* however, the supreme court held that a foreclosure sale is a precondition only when it would not be an idle act. When there is no security left to foreclose, a judgment on the note is the functional equivalent of a deficiency judgment and therefore subject to CCP §580b. Automatic application of this rule is limited to "standard" purchase money mortgage transactions. *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873 (see §5.26). Application in "variant" contexts (see §5.29) depends on an analysis of the overvaluation and the stabilization of property values purposes (see §§5.31-5.35).

For a case that deviated from the rules established in *Brown* and *Roseleaf*, see *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518, cited in §5.37. "*Brown* and its progeny" were further distinguished in a Ninth Circuit decision, *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1998) 223 BR 203, aff'd (9th Cir 2000) 234 F3d 1108, 1117. In *Prestige* the lender had lost its security as a result of the "sanction aspect" of CCP §726. Because the loan in question was a standard purchase money transaction and therefore permitted no personal recourse, the debtor contended that the lender was without remedy. In a decision seeming to strain to avoid such an outcome, the court characterized *Brown* and the other sold-out junior and purchase money cases as "inapposite." 234 F3d at 1117. In doing this, the court asserted that *Brown* and its progeny all involved the exhaustion of the security by a senior sale. Aside from simply asserting this distinction, the *Prestige* court offered no explanation for why this supposedly distinguishing fact makes any difference analytically on the issues of public policy or legislative intent.

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2. Nonstandard Transactions

§5.40 a. *Roseleaf:* Loan Secured by "Other" Security

The supreme court, in *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873, held that CCP §580b does not apply when the seller of property takes back notes secured by second deeds of trust on other properties already owned by the buyer. The court declared that the overvaluation and stabilization principles (see §§5.31-5.35) do not apply when a note is secured by property other than the property just purchased. See *Kurtz v Calvo* (1999) 75 CA4th 191, 89 CR2d 99. The seller holding "other security" may escape §580b by suing on its note if its security interest in the other property is later wiped out by a senior foreclosure sale. The reason for this position has never been satisfactorily explained in view of the policy grounds stated to underlie §580b, discussed in §5.31. It seems apparent that a seller who takes security in other property rather than accept a junior deed of trust on the property being sold probably does so because it believes that the property being sold is inadequate security (*i.e.,* overvalued) and that a depression is aggravated no less by a buyer who loses its other security and still owes a deficiency judgment to the seller. See *McCullogh v M & C Beauty College* (1987) 194 CA3d 1338, 240 CR 189.

The seller's lien on the other security in *Roseleaf* was a junior lien, but the opinion does not treat that fact as significant for CCP §580b purposes. Conceivably, even if the seller had held a first lien on the other security, it could have recovered a deficiency judgment under appropriate circumstances.

For a case that distinguished *Roseleaf* and refused to apply the "other security" variant standard to the sale of two parcels when the seller took back a second deed of trust on one parcel to secure partial payment of the price of the other, see *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518, cited in §5.37.

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§5.41 b. *Spangler:* Subordination to Construction Loan

The California Supreme Court held that a seller who takes back a subordinated junior deed of trust on property sold when the senior lien secured a construction rather than an acquisition loan is not engaging in a "standard" transaction (see §5.26), because the contemplated change of use (resulting from construction) makes the present value of the security unreliable as an indicator of future security value. *Spangler v Memel* (1972) 7 C3d 603, 102 CR 807. Moreover, the court held that the purposes of CCP §580b are best served by permitting the seller to obtain a deficiency judgment after a senior foreclosure sale. The court declared that (1) overvaluation in this context is best prevented by imposing the risk of failure on the buyer rather than the seller and (2) stabilization is not furthered by making the seller rather than the buyer bear the loss after the senior foreclosure has eliminated both interests. See *Jack Erickson & Assocs. v Hesselgesser* (1996) 50 CA4th 182, 57 CR2d 591 (apparent nonstandard transaction case treated as waiver); *Roffinella v Sherinian* (1986) 179 CA3d 230, 224 CR 502 (subordinated purchase money security treated as variation of standard transaction). See also §§5.21-5.35; *Wright v Johnston* (1988) 206 CA3d 333, 253 CR 418, in which the seller, who subordinated to subsequent refinancing of the senior loans and was left with no equity cushion, was permitted to recover a deficiency judgment.

The *Spangler* doctrine is generally read to require that to qualify as a nonstandard transaction, (1) a purchase money loan that was subordinated to a construction or other loan must have been expected to materially alter the nature of the security, and (2) the subordination must actually have been executed rather than remaining just latent or executory. See, *e.g., Crookall v Davis, Punelli, Keathley & Willard* (1998) 65 CA4th 1048, 77 CR2d 250; *Thompson v Allert* (1991) 233 CA3d 1462, 285 CR 367.

The reasoning in *Spangler* casts considerable doubt on the logic of *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873 (see §5.40), in standard transactions because the *Spangler* explanation applies with equal force to standard as well as nonstandard situations. Because the overvaluation policy relates to the purchase price of the property as set by the buyer and the seller, not the lender, the effect of shifting the risk of an inflated price from seller to buyer is the same whether the first loan is for construction or for purchase, at least when the property is commercial. The effect of a senior sale on a junior deed of trust (*i.e.,* leaving the junior without security or payment) is also independent of the nature of the senior deed of trust. Thus it is hard to perceive how overvaluation is expected to work in other situations or to limit *Spangler*'s denial of deficiency protection to construction-subordination cases.

The difficulty in applying the *Spangler* logic continues to plague the courts. *Spangler* suggests that CCP §580b might apply if the buyer used the property as its personal residence rather than for commercial purposes. Because the security value of residential property seems to depend on the nature of the purchaser's future use, such as commercial use, it is difficult to appreciate this limitation.

The suggested application of §580b to instances of subordination to noncommercial construction was taken up in *Ziegler v Barnes* (1988) 200 CA3d 224, 246 CR 69, in which a subordinated seller was allowed to seek a deficiency under *Spangler* even though the building was a single-family residence. See also *Boyle v Sweeney* (1989) 207 CA3d 998, 255 CR 153, in which a single-family residence was replaced with three condominiums; the court held that this change in intensity of use was equivalent to the change from residential to commercial use that justified the deficiency judgment in *Spangler*. For further discussion of *Spangler*, see §§5.33-5.34, 5.42-5.43.

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§5.42 c. Application of *Spangler* Rationale

The rationale of *Spangler v Memel* (1972) 7 C3d 603, 102 CR 807, has been applied to various circumstances, including the following:

- **Prudent maximization of value.** In *Long v Superior Court* (1985) 170 CA3d 499, 216 CR 337, the vendor sold a $150,000 parcel for $250,000 (its speculative value) and was permitted to recover on his subordinated $118,000 purchase money note after being sold out when the senior foreclosed on the construction loan. Despite the admitted overvaluation and the vendor's receipt of a down payment nearly equal to the real value of the property, the court declined to impose the restrictions of CCP §580b against the vendor, holding that he had merely "prudently attempted to realize maximum value" (170 CA3d at 507) from the property. Such statements make it difficult to predict what a court will hold to constitute purchase money in a given case.
- **Conversion of fee to lender interest.** In *Nickerman v Ryan* (1979) 93 CA3d 564, 155 CR 830, after a judgment of dissolution converted community property to a tenancy in common, the former wife transferred her interest in their motel and apartment building to her former husband, taking a note secured by a deed of trust on the motel as partial payment. Despite its clear purchase money nature, the court held that the note was not subject to CCP §580b, because the wife had entered into the transaction to be "free of the vicissitudes of the commercial enterprises" (93 CA3d at 574), a statement that describes most vendors. Indeed, in almost any case involving the sale of real estate, the purchaser's plans and abilities will markedly affect the security value of the property sold. *Spangler* gives no explanation of why this change of use policy must be confined to construction cases.
- **Cosmetic renovations.** In *Thompson v Allert* (1991) 233 CA3d 1462, 285 CR 367, the court of appeal held that subordination without a change in use of the deed of trust property did not qualify the transaction as a nonstandard variant under *Spangler;* rather it constituted a standard transaction subject to CCP §580b. The proceeds from the subordinating loan were used for "purely cosmetic" renovations to the property, leaving the same 33-unit apartment building as it had existed before the sale. The court stated that *Spangler* applies only when the subordination agreement signals a "pronounced change" (233 CA3d at 1466) in the use of the property.
- **No actual subordination.** The *Spangler* exception rule has been held inapplicable when the seller agreed to subordinate but had never in fact been called on to do so. *Crookall v Davis, Punelli, Keathley & Willard* (1998) 65 CA4th 1048, 77 CR2d 250; *Budget Realty, Inc. v Hunter* (1984) 157 CA3d 511, 204 CR 48; *Webber v Inland Empire Invs., Inc.* (1999) 74 CA4th 884, 88 CR2d 594.

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§5.43 d. *DeBerard* and *Lawler:* Limitation on *Spangler* Rationale

The supreme court unanimously held that a debtor could not give a valid waiver of CCP §580b as part of a workout arrangement with the creditor, even if it had not been given at the time of making or renewing the loan. *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292. See §5.70. Relying heavily on that decision, the court of appeal in *Lawler v Jacobs* (2000) 83 CA4th 723, 100 CR2d 52, gave a highly restrictive reading to the "*Spangler* exception" to §580b. The *Lawler* opinion suggests that a purchase money transaction may not come within the *Spangler* exception unless the sold-out secured vendor can demonstrate that (1) the subordinating construction loan was for a project that actually occurred and involved a "pronounced intensification of the property's anticipated postsale use"; (2) the construction financing "dwarf[ed] the property's value at the time of sale"; (3) the purchaser was in "a much better position than the vendor" to assess the property's possible value as modified and understand the risks of the project; and (4) applying §580b would "unfairly thrust the risk of the failure" of the project on the vendor. The *Spangler* exception to §580b (now more frequently referred to as a variety of "waiver") has little room for elaboration in light of decisions such as those in *DeBerard* and *Lawler*.

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§5.44 3. High-Bidding Purchase Money Sold-Out Junior

With regard to the other antideficiency rules, the sold-out junior that is otherwise exempt from them does come under their control when it is the high bidder at the senior sale. See §§5.11, 5.23. Since the purchase money sold-out junior is barred by CCP §580b in the standard transaction, any bid by the junior at the senior sale should not matter, and the junior remains unable to recover on its note. But when the transaction is nonstandard and a court concludes that the policies behind §580b are best served by allowing deficiency recovery, the question then arises of whether recovery should be allowed when the junior is the successful bidder at the senior sale.

Strict logic would dictate that a junior's high bid is no reason to reverse its purchase money status because the high-bidding doctrine is concerned only with double recovery principles, which are not involved here. The high-bidding purchase money junior's deficiency judgment would still be subject to fair value (*Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 221 CR 425) but not to the trustee sale restriction of CCP §580d.

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VI. APPLICATION OF ANTIDEFICIENCY RULES TO OTHER INSTRUMENTS

A. Installment Land Sale Contracts

§5.45 1. Under CCP §580b

The purchase money antideficiency provisions of CCP §580b apply to installment land contracts. The legislature added a provision to this effect in 1935, 2 years after it was first enacted, to avoid circumvention of the purchase money policy through installment land sale contracts instead of conventional mortgages or deeds of trust. A buyer (or vendee) who purchases property under an installment land contract receives antideficiency protection functionally equivalent to that given a buyer who gives back a deed of trust or mortgage for the unpaid portion of the purchase price. The seller (or vendor) can neither sue to collect unpaid back installments (*Venable v Harmon* (1965) 233 CA2d 297, 43 CR 490) nor accelerate and sue for the unpaid balance of the price (*Powell v Alber* (1967) 250 CA2d 485, 58 CR 657). Rescission combined with a monetary claim (that the rental value of the property in the buyer's possession exceeded the amount paid for it prior to breach) is probably also barred by CCP §580b because a purchase money mortgagee is not entitled to such a recovery (except for bad faith waste; see §5.58). Although rescission is available, calculating rental liability is relevant only for ascertaining how much of the already paid price the seller may retain, not how much the seller can recover in excess of the amount already received by the seller. See *Honey v Henry's Franchise Leasing Corp.* (1966) 64 C2d 801, 52 CR 18. See also *Kudokas v Balkus* (1972) 26 CA3d 744, 103 CR 318; California Real Property Sales Transactions §§9.14-9.17 (4th ed Cal CEB 2007); California Real Property Remedies and Damages, chap 4 (2d ed Cal CEB 2002).

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§5.46 a. Applicable Only to Mortgage Substitutes

Despite the language in CCP §580b that appears to cover all real estate purchase contracts, only long-term installment contracts function as mortgage substitutes (also called "hidden" or "disguised" mortgages). Accordingly, the courts do not generally apply §580b to purchase contracts that contemplate a short escrow and permanent long-term financing. See *Freedman v Rector, Wardens & Vestrymen of St. Matthias Parish* (1951) 37 C2d 16, 230 P2d 629; *Venable v Harmon* (1965) 233 CA2d 297, 43 CR 490. In such cases, §580b does not bar specific enforcement by the seller. See *Landis v Blomquist* (1967) 257 CA2d 533, 64 CR 865; *Laske v Lampasona* (1948) 89 CA2d 284, 200 P2d 871.

If the buyer fails to comply with a judgment for specific performance, the seller must then initiate a judicial sale. See *Ward v Union Bond & Trust Co.* (9th Cir 1957) 243 F2d 476. The language of CCP §580b, if taken literally, may bar the seller's right to a money judgment against the buyer following the sale.

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§5.47 b. Installment Land Sale Contracts Distinguished From Purchase Agreements

Installment land sale contracts and conventional executory purchase contracts are often virtually identical in form if not in purpose. The distinction between the two for purposes of the law of remedies is often easier to assert in theory than to apply in practice. The two types of arrangement can be distinguished both functionally (see §5.48) and statutorily (see §5.49).

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§5.48 (1) Functional Differences

Any executory real estate contract in which the seller retains legal title to ensure payment of the price (rather than to permit the parties to complete inspections and satisfy contingencies) is a candidate for treatment as a mortgage substitute. The hallmark of an installment land contract is the seller's retention of legal title for the same purpose that a creditor would take a deed of trust, *i.e.,* to secure a debt.

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§5.49 (2) Statutory Differences

The provisions of CC §§2985-2985.6 on real property sales contracts are useful in distinguishing installment contracts from ordinary buy-sell transactions. Civil Code §2985(a) defines installment contracts as those "which [do] not require conveyance of [legal] title within one year from the date of formation of the contract." Complex developer-landowner arrangements, however, involving options and phased takedowns of property, often exceed a 1-year period but are neither intended to be nor are properly classifiable as installment land contract secured transactions.

PRACTICE TIP: Seller's counsel should take care, when structuring an executory contract that will not close within 1 year, to document that the arrangement is not intended as a mortgage substitute. The documents should explain that the transaction may take more than a year to close for reasons not indicative of installment land contract characterization, but counsel should still advise the client that the courts (see §5.51) may view it differently.

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§5.50 2. Under Other Antideficiency Rules

Because CCP §580b covers installment contracts, CCP §§580d, 580a, and 726(b) are not applicable. See §4.32 on impact of CCP §726 on installment sale contracts. The mortgage analogy would give the purchaser rights of reinstatement equivalent to those held by a trustor or mortgagor. See *Petersen v Hartell* (1985) 40 C3d 102, 219 CR 170; *MacFadden v Walker* (1971) 5 C3d 809, 97 CR 537.

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§5.51 B. Other Devices That May Be Mortgage Substitutes

Mortgage protection cannot be limited to documents that declare on their face that they constitute mortgages; otherwise, the antideficiency rules could be evaded by the use of devious language, labels, and structures. The courts generally look to the substance rather than the form of a transaction to decide whether it functions as a real estate security device. The following devices may be considered mortgage substitutes:

- Holding agreements (*Lucky Invs., Inc. v Adams* (1960) 183 CA2d 462, 7 CR 57 (CCP §580b); *Jensen v Friedman* (1947) 79 CA2d 494, 179 P2d 855 (CCP §580d));
- Covenants not to convey or encumber, also called "negative pledges" (*Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379; *Kaiser Indus. Corp. v Taylor* (1971) 17 CA3d 346, 94 CR 773);
- Deeds absolute, especially when combined with repurchase options (*Wilson v Anderson* (1930) 109 CA 467, 293 P 627);
- Sale-leasebacks or ground leases (*Golden State Lanes v Fox* (1965) 232 CA2d 135, 42 CR 568; *Orlando v Berns* (1957) 154 CA2d 753, 316 P2d 705); and
- Executory deeds in lieu of foreclosure (*Hamud v Hawthorne* (1959) 52 C2d 78, 338 P2d 387).

When an instrument is deemed to constitute a mortgage, judicial foreclosure becomes the *only* remedy. See *Kaiser Indus. Corp. v Taylor* (1971) 17 CA3d 346, 94 CR 773. A trustee sale is available only if the instrument contains a power of sale provision, which seldom occurs except in installment land contracts because such a provision would lead to virtually certain mortgage recharacterization. The remaining antideficiency rules would automatically follow any such recharacterization.

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§5.52 C. Unsecured Notes

Unsecured notes are not governed by antideficiency rules. *Childs v Hunt* (1970) 9 CA3d 276, 88 CR 34. Even if the note is given as part of the purchase price for real property, CCP §580b does not apply. *Jonathan Manor, Inc. v Artisan, Inc.* (1967) 247 CA2d 651, 56 CR 14. Without explaining why, courts have held that the policy against overvaluation is not served by extending the restrictions of §580b to unsecured notes (see *Van Vleck Realty v Gaunt* (1967) 250 CA2d 81, 58 CR 246), although overvaluation seems even more probable when the seller prefers to rely on the buyer personally rather than on the property for repayment.

Because the antideficiency statutes do not apply to unsecured notes, a party who lends funds or advances credit in a real estate transaction but takes no security interest in the property may sue on its note for nonpayment without foreclosing first and without showing the fair value of the property or establishing that the loan was not a purchase money loan. *Christopherson v Allen* (1961) 190 CA2d 848, 12 CR 658.

It is unknown whether the unsecured creditor's status is affected when it becomes the high bidder at a foreclosure sale held by a secured creditor or whether courts will apply the doctrine of *Simon v Superior Court* (1992) 4 CA4th 63, 5 CR2d 428 (merging lender's first and second deeds of trust into single loan), to this sale as well. On the merger doctrine, see §§1.45, 4.44, 5.12, 9.28-9.31, 9.64.

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§5.53 D. Partially Secured Loans

When the total value of the security is not sufficient to provide full coverage of the entire debt, a creditor may elect to divide the debt into separate secured and unsecured components, with each represented by separate notes. The principal amount of the secured note is less than it would be if the unsecured note were not used; therefore, the secured note will carry a better loan-to-value ratio and may be more tradable in the secondary market. The unsecured note may not be riskier than the secured note if the security is of doubtful value. If the debtor has sufficient solvency, a money judgment on the unsecured note may be easier to obtain and collect than obtaining and enforcing a deficiency judgment. Because none of the antideficiency rules apply to unsecured notes (see §5.52), the creditor's previous trustee sale on the secured note, or even its underbidding at such sale, should not affect the creditor's recovery on the unsecured note. There is some dicta that the different notes must represent distinct obligations, but that distinction has never been applied to impair a truly fractionalized loan arrangement. See *Nevin v Salk* (1975) 45 CA3d 331, 342, 119 CR 370; *Jonathan Manor, Inc. v Artisan, Inc.* (1967) 247 CA2d 651, 56 CR 14.

EXAMPLE: A $300,000 purchase money loan might be divided into three $100,000 notes that do not overlap or cross-collateralize. One note, secured by the property sold, would be purchase money and subject to CCP §580b. Another, secured by other property, would be subject to the other antideficiency rules but probably not to §580b. The third would be left unsecured and would remain generally outside the ambit of the antideficiency rules. The creditor would have to accept the disadvantages of this arrangement. When the buyer wished to clear title on the secured property, the creditor could make a payoff demand only on the note secured by that property.

The drawback to this fractionalization is that the respective advantages of each alternative are denied to the other because the remedies for each are exclusive. Thus if the security rises in value and the debtor becomes insolvent, the unsecured note may become worthless, but the proceeds from the secured note's foreclosure sale would have covered the full loan amount if it had been fully secured. Conversely, if the security declines in value while the debtor's personal wealth increases, the secured note may be rendered partly worthless by the antideficiency rules, but the unsecured note may be fully collectible.

Attempts have been made to write notes that are or appear to be secured and unsecured simultaneously, but such devices have inevitably failed. See *Freedland v Greco* (1955) 45 C2d 462, 289 P2d 463 (duplicate notes, each covering entire debt but differently secured, treated as one single obligation); *Loretz v Cal-Coast Dev. Corp.* (1967) 249 CA2d 176, 57 CR 188 (declaration in loan documents that security covered only part of loan amount leaves no part of note unsecured, because security not released until entire debt is paid under CC §2912). It is likely that dragnet, cross-collateral, and cross-acceleration clauses in the loan documents can also destroy an otherwise valid fractionalization arrangement.

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VII. SITUATIONS NOT SUBJECT TO ANTIDEFICIENCY RULES

§5.54 A. Mistake

Equitable principles of unjust enrichment occasionally permit lenders to recover from borrowers even when their loans are purchase money loans. In *First Nationwide Sav. v Perry* (1992) 11 CA4th 1657, 15 CR2d 173, a lender whose deed of trust had been mistakenly reconveyed to the trustor by the trustee was allowed to seek restitution from the proceeds of a subsequent sale by the trustor when the trustor apparently knew or should have known of the error. In *Ghirardo v Antonioli* (1996) 14 C4th 39, 57 CR2d 687, a lender who miscalculated the amount of its payment demand and thus reconveyed its deed of trust for a less than full repayment from the borrower was entitled to sue for unjust enrichment.

Civil Code §2943(d)(3), which gives the lender an unsecured claim following satisfaction of an understated payoff demand, is not subject to a CCP §580b defense. *Ghirardo v Antonioli, supra*. See also *Cathay Bank v Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 266, 53 CR2d 595.

Relief based on unjust enrichment is not prohibited by CCP §580b (see §4.41). Furthermore, because such restitutionary recovery is limited to the value of the property (see *First Nationwide Sav. v Perry, supra*), there is little likelihood that such relief will run afoul of the fair value standards of CCP §§580a and 726(b). When the claim for unjust enrichment is asserted after the creditor has conducted a nonjudicial trustee sale, the applicability of §580d has not yet been decided.

PRACTICE TIP: Lenders facing the mistaken reconveyance scenarios in *Perry* and *Ghirardo* should bear in mind that, while they may have a remedy under CC §2943(d)(3) or on theories of implied contract or unjust enrichment, such claims may be subject to limitations periods less generous than those applicable to written contracts and negotiable instruments. For an illustration of this point, see *FDIC v Dintino* (2008) 167 CA4th 333, 84 CR3d 38, in which the lender was ultimately successful but only after the borrower had vigorously defended on statute of limitations grounds. When a mistaken reconveyance problem is discovered, counsel for the formerly secured lender should bring the appropriate recoupment claims promptly and not rely on 4- or 6-year limitations periods.

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§5.55 B. Fraud

A lender's recovery of damages against the borrower for fraud does not constitute a deficiency judgment for purposes of CCP §580a, §580b, or §580d. See CCP §726(f)-(h) (not applicable to loans of $150,000 or less (adjusted for inflation) on single-family residential property); *Lassar & Gross Int'l, Inc. v Dunham* (1987) 196 CA3d 496, 241 CR 854; *Guild Mortgage Co. v Heller* (1987) 193 CA3d 1505, 239 CR 59 (§580d no bar to post-trustee-sale fraud action); *Manson v Reed* (1986) 186 CA3d 1493, 231 CR 446 (§580b no bar to sold-out junior seller's fraud action); *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 138, 135 CR 802; *Franklin v Commonwealth Fin. Corp. (In re Franklin)* (9th Cir 1991) 922 F2d 536 (§580d and 3-month time period of §580a no defense to nondischargeability issue in bankruptcy). See also Fin C §§7459-7460, enacted to modify the decision in *First Fed. Sav. & Loan Ass'n v Lehman* (1984) 159 CA3d 537, 205 CR 600. The *Lehman* court had held that fraud actions were precluded in the purchase money context unless the complaint alleged misrepresentations as to the value of the security. Financial Code §§7459-7460 altered this rule. With limited exceptions for loans secured by single-family, owner-occupied property, any act constituting fraud under CC §1572 takes the lender's claim outside the one-action and antideficiency rules if the borrower's fraudulent conduct induced the original lender to make the loan. See Fin C §7460.

Such fraud claims are not defined as deficiency claims. They arise independently of the note and are based on a breach of legal duties distinct from the secured obligation. Nevertheless, some courts continue to apply antideficiency rules and antiwaiver policies to preclude fraud claims when those fraud claims are based on illicit antideficiency waivers or constitute attempts to obtain prohibited deficiency judgments "by indirection." See, *e.g.*, *Lawler v Jacobs* (2000) 83 CA4th 723, 100 CR2d 52 (in litigation between parties who were both attorneys, fraud claim based on unenforceable waiver of CCP §580b is prohibited).

On fraud and CCP §726(a), see §4.48.

The measure of damages for fraud (out-of-pocket losses under CC §3343 or consequential damages under CC §3333 when the fraud is by a fiduciary) is different from that used in deficiency judgments. See *Michelson v Camp* (1999) 72 CA4th 955, 962, 85 CR2d 539 (even if no breach of legal duties, liability can still be imposed for intentional fraud if lender was intended beneficiary); *Hardin v Gianni (In re King St. Invs.)* (BAP 9th Cir 1998) 219 BR 848. See also §4.48.

It is unclear what effect a recovery for fraud has on the lender's ability to then obtain a deficiency judgment. Presumably, any part of the recovery compensating the lender for funds disbursed as a result of fraudulent inducement should apply against the unpaid loan balance.

Damages may also be recovered for other types of fraudulent behavior despite the antideficiency rules. See *Bell v Roy* (1986) 187 CA3d 694, 232 CR 83 (trustor falsely released vendor's deed of trust); *Sawyer v First City Fin. Corp.* (1981) 124 CA3d 390, 177 CR 398 (conspiracy between trustor and senior to eliminate junior lien). See also *Passanisi v Merit-McBride Realtors, Inc.* (1987) 190 CA3d 1496, 1509, 236 CR 59 (attorney fees not barred by CCP §580d when beneficiary successfully resists trustor's action to enjoin foreclosure sale); *Kass v Weber* (1968) 261 CA2d 417, 67 CR 876 (rescission by defrauded beneficiary). An action for rent skimming (appropriating rents rather than applying them to mortgage payments) is not subject to the one-action or antideficiency rules. CC §891(g). On one-action rule's applicability to rent skimming, see §4.49.

Because fraud and similar intentional tort claims provide the creditor with claims not precluded by the borrower's antideficiency protections, creditors will sometimes seek to impose vicarious liability on the borrower for the intentionally tortious conduct of agents such as mortgage brokers and escrow holders. See, *e.g., Funfstuck v Scott* (Aug. 30, 2003, B165105; not certified for publication) 2003 Cal App Unpub Lexis 7909, 2003 WL 21978631 (lender did not succeed in recovering from borrower funds embezzled by loan broker). Because of the public policy basis for the antideficiency rules, however, such creative efforts will likely be successful only if the borrower is significantly involved in the wrongdoing, *e.g.*, when the borrower conspires to commit the fraud or other intentional tort.

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§5.56 C. Intentional Interference and Conspiracy

A judgment entered following a jury verdict against a debtor corporation and its alter ego affiliates for conspiring to interfere with contract by buying a senior loan and using it to wipe out a junior purchase money loan—conduct described by the court as a "sham foreclosure"—was affirmed in the face of a defense based on CCP §580b in *Webber v Inland Empire Invs., Inc.* (1999) 74 CA4th 884, 88 CR2d 594. In affirming, the court of appeal cited and relied on the court's decision in *Manson v Reed* (1986) 186 CA3d 1493, 231 CR 446, and its conclusion that applying §580b to preclude recovery for intentional wrongdoing would "condone" such wrongdoing (fraud in the case of *Manson*).

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§5.57 D. Waste

Civil Code §2929 imposes on the trustor a duty not to commit waste. Most form deeds of trust amplify this requirement by also prohibiting other conduct that could impair the value of the security (see §4.51). In some respects, §2929 protects the beneficiary better than would a deed of trust provision because the courts have held that such provisions do not run with the land to bind nonassuming successor owners, while the §2929 statutory duties do apply to such grantees. *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557. For further discussion of remedies for waste, see §§2.119-2.120 (after full credit bid at trustee sale), 4.51-4.53 (application of one-action rule), 6.9-6.15, 6.34-6.36, 6.40, 6.56 (remedies pending foreclosure), 8.74-8.82 (as basis for foreclosure).

Code of Civil Procedure §§580b and 580d both apply to protect a trustor from liability for waste other than bad faith waste. In *Cornelison*, the supreme court found sufficient similarity between liability for waste and deficiency liability to justify common statutory protection for both.

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§5.58 1. Bad Faith Waste

Code of Civil Procedure §§580b and 580d do not protect a trustor from liability for bad faith waste. In *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, the supreme court ruled that §580b bars the beneficiary of a purchase money obligation from recovering for waste unless bad faith can be shown. The beneficiary of a nonpurchase money obligation can recover for non-bad-faith waste only if it forecloses judicially with redemption preserved and the sale results in a deficiency. Similarly, if the foreclosure is by trustee sale, §580d bars relief for all but bad faith waste. On the effect of a full credit bid at a trustee sale on recovery for waste, see §2.120.

The discussion in *Cornelison* of what constitutes bad faith waste provides only vague guidance. It suggests that failure to care for property during a depression might constitute waste, without specifying whether it matters if the rent rolls have fallen or if the owner is unemployed. See *Osuna v Albertson* (1982) 134 CA3d 71, 184 CR 338; *Hickman v Mulder* (1976) 58 CA3d 900, 130 CR 304; *Mills v Sdrawde Titleholders, Inc. (In re Mills)* (9th Cir 1988) 841 F2d 902. A borrower's failure to pay property taxes despite the availability of income from the property to do so was held to constitute bad faith waste by applying the rule in *Cornelison*. See *Nippon Credit Bank v 1333 N. Cal. Blvd.* (2001) 86 CA4th 486, 103 CR2d 421; Bernhardt, *Faithful Waste,* 24 CEB Real Prop L Rep 151 (May 2001). On whether fair value principles would limit recovery for waste, see §6.11. On recovery of attorney fees in actions for bad faith waste, see *Aozora Bank Ltd. v 1333 N. Cal. Blvd.* (2004) 119 CA4th 1291, 15 CR3d 340 (attorney fees denied because recourse carve-out for waste did not expressly provide for recovery of attorney fees), discussed in §1.15.

Any deliberate act that impairs the security may be characterized as committed in bad faith. Omissions impairing the security are more difficult but not impossible to characterize as committed in bad faith, particularly if the defendant had the reasonable ability to prevent the harm and failed to do so in order to injure or gain an advantage over the lender. One Northern California jury returned a verdict for millions of dollars, finding that the debtor intentionally withheld payment of property taxes to induce the lender to participate in loan modification negotiations. See *Nippon Credit Bank v 1333 N. Cal. Blvd., supra*.

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§5.59 2. Federal Court Treatment of Waste

The federal courts, rejecting application of the rule promulgated in *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557 (see §5.58), to loans insured by the Federal Housing Administration, characterized the rule as one that encourages the spread of blight (by encouraging the owner to stay current on the mortgage rather than to maintain the property). Rather than giving waste liability antideficiency protection because of its similarity to deficiency liability, the federal courts hold that waste must be actionable precisely because deficiency recovery is not. There is no requirement, therefore, that bad faith be shown. *U.S. v Haddon Haciendas Co.* (9th Cir 1976) 541 F2d 777. But see *Mills v Sdrawde Titleholders, Inc. (In re Mills)* (9th Cir 1988) 841 F2d 902 (state law on waste applied in bankruptcy proceeding). See §5.63 on federal law and antideficiency rules.

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§5.60 E. Environmentally Impaired Property

When real property given to secure a loan is contaminated, federal and state laws require the owner or operator to remediate the situation and incur the necessary response costs of restoring the property to its precontamination state. Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675). For further discussion, see §4.54.

Legislation enacted in 1991 was written to deal with these concerns. A lender secured by "environmentally impaired" property may waive its lien and proceed as an unsecured creditor against the debtor. CCP §726.5(a)(1)(A). See §§4.55-4.56, 5.52. That election, however, is qualified by the requirement that, if the lender also holds other real property security, it must first foreclose on the other property and—in doing so—is subject to CCP §§580a, 580d, and 726(b). The reference to §§580a and 726(b) means that the fair value of the other security will be applied against the debt, not just the amount bid at the foreclosure sales. The reference to §580d means that the prior sales must be judicial rather than nonjudicial. Because a deficiency judgment for the same amount would be allowed under these circumstances, the statute appears to have the effect of waiving only §580b for a lender holding environmentally impaired security. For further discussion of election to waive lien, see §4.55.

Code of Civil Procedure §736(a) allows a lender to recover damages against a borrower for breach of an "environmental provision" (see definition in §4.56) before or after foreclosing on its loan and provides that such an action will not constitute a deficiency judgment within any of the antideficiency rules. For analysis of §736 and environmental indemnities, see §4.56.

Civil Code §2929.5(a) gives lenders a right of entry to inspect secured property, and CCP §564 provides for appointment of an environmental receiver (see §4.57). For a more detailed analysis, see Ferguson, Weir, Brody & Louie, *Assembly Bill 1735: New Rights for Lenders Holding Contaminated Real Property Security,* 15 CEB Real Prop L Rep 1 (Jan. 1992).

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VIII. CHOICE OF LAW

§5.61 A. Security Located Out of State

California debtors may be protected by CCP §580b even if the security is located out of state if the transaction has sufficient contacts with California or if the documents provide for the application of California law. *Kish v Bay Counties Title Guar. Co.* (1967) 254 CA2d 725, 62 CR 494; *Hersch & Co. v C & W Manhattan Assocs.* (9th Cir 1982) 700 F2d 476. The same is true for CCP §580d. *Consolidated Capital Income Trust v Khaloghli* (1986) 183 CA3d 107, 227 CR 879. In both situations, a local deficiency judgment may be prohibited even if the foreclosure occurred elsewhere. Conversely, a foreign deficiency or money judgment may be entitled to full faith and credit even if a California court would not have entered such a judgment itself. See *Stuart v Lilves* (1989) 210 CA3d 1215, 258 CR 780. For an approach to choice of law issues that contrasts with *Khaloghli*, see *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 37 CR3d 83.

If the loan documents specify, however, that another state's law applies, then CCP §580b may not apply even if local land is involved. *Kish v Bay Counties Title Guar. Co., supra; Consolidated Capital Income Trust v Khaloghli, supra; Kerivan v Title Ins. & Trust Co.* (1983) 147 CA3d 225, 195 CR 53; *Guardian Sav. & Loan Ass'n v MD Assocs.* (1998) 64 CA4th 309, 75 CR2d 151 (both borrower and lender were located outside California). See CC §1646.5. On applicability of CCP §726 when security is located out of state, see §4.58.

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§5.62 B. Debtor Resides Out of State

When the security for the debt is California real property but the debtor resides elsewhere or when the note contains a foreign choice of law provision, the antideficiency rules have mixed application. If the debtor is sued personally in another state, a money judgment entered there should be valid in California, although it may also release the California security under CCP §726(a). *Ould v Stoddard* (1880) 54 C 613. On §726, see §4.58. If the local real property is first foreclosed by a trustee sale, any subsequent deficiency judgment rendered in another state may be valid even though CCP §580d would bar such relief here. *Kerivan v Title Ins. & Trust Co.* (1983) 147 CA3d 225, 195 CR 53; *United Bank v K & W Trucking Co.* (1983) 147 CA3d 217, 195 CR 49. It is likely that local fair value provisions would be similarly inoperative. But a court has held that CCP §580b does not apply to a case involving California security and a debt instrument containing a choice of law clause invoking Texas law. *Guardian Sav. & Loan Ass'n v MD Assocs.* (1998) 64 CA4th 309, 75 CR2d 151. Although the foreclosure in *Guardian* was on California property and under California law, the court applied Texas law to the debt. For treatment by other courts of similar choice of law issues, see *SC Serv. Corp. v 1111 Prospect Partners* (D Kan 1997) 969 F Supp 1254, aff'd in part & vacated in part (10th Cir 1998) 153 F3d 728 (unpublished opinion; see 9th Cir R 36-3); *California Fed. Sav. & Loan Ass'n v Bell* (Hawaii App 1987) 735 P2d 499; *Catchpole v Narramore* (Arizona Supreme Ct 1967) 428 P2d 105.

For discussion of issues on conflict of laws and California antideficiency rules, see Comment, *Application of California's Antideficiency Statutes in Conflict of Laws Contexts,* 73 Cal L Rev 1332 (1985).

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§5.63 C. Application of Federal Law

When federal instrumentalities, such as the Federal Housing Administration (FHA) or Veterans Administration (VA), insure or guarantee loans (see, *e.g.,* 38 CFR §36.4323(e)), their collection efforts are subject to federal, not state, law. On applicability of CCP §726(a), see §4.59. State law is followed only if it furthers the policy of the federal loan program in question or if the government has waived its federal rights and consented to state regulation of enforcement on default. *U.S. v Ellis* (9th Cir 1983) 714 F2d 953; *U.S. v Stewart* (9th Cir 1975) 523 F2d 1070.

Federal law permits the United States government to recover from borrowers on FHA-insured or VA-guaranteed loans under the theories of subrogation and indemnity. See, *e.g.,* 38 CFR §36.4323(e). These provisions override the protections of CCP §580b. *Herlong-Sierra Homes, Inc. v U.S.* (9th Cir 1966) 358 F2d 300; *U.S. v Rossi* (9th Cir 1965) 342 F2d 505. See also *U.S. v Allgeyer* (9th Cir 1972) 466 F2d 1195. Similarly, federal policy considerations override CCP §580d. *Branden v Driver* (9th Cir 1971) 441 F2d 1171. See also *Carter v Derwinski* (9th Cir 1993) 987 F2d 611 (Idaho state law, which requires creditors to reduce deficiency claim to judgment within 3 months of nonjudicial foreclosure sale, has no bearing on VA's indemnity rights under 38 CFR §36.4323(e)).

The fair value provisions of Nevada law and redemption rights under Arizona law have been held to apply to Small Business Administration loans, which, unlike FHA loans, are negotiated individually. *U.S. v MacKenzie* (9th Cir 1975) 510 F2d 39. See also *U.S. v Yazell* (1966) 382 US 341, 15 L Ed 2d 404, 86 S Ct 500. But see *U.S. v Stadium Apartments, Inc.* (9th Cir 1970) 425 F2d 358 (rejecting application of state postsale redemption provisions to FHA-insured loan). Both the Multifamily Mortgage Foreclosure Act (12 USC §§3701-3717) and the Single Family Mortgage Foreclosure Act (12 USC §§3751-3768) permit federal agencies to obtain a deficiency judgment after foreclosure despite California's antideficiency restrictions. See 12 USC §§3705, 3755.

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§5.64 IX. WAIVERS

Civil Code §2953 provides that the borrower may not waive CCP §§726 and 580a protections when making or renewing a secured loan. Although CC §2953 does not refer to CCP §580b or §580d, the courts have not treated that omission as significant and have read those antideficiency sections into CC §2953. See authorities cited in §5.67. On waiver of CCP §726(a) protections, see §§4.60-4.66.

During or after foreclosure proceedings, the debtor may waive statutory protections by not asserting them in a timely manner. See §5.68. The debtor may prevent the creditor from recovering monetary relief by affirmatively raising an objection to any effort to obtain a deficiency judgment following

- a nonjudicial foreclosure sale (CCP §580d);
- any foreclosure of a purchase money loan (CCP §580d);
- passage of more than 3 months after the judicial foreclosure sale (CCP §§580a, 726(b)); or
- a judicial foreclosure sale without the lender's having first established the fair value of the property (CCP §§580a, 726(b)).

If the debtor fails to raise any of these objections, the defense will be waived and the judgment will be valid. See *Spector v National Pictures Corp.* (1962) 201 CA2d 217, 20 CR 307.

In multiple-security cases, the beneficiary's omission of part of the security will lead to loss of the lien on the part omitted. See *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897. But such omission does not appear to prohibit a deficiency judgment following sale of the security that was included. *Walker v Community Bank, supra*. See §§3.24, 9.4-9.8. If the trustor prefers that all the security be included (to reduce the size of any deficiency), this point must be raised defensively at the appropriate time in the proceedings and before the foreclosure sale. *United Cal. Bank v Tijerina* (1972) 25 CA3d 963, 102 CR 234. See §9.6. On subsequent waivers of CCP §726(a), see §4.64.

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§5.65 A. Disguised Waivers

If the effect of a transaction is to waive one or more of the antideficiency protections, even if there is no explicit waiver language, the courts may find an implicit or disguised waiver and invalidate the transaction or part of it. For example, a stipulation in the loan documents that establishes value of the security will not deprive the borrower of its right to demand a fair value hearing in any deficiency proceeding. *Loretz v Cal-Coast Dev. Corp.* (1967) 249 CA2d 176, 57 CR 188.

A debtor's indemnification of a mortgage guaranty insurer does not waive the debtor's protection under CCP §580d. *Commonwealth Mortgage Assur. Co. v Superior Court* (1989) 211 CA3d 508, 259 CR 425. A debtor's indemnification of the issuer of a letter of credit, which might otherwise be entirely invalid, is valid in all but owner-occupied one-to-four-unit residential buildings. See CCP §§580.5, 580.7; *Western Sec. Bank, N.A. v Superior Court* (1997) 15 C4th 232, 62 CR2d 243. Additionally, CCP §580.7 invalidates certain indemnifications of issuers of a letter of credit that supports a loan on an owner-occupied one-to-four-unit residential property if the letter of credit is issued to a natural person to avoid a default on a purchase money obligation.

Third party indemnification agreements, such as those sometimes required by lenders from loan brokers, are generally enforceable because the indemnitor is not an alter ego of the debtor. These indemnification agreements are often part of an independent brokerage agreement executed prior to the loan documents and often even before the identification of the potential borrower. *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 37 CR3d 83.

A purchaser of commercial property may waive the protection of CCP §580b by giving a note for the purchase price to a third party rather than to the seller directly. In *Kistler v Vasi* (1969) 71 C2d 261, 78 CR 170, because the note was given to the seller's broker to satisfy the seller's commission liability, it clearly constituted payment to the seller in substance (debt relief) if not in form. The supreme court's approval of the arrangement thus appears to constitute an intentional endorsement of this form of waiver. But see *Ziegler v Barnes* (1988) 200 CA3d 224, 246 CR 69.

NOTE: The technique in *Kistler* is effective only if the purchase transaction is one in which a seller is a third party lender who would not be barred by §580b. The purchaser of an owner-occupied, single-family house, for instance, could not waive §580b protections.

On disguised waivers of CCP §726, see §4.61.

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§5.66 B. Only Debtor Can Waive

A valid waiver requires an act of the debtor; the creditor alone cannot waive the debtor protection rules. For detailed discussion of prohibitions against creditors' unilateral waivers, see §4.62.

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§5.67 C. Contemporaneous Waivers

None of the antideficiency protections may be waived by a borrower at the time of making (or renewing) the loan. See CC §2953. The courts take the view that a necessitous borrower will always waive all its rights in order to obtain a loan. See *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7; *Winklemen v Sides* (1939) 31 CA2d 387, 88 P2d 147. This doctrine invalidates contemporaneous waivers of the following:

- The fair value provisions of CCP §§726(b) and 580a (*Winklemen v Sides, supra*);
- The 3-month limitation period of CCP §§726(b) and 580a (*California Bank v Stimson* (1949) 89 CA2d 552, 201 P2d 39);
- CCP §580d (*Freedland v Greco* (1955) 45 C2d 462, 289 P2d 463); and
- CCP §580b (*Powell v Alber* (1967) 250 CA2d 485, 58 CR 657).

Waiver language in the original loan documents is thus entirely ineffectual. On waiver of CCP §726(a), see §4.63.

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§5.68 D. Subsequent Waivers

The validity of subsequent waivers of the antideficiency rules is not always clear. Courts may uphold waivers given after the loan was originally created or renewed on the ground that the initial need to compel a debtor to waive all rights no longer exists. See, *e.g., Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7 (reasoning that policy on prohibiting contemporaneous waivers does not apply during loan enforcement proceedings). Consistent with that perception, CC §2953 prohibits only waivers given at the time a loan is made or renewed. Subsequent waivers are often mere failures to plead the relevant antideficiency rules (see §5.64) and are consistent with the view that the deficiency defenses are affirmative defenses that are waived if the debtor does not plead them. But see §§4.23-4.27, 4.66 on sanction aspect of CCP §726(a). The reasoning in *Salter* does not apply to executory waivers made while the debtor is in default. See §5.70.

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§5.69 E. Distinguishing Contemporaneous From Subsequent Waivers

What courts will characterize as a subsequent waiver may not always be clear. Is it a subsequent or contemporaneous waiver when an existing mortgage is assumed by a purchaser who also executes a waiver of some of the antideficiency protections? It is subsequent to execution from the beneficiary's point of view but contemporaneous from the purchaser's perspective. Because it is the new purchaser who executes the instrument, it is likely to be treated as a contemporaneous waiver (and therefore invalid; see §5.67). Furthermore, the creditor's willingness to permit the loan to be assumed may permit a court to recharacterize the creditor as a vendor subject to CCP §580b, thus refuting a claim that the waiver was subsequent. See §§9.126-9.131 (on assumptions), 9.132-9.135 (on effect of §580b).

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§5.70 F. Executory Waivers

An executory waiver occurs when, during the existence of the loan, the debtor agrees not to assert the antideficiency statutes as an affirmative defense if the secured creditor later seeks relief that would otherwise be barred. Before *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292, the courts of appeal were divided on the question of whether a debtor could validly waive CCP §580b as part of a later workout arrangement with the creditor. *DeBerard* settled the issue, with the supreme court's unanimously holding that such a waiver was invalid even though it had not been given at the time of making or renewing the loan.

The earlier distinction in California between contemporaneous and subsequent waivers was based on the assumption that any duress that might compel a borrower to waive rights will vanish after the loan is made. See *Hamud v Hawthorne* (1959) 52 C2d 78, 338 P2d 387; *Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7. The assumption that the debtor is not acting under duress is inapplicable to a debtor in default on a loan. See *Ghirardo v Antonioli* (1996) 14 C4th 39, 57 CR2d 687; *Palm v Schilling* (1988) 199 CA3d 63, 244 CR 600. If the waiver is given in return for an extension of time by the creditor, its validity is in doubt even though it was a subsequent rather than a contemporaneous waiver. A debtor who makes concessions to get more time is no different from any trustor who agrees that its property may be sold (at foreclosure) if it does not pay the loan on time, and the waiver is merely another form of mortgage, still subject to the antideficiency laws, as long as it was to take effect in the future (*i.e.,* like a mortgage) if a default later occurred.

DeBerard was given a broad application in *Cadle Co. II v Harvey* (2000) 83 CA4th 927, 100 CR2d 150, in which the court expressed the view that the "*Spangler* rule" (concerning nonstandard purchase money transactions) is the sole exception to the categorical rule against waiver of purchase money antideficiency protection at any time. See also *Lawler v Jacobs* (2000) 83 CA4th 723, 100 CR2d 52, explained in §5.43. Whether the *DeBerard* decision improves the situation of debtors in distress remains to be seen because informed secured lenders may be more motivated to foreclose promptly than to forbear in light of their inability to accept this significant concession as consideration for the delay. For an in-depth discussion of this issue, see Mastromonaco, DeBerard Properties, Ltd. v Lim: *Are Borrowers Helped or Hurt?,* 22 CEB Real Prop L Rep 166 (Aug. 1999).

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§5.71 X. REFINANCING

No court has yet directly addressed the question of whether refinancing a purchase money loan eliminates antideficiency protection. Despite the large number of refinancings in recent years, this paucity of reported authority is not surprising. Lenders rarely seek deficiency judgments in residential loan defaults because of the relatively modest amounts involved and because of public relations concerns and doubts about collectability. Instead, creditors generally use a trustee sale on refinanced loans. If the lender forecloses on the defaulted refinancing loan by a trustee sale, the issue of purchase money antideficiency protection is rendered moot by the creation of a deficiency bar under CCP §580d.

The strongest argument in favor of loss of antideficiency protection on refinancing is that the new loan was given only to pay off the balance of the old loan, not to directly fund purchase of the property. Semantic analysis of the antideficiency rules generally fails when opposed to perceived policy considerations. See, *e.g., Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425; *Birman v Loeb* (1998) 64 CA4th 502, 75 CR2d 294 (definition of "deficiency judgment"); *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518. If refinancing transactions are viewed as an attempt to waive CCP §580b, then under the reasoning of *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292, such waiver would be held invalid.

The difficulty is that there is no bright-line distinction between a second, truly original refinancing loan and one that merely impermissibly waives protections given to the purchaser under the first loan. A refinancing that occurs several years after the initial loan closing and that is made by a different lender, for a new principal amount, with new interest and repayment terms looks least like a continuation of the original loan, but every one of its variables can be argued as follows:

- A purchase money loan's nature is determined at the time it is made and if it was purchase money then, it retains that character. *Brown v Jensen, supra; LaForgia v Kolsky* (1987) 196 CA3d 1103, 242 CR 282.
- The execution of new loan documents does not alter the status of the original loan if the new note is a mere counterpart of the old loan. *Lucky Invs., Inc. v Adams* (1960) 183 CA2d 462, 7 CR 57.
- A change in interest rates or repayment terms occurs regularly in variable interest rate loans (see, *e.g.,* CC §1916.7) without affecting their purchase money status.
- The transfer of an existing note and deed of trust to a new lender does not affect the original status of the loan (if it did, any purchase money loan could easily be converted to a nonpurchase money loan by this simple ruse). *Costanzo v Ganguly* (1993) 12 CA4th 1085, 16 CR2d 55.

The preservation of the same lien priority for the "new" loan as held by the "old" loan (either through a new title search or by subrogation) also establishes a connection between the two loans.

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§5.72 XI. ANTIDEFICIENCY LAWS AND BANKRUPTCY

The relationship between foreclosure strategy and bankruptcy strategy is not fully resolved. Creditors have sought the bankruptcy trustee's approval for a sale of the security free and clear of all liens under 11 USC §363, contending that such sales do not constitute foreclosure sales that bring the antideficiency rules into play. See *Coppola v Superior Court* (1989) 211 CA3d 848, 259 CR 811, cited in §11.73. The sale in *Coppola*, however, was conducted at the debtor's behest, and it is not known whether a sale sought by the creditor would be similarly immune from California's debtor protection statutes. On the interesting distinction between sales mandated by the bankruptcy court and those that have merely been permitted by the court (with the bankruptcy trustee's consent), see *Spencer v Marshall* (2008) 168 CA4th 783, 85 CR3d 752. The court in *Spencer* held that a sale that violated California's Home Equity Sales Contract Act (HESCA) (CC §§1695-1695.17) was not exempt from the Act by the fact that the sale had been approved by a bankruptcy trustee and allowed by the bankruptcy court.

A related strategy is a creditor's proposal of a reorganization plan that involves surrendering the security to the creditor in partial satisfaction of the debt, leaving the unsatisfied balance for independent judicial action (a "snatch dirt" plan). Whether this procedure will be effective in light of the antideficiency statutes is also not yet known. See generally *Vista Del Mar Assocs. v West Coast Land Fund (In re Vista Del Mar Assocs.)* (BAP 9th Cir 1995) 181 BR 422 and *Butner v U.S.* (1979) 440 US 48, 59 L Ed 2d 136, 99 S Ct 914 (requiring that bankruptcy reorganization plans be lawful under and in conformity with state real property law).

Some decisions and commentary suggest an increasing sentiment favoring uniform bankruptcy rules and decreased deference to state laws in defining substantive rights and limits on claims and secured creditor rights. A good example of this trend is the decision in *In re Pruitt* (Bankr D Conn 2009) 401 BR 546, a personal property (motor vehicle) secured transactions case that reflects a very narrow view of the Supreme Court's decision in *Butner*. The impact of cases like *Pruitt* on real estate secured transactions is debatable, however, given the relative national uniformity of personal property rules under Article 9 of the Uniform Commercial Code. State and local laws of real property and real property security are traditionally far more varied. The importance of national mortgage markets and federal home loan programs provides a basis for arguments that favor a broader scope of federal preemption of state property laws.

One decision mitigating the risks to borrowers of filing a bankruptcy petition holds that no principle in bankruptcy law prohibits either the debtor or the estate from holding defenses such as the antideficiency bar of CCP §580d. *In re Grace* (Bankr ND CA, Oct. 4, 2003, 01-11078; not reported in BR) 2003 WL 22764808 (antideficiency defenses arising postpetition after secured creditor holding both senior and junior encumbrances foreclosed nonjudicially following relief from stay). For debtor strategies, including a summary of bankruptcy options, see chap 7. For comprehensive discussion of secured creditor's rights against debtor in bankruptcy, see chap 11.

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6

Rents, Receiverships, and Leases

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I. INTRODUCTION

§6.1 A. Creditor's Limited Right to Possession and Rents

A mortgage or deed of trust gives the creditor a lien against the debtor's interest in real property, which can be satisfied by judicial foreclosure or by a nonjudicial trustee sale of that interest. Before foreclosure, however, the instrument does not give the creditor any independent right to possession of the real property (*People's Sav. Bank v Jones* (1896) 114 C 422, 46 P 278) or to the rents derived from the property (*Lee v Ski Run Apartments Assocs.* (1967) 249 CA2d 293, 57 CR 496). CC §2927; CCP §744. In this chapter, possession and rents are treated as separate interests in encumbered property, distinct from each other and from the title given as security.

If the security instrument has no special enabling language, such as an assignment of rents clause (see §6.20), a default by the debtor does not deprive the debtor of possession of the property or its rents until after a foreclosure has been completed. This is not so in title theory states, which hold that the mortgage gives the creditor a title to the mortgaged property (and therefore to its possession and right to rents from the possession). California, however, follows a lien theory regarding rents, even when a deed of trust is involved, which means that there is no right to rents until a foreclosure sale eliminates the debtor's title. See *Kinnison v Guaranty Liquidating Corp.* (1941) 18 C2d 256, 115 P2d 450. The nonjudicial foreclosure sale entitles the purchaser to possession and rents (see §§2.100, 6.83). Without special language in the security instrument, the creditor has no right to possession or rent before the sale. (Following a judicial foreclosure sale, the purchaser is entitled to rents but not possession until expiration of the redemption period.) On parties' rights after judicial foreclosure sale, see §§6.73-6.82; see also 3.99-3.101. On parties' rights after trustee sale, see §§6.83-6.89; see also 2.99-2.100. On provisions affecting priority of leases and loans, see §§6.90-6.98.

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§6.2 B. Effect of Assignment of Rents Clause

Most deed of trust forms contain an assignment of rents clause, which gives the beneficiary a right to collect rents immediately on the trustor's default. Although it is a contractual provision, the assignment is regulated by statute (see §§6.19-6.31). Enforcing the assignment is discussed in §§6.32-6.71. For additional discussion of assignment of rent forms and statutory regulation of assignment clauses, see California Real Estate Finance Practice: Strategies and Forms, chaps 4-5 (Cal CEB 2000).

Hidden security instruments (also called "mortgage substitutes" or "hidden mortgages") usually lack assignment language because a provision that gives one party the right to take rents on the other's nonperformance might reveal the document's true mortgage character. On hidden mortgages, see §§3.44, 4.33, 5.51. Thus, deeds absolute, deeds and options intended as mortgages, or agreements not to encumber rarely include assignment of rents clauses. See, *e.g.*, *Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379. If such an instrument is ultimately determined to be a mortgage, it becomes one without the "fine print" as far as rents and possession are concerned. See, *e.g.*, *Earp v Earp* (1991) 231 CA3d 1008, 283 CR 43.

The presence or absence of an assignment of rents clause has a significant effect on the remedies available to the beneficiary after the trustor defaults. A debtor in possession of the mortgaged property is less likely to continue maintaining it after a default on the loan. Because foreclosure takes time, there is a significant risk that the property will deteriorate in the hands of the trustor, who is unlikely to be willing or able to spend the necessary funds to maintain property that is about to be lost. In addition, a delinquent trustor may be motivated to maximize its efforts to collect rents and other profits during this period without using these funds to cure its loan defaults. Assignment of rents and profits clauses are designed to prevent such "waste" and "skimming." See *U.S. v Haddon Haciendas Co.* (9th Cir 1976) 541 F2d 777. See also *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557. On rent skimming, see §§4.49, 5.55, 6.13. On waste, see §§2.119-2.120, 4.51-4.53, 5.57-5.59, 6.10-6.12.

NOTE: The lack of a rents and profits clause does not automatically rule out all remedies for depriving the trustor of possession and rents before foreclosure. See discussion of receiverships in §§6.15-6.18.

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II. POSSESSION AND RENTS BEFORE FORECLOSURE

§6.3 A. Mortgagee in Possession

One way for a creditor to protect against waste and reach the rents is to take possession of the property, with the debtor's consent, during the life of the loan. A secured creditor who takes such consensual possession of the real property security is known as a "mortgagee in possession." This is a specialized legal concept that carries with it consequences beyond those created in a normal deed of trust or mortgage. A creditor who becomes a mortgagee in possession thus acquires both advantages and liabilities (see §§6.4-6.8).

NOTE: The term "mortgagee in possession" does not refer to a secured creditor who has deprived the debtor of rents or possession through the appointment of a receiver by court order (see §6.43).

Because of the legislative overhaul and rationalization of the rents and profits procedures and concepts (see discussion of CC §2938 in §§6.20, 6.25-6.28), few mortgagee-in-possession issues arise. Certainly, no informed creditor will seek the status intentionally. And CC §2938(e)(1) eliminates most of the risk that a creditor will inadvertently become a mortgagee in possession by the taking of ill-advised self-help enforcement steps. Nevertheless, enough risk of mortgagee-in-possession status still exists to warrant a brief review of the attendant rights and liabilities in §§6.4-6.8.

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§6.4 1. Rights

A creditor who becomes a true mortgagee in possession may retain possession of the property until the debt is paid. *Snyder v Western Loan & Bldg. Co.* (1934) 1 C2d 697, 37 P2d 86. Even when an action to collect on the promissory note would be barred by the statute of limitations, a mortgagee in possession may remain in possession as long as the obligation is unsatisfied. *Spect v Spect* (1891) 88 C 437, 26 P 203. This is of little importance to the beneficiary under a deed of trust because the power of sale remedy is generally not subject to time limitations (see §§2.10, 3.10, 3.16-3.20), but classification as a mortgagee in possession can be important to a creditor holding a mortgage or hidden security instrument that is subject to a statute of limitation. See *Aguilar v Bocci* (1974) 39 CA3d 475, 114 CR 91.

A more important reason to become a mortgagee in possession is that such possession carries with it the right to take the rents and profits generated by the real property security. A mortgagee in possession may apply the profits from the property toward payment of the debt even if there is no assignment of rents clause in the security instrument. *Nelson v Bowen* (1932) 124 CA 662, 12 P2d 1083. See *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579. Rent is consideration for the right to possess property; thus the right to receive rents belongs to the party that has the right to be in possession, which is the creditor when it is a mortgagee in possession.

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§6.5 2. Liabilities

A mortgagee in possession must account to the debtor for management of the property and is liable for failing to act reasonably and in a businesslike manner in handling the real property and the rents collected. *Davis v Stewart* (1944) 67 CA2d 415, 154 P2d 447. Despite these obligations, the mortgagee in possession has no right to compensation for its management efforts. *Earp v Earp* (1991) 231 CA3d 1008, 1014, 283 CR 43. A mortgagee in possession does not ensure the profitability of the premises but is responsible for any losses caused by its negligence. *Murdock v Clarke* (1891) 90 C 427, 438, 27 P 275. Liability extends to junior creditors as well as to the debtor. See *Anglo-Californian Bank, Ltd. v Field* (1908) 154 C 513, 98 P 267.

A creditor with an assignment of rents clause in its security instrument may obtain most of the advantages of possession without the accompanying liabilities through the appointment of a receiver (which does not carry mortgagee-in-possession status). Rent assignment clauses are therefore considerably superior to the direct taking of possession by the creditor (see §§6.19-6.31). Mortgagee-in-possession status is particularly dangerous if there is any risk that the property is contaminated, because any owner or operator may be held responsible for clean-up costs (see §§4.54-4.57, 5.60).

PRACTICE TIP: Having a receiver appointed insulates the creditor because the receiver is the agent of the court (not of the creditor). This benefit comes at the cost of a theoretical loss of control because the receiver's decisions and powers are limited by the appointing order and the receiver is charged with considering and protecting the rights of all interested parties. In practice, however, receivers tend to be particularly responsive to the suggestions of the secured creditor who has obtained the appointment.

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§6.6 3. Debtor's Consent Required

Under California's Civil Code, a mortgage does not automatically entitle the mortgagee to possession of the mortgaged property (as was true under the title theory of mortgages at common law). CC §2927. See also CCP §744. A debtor may make an independent agreement with the creditor, however, to let the creditor take possession of the property, either at the inception of the loan or at a later time. No additional consideration is required. *Nelson v Bowen* (1932) 124 CA 662, 12 P2d 1083. The mere entry by the creditor with the debtor's consent is sufficient. A formal agreement is unnecessary; consent is implied, especially when the creditor has entered after a default and without the debtor's objection. *Hooper v Young* (1903) 140 C 274, 74 P 140 (deed absolute); *Spect v Spect* (1891) 88 C 437, 26 P 203 (mortgage). Some courts have even stated that a peaceable entry may be all that is required for a creditor to become a mortgagee in possession. *Snyder v Western Loan & Bldg. Co.* (1934) 1 C2d 697, 37 P2d 86; *Nelson v Bowen, supra*. But see *Freeman v Campbell* (1895) 109 C 360, 42 P 35. A forcible entry, however, will subject the intruding creditor to liability for forcible entry and trespass rather than creating mortgagee-in-possession status. *McGuire v Lynch* (1899) 126 C 576, 59 P 27 (trespass); *Calidino Hotel Co. v Bank of America Nat'l Trust & Sav. Ass'n* (1939) 31 CA2d 295, 306, 87 P2d 923 (forcible entry).

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§6.7 4. Entry After Invalid Foreclosure Sale

There is no definitive rule covering entry into possession after an invalid foreclosure sale. On one hand, the California Supreme Court has held that a purchaser who took possession under a judicial sale that was void for lack of an indispensable party was nevertheless a mortgagee in possession. *Burns v Hiatt* (1906) 149 C 617, 87 P 196. On the other hand, the same court has held to the contrary when the entry followed a private sale under a power of sale in a mortgage (as distinct from a deed of trust) that was barred by the statute of limitations. *Faxon v All Persons* (1913) 166 C 707, 137 P 919.

When a creditor takes possession under circumstances that do not entitle it to claim mortgagee-in-possession status, it loses all the advantages of that status. The creditor cannot retain possession to force payment of a debt that is otherwise barred (*Faxon v All Persons, supra*), and it cannot apply rents collected toward reducing the debt (*Freeman v Campbell* (1895) 109 C 360, 42 P 35). Any money collected must be turned over to the debtor even though the mortgage debt remains unpaid. *Belcher v Aaron* (1937) 8 C2d 180, 64 P2d 402. Thus, the creditor must return to the debtor any rents, which it will likely not be able to recover thereafter because of California's antideficiency laws. See chap 5.

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§6.8 5. Acts Not Triggering Mortgagee-in-Possession Status

Mortgagee-in-possession status does not follow from the mere taking of a security interest in land. Neither a mortgage nor a deed of trust in and of itself gives the creditor a right to possession of the real property. CC §2927; *Snyder v Western Loan & Bldg. Co.* (1934) 1 C2d 697, 37 P2d 86; *Bank of America v Bank of Amador County* (1933) 135 CA 714, 28 P2d 86. Nor does a deed absolute intended as a mortgage authorize the creditor to take possession of the property unless the deed expressly so provides. *McGuire v Lynch* (1899) 126 C 576, 59 P 27.

Physical acts of management—not merely rent collection—are required for a creditor to become a mortgagee in possession (*Bank of America v Bank of Amador County, supra*). The creditor does not become an automatic mortgagee in possession merely because any of the following circumstances exist:

- The security documents contain an assignment of rents clause (*Freeman v Campbell* (1895) 109 C 360, 42 P 35; *Bank of America v Bank of Amador County, supra*);
- The creditor personally collects rents from the tenants under an assignment of rents clause (CC §2938(e)(1); *Strutt v Ontario Sav. & Loan Ass'n* (1972) 28 CA3d 866, 879, 105 CR 395; but see *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579, suggesting, in dictum and in pre-CC §2938(e)(1) context, that creditor's collection of rents would be enough to impart mortgagee-in-possession status);
- The creditor enters the premises to make repairs to preserve the security (*Gudel v Ellis* (1962) 200 CA2d 849, 858, 19 CR 751); or
- The creditor obtains the appointment of a receiver to manage the property (CC §2938(e)(1); *Tourny v Bryan* (1924) 66 CA 426, 226 P 21; see also *Murdock v Clarke* (1891) 90 C 427, 27 P 275).

Persuading the debtor after default to allow the creditor to collect rents without assuming responsibility for property management also should not have the effect of making the creditor a mortgagee in possession. In the examples described above, the creditor still must account for rents actually collected but is not subject to the prudent business standard that courts apply to a true mortgagee in possession (see §6.5).

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§6.9 B. Remedies Absent Assignment of Rents

Although every printed form or computer-drafted version of a deed of trust inevitably contains some provision giving the creditor some form of interest in rents (or rents, issues, and profits) from the land, that is usually not the case when a hidden or disguised security transaction is involved. See, *e.g.*, *Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379 (covenant not to convey); *Kaiser Indus. Corp. v Taylor* (1971) 17 CA3d 346, 94 CR 773 (holding agreement); *Todd v Todd* (1912) 164 C 255, 128 P 413 (option). This section covers the remedies available to a creditor secured by real estate but without the additional security of the rents from the real estate.

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1. Damages for Waste

§6.10 a. Legal Basis

Civil Code §2929 imposes a duty on the owner of encumbered property not to impair the security; a violation of that duty is informally characterized as "waste." Although §2929 does not specify any particular remedy, it is generally accepted that damages for waste may be recovered. See *Cornelison v Kornbluth* (1975) 15 C3d 590, 598 n3, 125 CR 557; *American Sav. & Loan Ass'n v Leeds* (1968) 68 C2d 611, 616, 68 CR 453. Damages may also be recovered against nondebtor third parties who reduce the value of the security through wrongful acts. *United States Fin. v Sullivan* (1974) 37 CA3d 5, 12, 112 CR 18. See also CCP §732, under which any person aggrieved, presumably including a creditor holding a security interest, may bring an action for treble damages against a tenant causing waste.

Most deeds of trust (1) contractually require the debtor to maintain the property and not otherwise impair the security and (2) provide for relief against the debtor for failing to abide by the agreement, which ordinarily includes the creditor's right to perform any act required of the debtor that is necessary to protect the real property security. (If the debtor does not reimburse expenses of the beneficiary, they may be added to the debt and become the basis for declaring a default.)

On waste actions by foreclosing creditor after trustee sale, see §§2.119-2.120, 4.51-4.53, 5.57-5.59.

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§6.11 b. Effect of Antideficiency and Full Credit Bid Rules

The right to recover damages for impairment of security or waste is subject to the antideficiency rules. Code of Civil Procedure §§580b and 580d apply to bar any recovery unless the beneficiary can show that the waste was committed in bad faith. *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557. See *Osuna v Albertson* (1982) 134 CA3d 71, 184 CR 338. See also §§2.119, 5.58. Only if the security was not given for purchase money and the foreclosure was judicial may the beneficiary recover damages for waste from the trustor. (Such recovery would hardly be necessary in ordinary situations, because a deficiency judgment probably would produce the same result.) There may, however, be variant situations in which the fair value principles would limit recovery for waste. See *Cornelison v Kornbluth* (1975) 15 C3d 590, 601, 125 CR 557.

NOTE: Some federal courts disagree with this analysis and opine that a beneficiary has a right to recover damages for waste precisely because California's antideficiency rules prohibit any other form of monetary recovery. See *U.S. v Haddon Haciendas Co.* (9th Cir 1976) 541 F2d 777. These courts believe that the antideficiency protection given by state courts to nonrepairing trustors encourages slums and is unfair to tenants.

There is no right to recover for waste after a full credit bid by the beneficiary, because the debt is treated as fully paid by the bid. *Cornelison v Kornbluth, supra*. See §2.120. Moreover, in light of CCP §726(a), which mandates exhausting the security before pursuing the trustor personally (see §4.6), it is unlikely that a beneficiary would be able to bring a damage action against the trustor before foreclosing on its lien.

The same restrictions apply when the beneficiary sues a nonassuming successor owner of the property rather than the original borrower. However, an action for waste can be brought against nonowner third parties before foreclosing. This works to the trustor's benefit by reducing the obligation. See *United States Fin. v Sullivan* (1974) 37 CA3d 5, 12, 112 CR 18. See also *Easton v Ash* (1941) 18 C2d 530, 116 P2d 433.

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§6.12 c. Bad Faith and Other Forms of Waste

The courts have given little guidance on distinguishing between bad faith waste and other types of waste. The distinction may coincide with the traditional common law distinction between active (or affirmative) and passive (or permissive) waste. Language in *Cornelison v Kornbluth* (1975) 15 C3d 590, 603, 125 CR 557, suggests that passive waste is not in bad faith when it arises from the trustor's financial distress. See also *Hickman v Mulder* (1976) 58 CA3d 900, 130 CR 304; *Krone v Goff* (1975) 53 CA3d 191, 127 CR 390; *Mills v Sdrawde Titleholders, Inc. (In re Mills)* (9th Cir 1988) 841 F2d 902.

On beneficiary's rights concerning waste, see §§2.119-2.120, 4.51-4.53, 5.57-5.59, 6.10, 6.15.

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§6.13 2. Liability for Rent Skimming

Under CC §§890-894, a trustor of residential property (or a successor owner, whether or not it has assumed the obligation) that collects rents during the first year of ownership and does not use them to service the mortgage is liable for rent skimming. Even a person, such as an adverse possessor, who does not have a contractual duty to make payments to the mortgage holder can be liable for rent skimming because CC §890 imposes a statutory obligation to apply rental income to any outstanding loan secured by the property. *People v Lapcheske* (1999) 73 CA4th 571, 86 CR2d 565. A person who is guilty of rent skimming is liable for actual damages, attorney fees, and costs. Actual damages must be trebled for multiple acts of rent skimming when the beneficiary is the seller, and they may also be so increased in favor of other beneficiaries. *People v Bell* (1996) 45 CA4th 1030, 53 CR2d 156. Civil Code §891(g) specifically provides that CCP §§580a-580b, 580d, and 726 (see §§4.49, 5.55) do not apply to these actions. Neither the legislature nor the courts have decided whether the full credit bid rule (see §2.120) prevents a statutory claim for rent skimming. Civil Code §891 also permits the award of broad equitable relief in rent-skimming situations. Tenants may assert claims for rent skimming and recover damages, including attorney fees. CC §891(d). There are similar rules under federal law. See 12 USC §§1709-2, 1715z-4(a)b. See also *U.S. v Laykin* (9th Cir 1989) 886 F2d 1534.

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§6.14 3. Injunctive Relief

Under CCP §745(a), a beneficiary may bring an action to enjoin acts of waste during the foreclosure period. A mandatory injunction is difficult to obtain and rarely effective to compel a defaulting trustor to take care of the property, but it may have some value when there is a risk that the trustor will dismantle or remove some of the property. See *Robinson v Russell* (1864) 24 C 467. A temporary restraining order (TRO) is sometimes helpful as a provisional remedy to preserve the status quo while the beneficiary seeks appointment of a receiver (see §§6.15-6.18, 6.34-6.48). A TRO can further direct the trustor to keep and account for all rents collected until the receiver is appointed. Most courts will restrict the scope of the TRO to rents accruing after a default.

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4. Receivership—No Assignment of Rents Clause

§6.15 a. CCP §564(b)(2): Waste; Insufficient Security

When the deed of trust does not contain an assignment of rents clause, the beneficiary nevertheless may have a receiver appointed to protect the property as part of a judicial foreclosure action under CCP §564(b)(2). *Neider v Dardi* (1955) 130 CA2d 646, 279 P2d 598. To obtain an order appointing a receiver as part of a foreclosure action, grounds must exist for foreclosing. It is unclear whether mere neglect of the property or the trustor's waste is a ground for foreclosure, even if the security instrument contains a covenant against waste, unless it also provides that waste is an event of default. Most trust deed forms contain such a covenant (see §8.69). Nothing in CC §2929 or CCP §745 (see §§6.10, 6.14) authorizes a foreclosure on the basis of waste alone. See Leipziger, *The Mortgagee's Remedies for Waste,* 64 Cal L Rev 1086 (1976). On preventing waste, foreclosure based on waste, and recovery of damages, see §§2.119-2.120, 4.51-4.53, 5.57-5.59, 6.10-6.12, 6.15.

The criteria for appointment of a receiver under CCP §564(b)(2) are more restrictive than those applicable to a receiver appointed under an assignment of rents clause in a specific performance action (see §6.37). To obtain a receiver in a judicial foreclosure action when there is no assignment of rents, the beneficiary must show either of the following:

- The property is in danger of being lost, removed, or materially injured; or
- The trustor has failed to perform a condition of the deed of trust *and* the property is probably insufficient to satisfy the debt.

EXAMPLE: A construction lender may request the appointment of a receiver to complete the construction project under CCP §564(b)(2). See §§10.45-10.50.

It is not enough for the beneficiary to show nonpayment of the debt and a decline in the value of the security; the property value must have fallen below the unpaid balance of the loan. This situation necessitates an evidentiary showing of the property's present value. See *Hibernia Sav. & Loan Soc'y v Ellis Estate Co.* (1933) 132 CA 408, 22 P2d 806. Because the appointment of a receiver is viewed as a harsh and drastic remedy, a clear showing that less onerous remedies are inadequate may be required. *Cohen v Herbert* (1960) 186 CA2d 488, 8 CR 922.

The wording and grammar of CCP §564(b)(2) may also be interpreted to require a showing of insufficiency of security in both instances listed in the bullets above, and trustors may advocate this position. Beneficiaries will argue that requiring a showing of inadequacy of value in cases of threat to the security denies them the right to maintain an adequate margin of security. On margin of security generally, see *People ex rel Dep't of Transp. v Redwood Baseline, Ltd.* (1978) 84 CA3d 662, 149 CR 11. See also §§4.51, 5.18, 8.70-8.71.

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§6.16 b. Limited Ability to Collect Rents

A difficulty confronting a beneficiary whose deed of trust lacks an assignment of rents clause is that a receiver appointed under CCP §564(b)(2) may be limited to preserving the property from waste and may not be entitled to claim rents except as needed to avoid waste. Rents and title are different interests, and one may have title to property without having the right to receive rents from it. *Walmsley v Holcomb* (1943) 61 CA2d 578, 143 P2d 398. Thus, mortgaging the title does not itself convey a present right to the rents from it. *Locke v Klunker* (1898) 123 C 231, 55 P 993; *Turner v Superior Court* (1977) 72 CA3d 804, 812, 140 CR 475. Even if the rents are treated as directly connected to the title, title still remains in the trustor until the foreclosure sale is completed. Thus, without an assignment of rents clause, the rents from the property may be a separate and unencumbered asset. See *Snyder v Western Loan & Bldg. Co.* (1934) 1 C2d 697, 37 P2d 86.

Appointing a receiver cannot enlarge the scope of the lien against the property. If the deed of trust does not cover rents, the receivership may not either. *Turner v Superior Court* (1977) 72 CA3d 804, 812, 140 CR 475. Even though CCP §568 empowers a court to authorize a receiver to collect rents, that power is limited to situations in which there is an independent ground for placing the rents under the court's control, *i.e.,* when the mortgage has an assignment of rents clause or when the rents must be used to preserve the property. *Gudel v Ellis* (1962) 200 CA2d 849, 19 CR 751.

Early beneficiaries sought to avoid these difficulties by stipulating in their deeds of trust that a receiver would be appointed whenever the trustor defaulted. But this stipulation is of little help because the courts have held that jurisdiction to appoint a receiver cannot be conferred by consent. *Baker v Varney* (1900) 129 C 564, 62 P 100. See also *Barclays Bank v Superior Court* (1977) 69 CA3d 593, 137 CR 743. Despite a stipulation for appointment of a receiver in the deed of trust itself, the beneficiary must still prove probable insufficiency of the security to bring it about. *Bank of Woodland v Stephens* (1904) 144 C 659, 79 P 379.

NOTE: Because a receivership under CCP §564(b)(2) is both more difficult to obtain and less useful than a receivership to enforce an assignment of rents clause, §564(b)(2) is invoked far less often than is CCP §564(b)(9), (11). (In reviewing relevant case law, the practitioner should bear in mind that CCP §564(b)(9) was numbered previously as former CCP §564(b)(7) and (b)(8).) In 1995, the legislature added former CCP §564(b)(10), now CCP §564(11), which specifically authorizes appointment of a receiver in an action for specific performance of a rents assignment in a deed of trust (see §6.37).

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§6.17 c. Other Grounds for Receivership

The beneficiary has other remedies for obtaining possession before or during foreclosure absent a rents and profits clause. For example, CC §2929.5 and CCP §564(c) permit the appointment of a receiver for the limited purpose of inspecting for hazardous substances. This type of receivership provision, however, is narrow, infrequently invoked, and by no means a satisfactory alternative to a broadly worded assignment of rents clause.

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§6.18 d. Beneficiary Liability

Absent conspiracy or inappropriate control over the receiver, the beneficiary is not liable for the receiver's behavior and is not charged with mortgagee-in-possession status by virtue of the receivership. *Tourny v Bryan* (1924) 66 CA 426, 226 P 21. See §6.8. The beneficiary, however, may be responsible for any shortfall in administrative expenses. *Ephraim v Pacific Bank* (1900) 129 C 589, 592, 62 P 177, cited with approval by the United States Supreme Court in *Atlantic Trust Co. v Chapman* (1908) 208 US 360, 373, 52 L Ed 528, 534, 28 S Ct 406.

On appointment of receiver to complete construction under CCP §564(b)(2), see §§10.45-10.50. On appointment of receiver under assignment of rents clause, see §§6.34-6.48. On economics of having receiver appointed, see §6.36.

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III. STATUTORY REGULATION OF ASSIGNMENT OF RENTS

§6.19 A. Current and Former Rules

Civil Code §2938 regulates assignment of rents clauses made on or after January 1, 1997, and supersedes a variety of earlier inconsistent and confusing case and statutory laws. Transactions executed before that date remain subject to former CC §§2938-2938.1. See Stats 1991, ch 501 and Stats 1992, ch 453. (Former CC §2938, which covered "absolute assignments of rent," effective January 1, 1992, provided that it was merely declaratory of existing law. However, former CC §2938.1, which covered assignments made "as additional security," provided that it covered all such assignments made on and after January 1, 1993, which left unclear the question of "nonabsolute assignments" made before that date.)

Because of the varying effectiveness dates, this chapter covers both the current and the old rules for rent assignment clauses. Creditors at the very least will prefer the certainty afforded by the current statute and may be expected to demand debtor consent to application of those provisions (regardless of the original date of the transaction) in working out troubled loans.

Under current CC §2938, an assignment of rents provision executed on or after January 1, 1997, is subject to analysis from the following practical perspectives:

- Creation of an interest in rents (see §§6.20-6.28);
- Perfection of the interest in rents (see §§6.29-6.30);
- Enforcement of the interest in rents (see §§6.32-6.89); and
- Scope of the assignment of rents (see §6.31).

Under the previous rents statutes and judicial decisions, these four perspectives were often blurred or overlooked entirely. For an excellent description of the current statute, written by the members of the committee that drafted the section, see Williams, Hindmarsh, O'Neill & Waldman, *Assignment of Rents—The Next Generation,* 15 Cal Real Prop J 27 (No. 1, 1997).

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§6.20 B. Assignment Needed to Collect Presale Rents

Without an assignment of rents provision or a separate assignment of rents, a beneficiary has no entitlement to rents from the property until after the foreclosure sale has divested the trustor of title. Most deeds of trust make two references to the issue of rents:

(1) The granting clause in the first paragraph of the document usually includes the trustor's title and then adds "together with the rents, issues, and profits, thereof" or similar language, often with additional qualifying provisions; and

(2) A separate paragraph of the deed of trust (see Form Assignment of Rents in California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000)) clarifies the nature of the parties' respective rights to rents.

In addition, many beneficiaries require a separate assignment of rents document. See Real Estate Finance, chap 5.

Civil Code §2938(a) provides that any assignment of rents clause is "effective to create a present security interest" in existing and future rents on "execution and delivery" of a "written assignment of an interest" in rents. All post-1997 assignments come under this unitary standard. The statute gives no guidance on what language is necessary to constitute a written assignment, but, in light of the elaborate rents clauses in current security instruments, it is unlikely that an inadequate one will be found. Moreover, the simple addition of the phrase "together with the rents" in the granting paragraph of all deeds of trust is probably sufficient to accomplish that purpose.

Execution and delivery occur as a matter of course when the deed of trust is signed and given to the beneficiary directly or through an escrow agent. As a result of those steps, as between trustor and beneficiary, the beneficiary has a security interest in the rents from the trustor's property. Similar language existed in former CC §2938. See Stats 1991, ch 501. The issue of execution and delivery was not covered under former CC §2938.1. See Stats 1992, ch 453.

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§6.21 C. Traditional Types of Clauses

Traditionally, rents clauses have appeared in three versions:

- Absolute assignments of the rents (see §§6.22, 6.26);
- Assignments as additional security (see §§6.23, 6.27); or
- Absolute assignments conditional on default (see §§6.24, 6.28).

The interpretation given to (and the enforceability of) these clauses depends on when they were executed (see §§6.25-6.28).

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§6.22 1. Absolute Assignment

Under an "absolute assignment of rents," the creditor rather than the debtor technically owns and is therefore entitled to collect the rents. An absolute assignment is rarely made at the time the loan is made, because it does not serve the purposes of either party. Usually, the creditor has no desire to collect rents directly as long as the loan remains current, nor does the creditor desire to be treated as a mortgagee in possession. See *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579. See also §§6.3-6.8. Likewise, the debtor is reluctant to permit the creditor to receive rents directly as long as there is no default. In contrast, if the loan has gone into default, the creditor may insist, as a condition of loan restructuring, that all rents thereafter be collected by it until the loan has been retired or the default cured.

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§6.23 2. Assignment as Additional Security

At the other extreme, a creditor may take a security interest in the rents over and above the security interest in the title. These provisions may be in the deed of trust or in a separate instrument. Just as a default compels the creditor to take steps to reach the debtor's title for satisfaction (by foreclosure), it also compels the creditor under the rents clause to take steps toward utilizing the rents (by collecting them). The provision gives the creditor neither a present nor a future right to rents unless appropriate enforcement steps are taken. Until then, the lien on the rents is considered to be "inchoate." Delinquent debtors were often able to successfully withhold the rents from their creditors (thus building a war chest for litigation against those creditors) by filing bankruptcy before the creditor took the appropriate enforcement steps.

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§6.24 3. Absolute Assignment Conditional on Default

The third category, an "absolute assignment conditional on default," arose as an attempt to eliminate the delay and need to take additional action after the debtor's default. This clause purports to absolutely assign the rents to the creditor but gives a license back to the debtor to collect the rents and dispose of them on the creditor's behalf as long as the loan is current. The license terminates on a default (either automatically or after notice). The intent is to make the creditor's claim on the rents after default sufficiently good that a subsequent bankruptcy filing would not impair it.

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§6.25 D. Current Law Abolishes Formal Distinctions Between Types of Clauses

Under the current CC §2938, an assignment of rents executed on or after January 1, 1997, made in connection with an obligation secured by real property gives the assignee a present security interest in the rents "irrespective of whether the assignment is denoted as absolute, absolute conditioned on default, additional security for an obligation, or otherwise." Thus, as of January 1, 1997, a literally enforceable absolute or conditional absolute assignment of rents (see §6.22) may no longer be created. Language purportedly used to create such an interest will merely create an assignment of rent as additional security for the loan (see §§6.23, 6.27). In addition, the same steps are used not only for the creation but also for the perfection and enforcement of the beneficiary's interests in the rents. Those steps are discussed in §§6.29, 6.33-6.71.

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§6.26 1. Effect on Absolute Assignments

True absolute assignments drafted before 1997 are unaffected by the current statute and remain subject to former CC §2938, which declared that they constituted present transfers of the assignor's interest in existing and future rents effective on execution and delivery by the assignor. See Stats 1991, ch 501. Although the current CC §2938(c) requires the beneficiary to take additional "enforcement" steps to fully realize its security interest, those steps will undoubtedly have been taken to enforce a true absolute assignment of rents, *i.e.,* one in which the rents are being used to liquidate the debt directly rather than being held as security for the trustor's nonpayment of the debt.

PRACTICE TIP: Although the distinction between absolute and conditional assignments still has practical significance in light of the prospective nature of CC §2938 (see §6.20), the careful practitioner should treat any rents provision (even those created before 1997) as requiring some form of enforcement step and should act accordingly (generally by seeking a receivership).

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§6.27 2. Effect on Assignments as Security

Former CC §2938.1, enacted in 1992, applied to assignments of rents given as additional security. See Stats 1992, ch 453. It was repealed effective January 1, 1997, by the legislation that enacted current CC §2938. Consequently, it continues to apply to assignments as additional security executed between January 1, 1993, and January 1, 1997. Pre-1993 assignments are subject only to prestatutory case law.

Former CC §2938.1 provided that security assignments need only be recorded and that neither possession nor appointment of a receiver was necessary to "perfect" the beneficiary's interest in the rents. However, as discussed in §§6.29-6.30, perfection of the beneficiary's interest is not the same as enforcement of the beneficiary's right to reach actual rents. It is likely that the requirements of current CC §2938 apply also to rent assignments governed by former CC §2938.1.

With regard to pre-1993 rent assignments, case law had generally required an enforcement step, by either the appointment of a receiver or taking of possession of the property, but it had also permitted a mere demand for the rents to be a sufficient first step. See *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579; *Great W. Life Assur. Co. v Rothman (In re Ventura-Louise Props.)* (9th Cir 1974) 490 F2d 1141, 1145 n1; *U.S. v Redevelopment Agency* (ND Cal 1995) 926 F Supp 928, aff'd (9th Cir 1997) 111 F3d 139 (unpublished opinion). Because similar steps are now provided for in current CC §2938 (see §6.33), it is likely that this section will also effectively regulate pre-1993 assignments.

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§6.28 3. Effect on Conditional Absolute Assignments

Current CC §2938(a) provides that an assignment of rents clause gives the creditor merely a security interest in the rents even if it is stated to be absolute or absolute conditioned upon default. Thus, both absolute and conditional absolute assignments executed after January 1, 1997, constitute simple security assignments of rents (see §§6.23, 6.27) from the debtor to the creditor.

For pre-1997 conditional absolute assignments of rent, the answers are less clear. The California Supreme Court has held that such a clause becomes operative on the occurrence of the default (see *Kinnison v Guaranty Liquidating Corp.* (1941) 18 C2d 256, 115 P2d 450), but, given that the transaction in this case involved an absolute assignment made as part of a workout of a troubled loan, the statement is often disregarded as dictum. The Ninth Circuit Court of Appeals came to a similar conclusion, holding that such form of assignment required nothing more on the part of the creditor to prevail in a bankruptcy filed after default but before the creditor had taken any other step. *In re Ventura-Louise Props. (Great W. Life Assur. Co. v Rothman)* (9th Cir 1974) 490 F2d 1141. This case, however, has generally been criticized by commentators as misunderstanding California law. See also *Equitable Mortgage Co. v Fishman (In re Charles C. Stapp, Inc.)* (9th Cir 1981) 641 F2d 737. If the federal rulings prevail, pre-1997 conditional absolute assignments constitute a more effective collection tool than their post-1997 counterparts, which are subject to numerous other regulations by CC §2938.

The court in *In re Goco Realty Fund I* (Bankr ND Cal 1993) 151 BR 241, however, held that former CC §2938 did not permit the creditor-assignee to recover postdefault, prebankruptcy rents that the debtor-assignor had transferred to its attorneys because the creditor had never demanded the rents or possession of the property. The court held that, until the assignment is made "choate" by the creditor's having taken an enforcement step, the rents belong to the debtor. See also *Federal Nat'l Mortgage Ass'n v Bugna* (1997) 57 CA4th 529, 67 CR2d 233; *MDFC Loan Corp. v Greenbrier Plaza Partners* (1994) 21 CA4th 1045, 26 CR2d 596; *Malsman v Brandler* (1964) 230 CA2d 922, 41 CR 438. But see *Scottsdale Med. Pavilion v Mutual Benefit Life Ins. Co. (In re Scottsdale Med. Pavilion)* (BAP 9th Cir 1993) 159 BR 295, aff'd (9th Cir 1995) 52 F3d 244 (interpreting Arizona law).

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E. Perfection of Assignment of Rents

§6.29 1. Current Statute; Recording

Under current CC §2938, execution and delivery of an assignment of rents is sufficient to *create* a security interest in the rents, but recordation is necessary in order to "perfect" it, *i.e.,* give it priority over rival claims. Without perfection, a creditor's claim to the rents may be superior to the claim of its debtor but nevertheless subordinate to the claim of a competing creditor who recorded first. (This principle conforms to Com C §§9301-9342 and to standard recording logic on interests in land.)

Under this system, a senior creditor with an assignment of rents holds a claim to the rents prior to those of a junior creditor only if the senior's assignment is recorded first, just as with its lien on the title to the security. If the assignment clause is in the deed of trust, recordation of that instrument automatically settles the perfection question, but if the assignment of rents provision is in a separate instrument, the creditor must also record it.

If the senior security instrument is timely recorded but the accompanying rents clause is not, priority fights will arise between that creditor and a subsequent, otherwise junior creditor whose rents clause is first recorded. Courts will be required to decide whether the existence of the recorded senior instrument gave the second creditor a duty to inquire about its scope, which would mean complete priority for the first creditor even though the second creditor recorded its claim to rents first.

If a court determines that the second creditor has the prior claim to rents, once that party takes the appropriate enforcement steps (see §§6.33-6.71), all rents thereafter derived from the property secure the claim of the second rather than the first creditor. The first creditor has a senior lien on the title and may keep all proceeds from a foreclosure sale that are necessary to satisfy its claim, but it may not reach the rents if the sale proceeds are inadequate. The second creditor is entitled only to the excess sale proceeds after the first creditor has been paid, but it may also take all rents that were collected on its behalf.

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§6.30 2. Former Law

Former CC §2938 (dealing with conditional absolute assignments) contains the same perfection provision as the present statute. See Stats 1991, ch 501. The priorities questions regulated by the rules of perfection appear to be resolved identically under both sections. See §6.29. Former CC §2938.1 (dealing with security assignments) also provided that the assignment was perfected on recordation, but it added that taking possession or having a receiver appointed was unnecessary for perfection purposes. See Stats 1992, ch 453. This final clause does not appear in current CC §2938, probably because it is unnecessary. Taking possession and appointing a receiver are enforcement steps, which have nothing to do with the issue of perfection. (Indeed, if there were no rival creditors, a rents claimant would be entitled to the rents after default even though its claim was never perfected through recording.)

Earlier cases confused the issue by using perfection to refer to the enforcement steps a secured creditor must take to make its lien on rents "choate." The mere right to a lien on rents has been regarded as an interest that may be set aside in bankruptcy; only after the creditor has taken the appropriate steps after default, sequestering those rents for satisfaction of its own claim, is its interest in the rents sufficiently strong to survive the debtor's bankruptcy. Much of the earlier legislation can best be understood as legislative attempts to protect creditors in the event of a debtor bankruptcy. See Reynolds, *A New Look at Secured Creditors' Rights to Rents and Profits: Is the Pendulum Swinging Back?,* 15 CEB Real Prop L Rep 257, 261 (Aug. 1992). Furthermore, 11 USC §552(b)(2), added by the Bankruptcy Reform Act of 1994, appears to have made state perfection law unnecessary for postpetition rents (see §§7.124-7.125).

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§6.31 F. Scope of Assignment of Rents

A security interest in "rents, issues, and profits" created by a deed of trust or separate assignment of rents does not extend to the proceeds of a sale of the real property; a lien on sale proceeds must be taken expressly. *Lin v Ehrle (In re Ehrle)* (BAP 9th Cir 1995) 189 BR 771. Similarly, an assignment of rents under a deed of trust or separate document does not cover the proceeds or profits of a business operated on the real property. See *U.S. Dep't of Hous. & Urban Dev. v Hillside Assocs. (In re Hillside Assocs.)* (BAP 9th Cir 1990) 121 BR 23 (revenues generated by operation of nursing home were not rents); *Zeeway Corp. v Rio Salado Bank (In re Zeeway Corp.)* (BAP 9th Cir 1987) 71 BR 210 (drag strip gate receipts are not rents). But see *Wattson Pac. Ventures v Valley Fed. Sav. & Loan (In re Safeguard Self-Storage Trust)* (9th Cir 1993) 2 F3d 967 (rent for self-storage units under lease is cash collateral).

Congress settled the debate over whether hotel room receipts are cash collateral, at least in bankruptcy proceedings. The Bankruptcy Reform Act of 1994 §214(b) (Pub L 103-394, §214(b), 108 Stat 4106, 4126) amended 11 USC §§363(a) and 552(b)(2) specifically to include hotel "room receipts" in the definition of cash collateral when there is a perfected prepetition assignment of rents in favor of the creditor. See §§6.29-6.30 on perfection of lien on rents. See also *Financial Sec. Assur., Inc. v Days Cal. Riverside Ltd. Partnership (In re Days Cal. Riverside Ltd. Partnership)* (9th Cir 1994) 27 F3d 374 (hotel room charges are "rents" subject to creditor's prepetition assignment of rents, but net revenues from food and beverage service are not "rents").

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IV. ENFORCING ASSIGNMENT OF RENTS DURING FORECLOSURE

§6.32 A. Former Law

Former CC §§2938-2938.1 treated the issue of enforcement as a question of "perfection" and therefore made no mention of what steps, if any, a creditor had to take to convert its inchoate lien on future rents in general into a concrete lien on particular rents arising from the property. See Stats 1991, ch 501 and Stats 1992, ch 453. Case law had been inconsistent both on the need for an enforcement step (see *Federal Nat'l Mortgage Ass'n v Bugna* (1997) 57 CA4th 529, 67 CR2d 233; *In re Goco Realty Fund I* (Bankr ND Cal 1993) 151 BR 241; but see *MDFC Loan Corp. v Greenbrier Plaza Partners* (1994) 21 CA4th 1045, 26 CR2d 596) and on the question of what action was sufficient to satisfy that requirement. This uncertainty left creditors wondering whether it was necessary to take actual possession or have a receiver appointed or whether they could simply appoint the debtor as their collection agent or merely make demand for the rents. See *Carlon v Superior Court* (1934) 2 C2d 17, 38 P2d 149; *Snyder v Western Loan & Bldg. Co.* (1934) 1 C2d 697, 37 P2d 86; *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579. But see *Childs Real Estate Co. v Shelburne Realty Co.* (1943) 23 C2d 263, 143 P2d 697; *Lee v Ski Run Apartments Assocs.* (1967) 249 CA2d 293, 57 CR 496; *Malsman v Brandler* (1964) 230 CA2d 922, 41 CR 438. Disagreement among the bankruptcy courts heightened the confusion. See *Great W. Life Assur. Co. v Rothman (In re Ventura-Louise Props.)* (9th Cir 1974) 490 F2d 1141, 1145 n1 (mere demand on tenants would perfect lien). See Comment, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor,* 31 Hastings LJ 1433 (1980).

NOTE: Given the enormous clarification afforded by current CC §2938, courts will likely treat its procedures as authoritative even in cases involving pre-1997 assignments of rents to avoid being mired in the prestatutory chaos.

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§6.33 B. Four Enforcement Options Under Current Law

Under current CC §2938(c), a creditor is entitled to "enforce" the rent assignment on default by the debtor by taking any one of several enumerated enforcement steps. After the necessary step has been taken, the creditor is entitled to collect all rents previously uncollected. The section gives the creditor the choice of four enforcement steps:

(1) Appointment of a receiver (see §§6.34-6.48);

(2) Obtaining possession of the rents (see §6.49);

(3) Delivery to tenants (with copies to other parties) of a written demand for turnover of rents in a prescribed form (see §§6.50-6.52, 6.107); or

(4) Delivery to the debtor (with copies to other parties) of a written demand for the rents (see §6.53).

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§6.34 C. Obtaining Appointment of Receiver

Under CC §2938(c)(1), the appointment of a receiver requires the beneficiary to go to court rather than make extrajudicial attempts to collect the rents itself (see §§3.5, 6.37). Appointment of a receiver is always discretionary with the court. The beneficiary may take one or more of the four enforcement steps available. CC §2938(c). Furthermore, under CC §2938(g)(4), the rights of the trustor to require the beneficiary to pay taxes and to protect, insure, and preserve the property do not diminish the beneficiary's rights to request the appointment of a receiver.

Because the self-help alternatives of CC §2938 require the tenants' cooperation and may require that notices be delivered on a monthly basis, the appointment of a receiver is still the preferred first step for the beneficiary of a defaulted loan.

The appointment of a receiver to specifically enforce a rents assignment is further authorized by CCP §564(b)(11)-(12), the provisions of which are less restrictive than CCP §564(b)(2), discussed in §§6.15-6.18, 6.35. The procedural aspects of appointment of receivers are addressed in CCP §§564-570 and Cal Rules of Ct 3.1175-3.1184. See, *e.g.,* CCP §566 on receivers' qualifications and CCP §567 on the receiver's bond and oath. In most jurisdictions, a small number of persons (who also serve as trustees in bankruptcy) receive most of the appointments as receivers. Many state superior courts maintain receiver lists.

PRACTICE TIP: Counsel should alert the beneficiary to investigate different individuals providing receiver services because some are more aggressive than others when property is partially vacant or needs repairs. If property management is or will likely become problematic, counsel should avoid proposing a receiver with whom counsel has no experience. If requesting a receiver pending a judicial foreclosure, counsel may inquire about the prospective appointee's level of experience, including execution sales.

After entry of foreclosure judgment, a beneficiary may save administrative expenses by moving for an order reappointing the same receiver to conduct the postjudgment sale and, if the beneficiary purchases the property, to handle postsale matters (see §§3.71-3.85, 6.35, 6.72-6.82). A separate order and an additional bond are required. The beneficiary should avoid the appearance of any conflict of interest by not directly promising the receiver any future work.

Although CC §2938(c) lists a receivership as one enforcement alternative, neither it nor the earlier versions of the statute indicate how a receivership is supposed to work. Code of Civil Procedure §§564-570 and Cal Rules of Ct 3.1175-3.1184 provide the general procedural framework for receiverships. On filing requirements for obtaining appointment of receiver, see §§6.37-6.40, 6.99-6.102.

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§6.35 1. Functions of Receiver

The primary functions of the receiver are to collect rent, maintain the property, pay property taxes and insurance and, if required in the court order, make the payments on any senior liens while foreclosure is pending (see CCP §564(b)(11)-(12); see also §§2.12, 3.5, 6.34, 6.44). Under CCP §564, a receiver may also be appointed for the following reasons:

- To enable the beneficiary, as the secured lender, to enforce its rights to enter and inspect the property to ascertain the presence of hazardous substances (see CC §2929.5; CCP §564(c); see also §§4.54-4.57, 5.60, 6.17) (these sections provide neither beneficiary nor receiver any rights other than that of inspection);
- If (1) the property is in danger of being lost, removed, or materially injured; or (2) the deed of trust is in default and the property is probably insufficient to discharge the debt (see CCP §564(b)(2); see also §§3.5, 4.52, 6.15-6.18, 6.67);
- To implement a judgment of sale or otherwise dispose of the property after foreclosure judgment (see CCP §564(b)(3)-(4); see also §§3.64-3.85);
- To preserve the property pending an appeal (see CCP §§564(b)(4), 568.2-568.3); and
- After a judicial foreclosure sale, to collect, expend, and disburse rents during the redemption period (see CCP §564(b)(4); see also §§3.55, 3.99, 6.70, 6.74, 6.77).

If a receiver is appointed postsale, a separate order (from that appointing the presale receiver) and a separate bond will be required; on redemption by the trustor, any rents collected during the redemption period must be applied against the redemption price.

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§6.36 2. Additional Considerations for Appointment of Receiver

With a single-family dwelling rented out during a *nonjudicial* foreclosure (see chap 2), a receiver is probably not going to collect enough rent to justify the court costs; the attorney fees; the service, accounting, and report fees of the receiver; and other expenses incidental to a receivership (see §§6.40, 6.46, 8.84-8.86). With an apartment complex (or a large commercial building) and a pending *judicial* foreclosure (see chap 3), it is almost always in the beneficiary's best interest to have a receiver appointed as soon as possible after the trustor defaults. Other considerations are the margin of equity in the property, rent-skimming issues (see §6.13), and whether the rent assignee has the requisite property management and accounting skills or resources to select an alternative method of enforcing the rent assignment under the current CC §2938(c).

PRACTICE TIP: The appointment of a receiver is the better and safer approach for a beneficiary when compared with efforts to directly gain control of the rents. The receivership, if done properly, avoids the risk that the beneficiary will be deemed a mortgagee in possession (see §§6.8, 6.43). Because the receiver is an agent of the court and not of the beneficiary, the receivership will provide the beneficiary with considerable insulation against third party claims. These benefits, however, come at the cost of the beneficiary's loss of direct control and the diversion of some portion of the rents to pay the receiver's fees and expenses. If the beneficiary and trustor are negotiating a loan workout or a reinstatement, another option is to stipulate to pay the rents into an escrow to avoid the expenses of a receivership.

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§6.37 3. Specific Performance of Assignment

The usual method for obtaining appointment of a receiver after default is an action for specific performance of the assignment of rents clause (see form in §6.99). This action is usually brought under CCP §564(b)(9), the general "equity" provision, rather than under CCP §564(b)(2), because of the lesser burden of proof required. See *Mines v Superior Court* (1932) 216 C 776, 16 P2d 732; *Mercantile Mortgage Co. v Chin Ah Len* (1935) 3 CA2d 504, 39 P2d 817.

Code of Civil Procedure §564(b) (11)-(12) (see §§3.5, 3.12, 6.34-6.35, 6.40, 6.56) makes explicit the creditor's right to have a receiver appointed in an action for specific performance of an assignment of rents clause. There is no need for the creditor to show risk of loss or probable insufficiency of the security as is true for receivers appointed incident to foreclosure actions. Current CCP §564(b)(11) also makes explicit the legitimacy of having a court appoint a receiver for the duration of the creditor's nonjudicial trustee sale of the security.

PRACTICE TIP: A cause of action to specifically enforce the rents and profits clause is the proper platform for a receivership, and a judicial foreclosure cause of action is not essential. Including a judicial foreclosure, however, (1) broadens the grounds for seeking appointment of a receiver (*e.g.*, under CCP §564(b)(2)) (see §6.15); (2) keeps more remedial options open to the secured creditor (especially if the debt is recourse and nonpurchase money) (see §§2.10, 3.5; see also §§3.4-3.11); and (3) lessens the possibility that the secured creditor will suffer a CCP §726 sanction by taking a final judgment without enforcing all the security (see §§3.68, 4.25-4.27).

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§6.38 4. Procedures for Obtaining Order Appointing Receiver

There are three law and motion methods for seeking appointment of a receiver after the specific performance action (see §6.37) has been filed. These procedures are explained in greater detail in Handling a Real Property Foreclosure, step 37 (Cal CEB Action Guide May 2008) and are summarized here:

(1) **By ex parte application** (Cal Rules of Ct 3.1200-3.1207, 3.1130, 3.1175-3.1184). This method may be used immediately after the complaint is filed, but the beneficiary must make an additional showing of urgency either in declarations or in a verified complaint. Among other matters, the beneficiary must demonstrate that the beneficiary will suffer irreparable injury during the time necessary for a noticed hearing (Cal Rules of Ct 3.1175(a)(1)) and that the receivership will not seriously interfere with the trustor's business operations (Cal Rules of Ct 3.1175(a)(4)). The beneficiary must give advance notice to the trustor under Cal Rules of Ct 3.1200-3.1207, unless special circumstances exist. These and other matters required by Cal Rules of Ct 3.1175, 3.1200-3.1207 must be proved in the supporting declarations.

When the appointment is made ex parte, the court must also issue an order to show cause, setting a date and time for a hearing to confirm the appointment within 10 days (see Judicial Council optional forms in §§6.103-6.104), and the ex parte order and all supporting documents must be personally served (see Cal Rules of Ct 3.1176(a)-(b)), usually with the summons and complaint. The beneficiary must post an undertaking when the receiver is appointed ex parte. CCP §566(b). The receiver must post an undertaking and an oath before acting in that capacity, whether appointed on noticed motion or ex parte. CCP §567(b). See generally California Civil Procedure Before Trial, chaps 13, 17, 33 (4th ed Cal CEB 2004).

(2) **By order to show cause** (see CCP §§527(f)(1), 564-568, 1005, 1014; Cal Rules of Ct 3.1150(a)-(e), 3.1177-3.1179; *Nichols v Superior Court* (1934) 1 C2d 589, 36 P2d 380; *Olsan v Comora* (1977) 73 CA3d 642, 140 CR 835). When this method is used, the beneficiary makes an ex parte application for an order to show cause and presents the application with the same papers required for a noticed motion; the court sets the hearing date and directs the defendant to show cause on that date why a receiver should not be appointed. See forms in §§6.105-6.106. This method is required if the defendant has not appeared in the action and requires personal service of the moving papers with or after service of the summons and complaint. See Civ Proc Before Trial, chaps 13, 17, 33.

(3) **By noticed motion** (CCP §§1005, 1010; Cal Rules of Ct 3.1100-3.1310, 3.1130, 3.1312). This method requires the plaintiff to wait to file and serve the notice of motion and supporting papers until the defendant has appeared. CCP §1014. See Civ Proc Before Trial, chaps 12, 18, 33. See forms in §§6.100-6.102.

Regardless of which method is used, the plaintiff must submit a supporting declaration (see form in §6.101), and each party appearing at the hearing on the appointment may in writing nominate one or more persons to act as receiver and state the reasons for the nomination (Cal Rules of Ct 3.1177). On receiverships, including procedures and additional forms, see §§10.43-10.50. See also Civ Proc Before Trial, chap 33.

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§6.39 5. Nomination of Property Manager

As part of the motion for appointment of the receiver, the beneficiary may ask that the court authorize the receiver to employ a competent property manager (see §6.38), or the receiver may apply to the court at a later date for such permission.

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§6.40 6. Powers of Receiver Limited by Order

A well-drafted order is essential. Permissible and mandatory powers and duties of receivers are specified in CCP §§568-570; Cal Rules of Ct 3.1179-3.1184. See also CCP §564(b)(11). At a minimum, the order should provide for the following:

- Authorization for the receiver to manage, repair, and lease the property and to collect rents and profits;
- Payment by the receiver of real property taxes, insurance premiums, assessments, and senior liens, and the order in which they must be paid;
- A method for setting the receiver's compensation (*e.g.,* hourly rate based on declarations by the receiver to the court), subject to final court approval;
- Authorization for the receiver to retain counsel and pay counsel fees from the rents collected, subject to final court approval; and
- Monthly accountings by the receiver, rendered to the parties and filed with the court.

Orders often require the receiver to apply all rents collected as follows:

- First to the expenses of administering the receivership;
- Second to the payment of all expenses incurred by the receiver in managing the property;
- Third to the payment of taxes and secured debts having priority; and
- Fourth to retention by the receiver of a working capital fund, with the balance of the rents to be paid to the foreclosing creditor after the foreclosure is completed.

See, *e.g., Turner v Superior Court* (1977) 72 CA3d 804, 140 CR 475. See also *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897; *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, aff'd without published opinion (9th Cir 1995) 46 F3d 1143.

NOTE: Some creditors prefer to receive periodic payments of the rents before the foreclosure instead of waiting until afterward to collect them. These payments, however, may intentionally or inadvertently reinstate the debt (thus justifying termination of the receivership (see §§6.41, 6.45)). Such payments may also cause bidding errors if the recordkeeping is inaccurate (see §2.82). Finally, these payments may raise a question about the applicability of sanctions under CCP §726(a) (see §6.41), particularly if the funds paid were not actually rents.

For more on receiver's powers, see §§6.44-6.46. For attorney-drafted form order appointing receiver, see §6.102. For Judicial Council form orders, see §§6.103-6.106. For additional attorney-drafted form orders and other receivership pleadings, see California Civil Procedure Before Trial, chap 33 (4th ed Cal CEB 2004).

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§6.41 7. Effects of CCP §726

An assignment of rents clause allows the beneficiary to treat the rents as additional security insofar as the one-action rule is concerned. As long as only one judicial action is undertaken, the one-action mandate of CCP §726 is met. An action to enforce the rents clause by way of a receiver does not constitute an "action" within the meaning of §726. See CCP §564(d); CC §2938(e)(2). See also §§4.12-4.22, 9.4, 9.9.

A judicial foreclosure judgment that did not include rents already sequestered might lead to loss of the security interest in them (see *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897), but a completed trustee sale (which is not an "action") does not stop the beneficiary from then claiming rents held by the receiver to cover an insufficient sale price (see §§2.82, 2.84, 6.46). Appointment of a receiver and initiation of trustee sale proceedings may be undertaken simultaneously; generally no election of remedies is involved. *Mortgage Guar. Co. v Sampsell* (1942) 51 CA2d 180, 186, 124 P2d 353.

Code of Civil Procedure §564(d) currently provides that an action to appoint a receiver does not constitute an "action" under CCP §726(a). Also, neither the taking of an enforcement step (*i.e.*, having a receiver appointed) nor the subsequent collection or application of rents (also referred to as "moneys received by the assignee") triggers CCP §726 or any of the antideficiency rules. CC §2938(c), (e)(2).

NOTE: Before the enactment of CCP §564(d) in 1991, there was concern that proceeding to a final judgment in a receivership action (or receiving rent funds from the receiver) before foreclosure could create a one-action bar to subsequent judicial or nonjudicial foreclosure. See *Great Am. First Sav. Bank v Bayside Developers* (ordered not published Mar. 12, 1992; superseded opinion at 232 CA3d 1546, 284 CR 194). After *Bayside* was ordered depublished, its rulings were rejected in the federal courts. See *Resolution Trust Corp. v Bayside Developers* (ND Cal 1993) 817 F Supp 822, aff'd (9th Cir 1995) 43 F3d 1230, 1242. See also *500 Ygnacio Assocs. v Aetna Life Ins. Co. (In re 500 Ygnacio Assocs.)* (Bankr ND Cal 1992) 141 BR 191, 194.

With regard to receiverships not subject to the current rents statute, beneficiaries generally avoid taking any final judgment in their receivership proceedings until after their foreclosure sale is completed. This may not be possible, however, in counties that do not allow an action to languish while, *e.g.,* a beneficiary cleans up environmental problems. Because a nonjudicial foreclosure sale is not an action, its completion does not eliminate the beneficiary's rights to pursue the additional security of the rents held by the receiver as long as the unpaid balance of the debt exceeds the rents held and the beneficiary did not make a full credit bid (see §§2.82, 2.84).

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§6.42 8. Effects of Antideficiency Laws

Treatment of rents as additional security eliminates most antideficiency defenses raised by debtors. On antideficiency rules, see chap 5. Code of Civil Procedure §580d does not prohibit the beneficiary from recovering rents even when the foreclosure sale is nonjudicial, because realizing on further security is not treated as equal to collecting a deficiency. See *Freedland v Greco* (1955) 45 C2d 462, 289 P2d 463. For the same reasons, the beneficiary may obtain the rents even though it holds a purchase money deed of trust because CCP §580b has been held not to prohibit taking (and collecting) additional security. *Mortgage Guar. Co. v Sampsell* (1942) 51 CA2d 180, 186, 124 P2d 353. See §§6.53, 6.55, 6.58, 9.8. Finally, the courts have held that the fair value provisions of CCP §§726 and 580a (see §§5.16-5.23, 9.7) do not apply to multiple security. *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 120 P2d 869; *Mortgage Guar. Co. v Sampsell, supra*. As a result, beneficiaries often calculate their bids at the trustee sale not according to the security's value but by subtracting the rents held by the receiver from the balance owing on the debt, in order to have a shortfall equal to what the receiver holds (see §§2.82, 6.46).

NOTE: The full credit bid rule and other bidding rules may limit the creditor's recovery even if the antideficiency laws do not (see §§2.82, 2.84, 6.46).

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§6.43 9. Mortgagee in Possession Avoided

Having a receiver appointed does not make the beneficiary a mortgagee in possession. *Bank of America v Bank of Amador County* (1933) 135 CA 714, 28 P2d 86. Nor is the beneficiary generally liable for any misconduct by the receiver. *Tourny v Bryan* (1924) 66 CA 426, 226 P 21. See §6.8.

Historically, the chief reason for preferring a receiver over self-help collection of rents was to avoid mortgagee-in-possession status. Current CC §2938(e)(1) codifies the common law rule that a receivership does not confer on a beneficiary mortgagee-in-possession status and adds that none of the enforcement steps triggers that status. Although some practitioners believe that self-help rent collections may become more common, the statute gives the assignor and others the right to make written demand on the rent-collecting beneficiary to pay the costs of protecting the property, including taxes, insurance, and building and housing code compliance. CC §2938(g)(1). This can subject a self-help beneficiary to exactly the same exposure as if the beneficiary were a mortgagee in possession, thus undermining a major reason for choosing self-help.

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§6.44 10. Receiver's Duties; Neutrality

The receiver's obligation is to collect the rents and hold or dispose of them under the court's order (see §§6.40, 6.45-6.46, 6.102). On rents collectible under current CC §2938(c) enforcement options, see §§6.54-6.56. The receiver as the agent of the court, not of the creditor, is neutral and independent and as such is bound to do what the court instructs rather than what either party desires. See Cal Rules of Ct 3.1179; *Belcher v Aaron* (1937) 8 C2d 180, 64 P2d 402. See also §§6.34, 6.40, and Practice Tip in §6.36. The receiver's powers over the property are limited to preserving and protecting it, not upgrading or otherwise seeking to enhance its value by making capital improvements unless authorized by the court. See CCP §568; Cal Rules of Ct 3.1179(b).

When appointed under an assignment of rents clause, the receiver normally lacks power to sell the property. To justify sale of the property, a receiver must obtain court approval (CCP §568.5) by showing that an imminent financial crisis will occur if the sale is not made. *Cal-American Income Prop. Fund VII v Brown Dev. Corp.* (1982) 138 CA3d 268, 187 CR 703.

Statutes may impose additional duties on the receiver. For example, when property containing rental housing is subject to an order or notice from a local entity to correct substandard conditions, the receiver must notify the court about whether any threat or danger to the occupants exists and whether there are sufficient funds for abatement. A tenant, tenant association, or specified government agency may file a motion for instructions from the court on abating the substandard conditions. CCP §§568.2-568.3. See California Landlord-Tenant Practice, chap 3 (2d ed Cal CEB 1997).

Language in the deed of trust or in a separate assignment agreement may confer other powers on the receiver (see, *e.g.,* clauses in California Real Estate Finance Practice: Strategies and Forms, chap 5 (Cal CEB 2000)), but unless the appointment order confirms such additional powers, those provisions are not likely to be effective. On statutory powers and administrative and other obligations of receivers generally, see CCP §§568-570; Cal Rules of Ct 3.1179-3.1184. On administrative and accounting duties of receivers, see California Civil Procedure Before Trial, chap 33 (4th ed Cal CEB 2004).

NOTE: Because the receiver is supposed to be neutral and independent, when the creditor directs and controls the receiver's actions, the creditor arguably loses the benefits of the receivership (including avoidance of mortgagee-in-possession status (see §§6.8, 6.43)). This argument will be more potent if the degree of creditor influence is extreme and causes the receiver to violate or exceed the receiver's authority as stated in the appointing order. Given that most receivers are nominated by (and hope for repeat business from) the creditor, the debtor's counsel may find it profitable to depose the receiver to ascertain the level of creditor control and direction.

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11. Disposition of Rents Collected Before Foreclosure

§6.45 a. Presale

Unless the appointing order mandates otherwise, the receiver retains possession of rents collected until the court orders them disbursed. *Garretson Inv. Co. v Arndt* (1904) 144 C 64, 77 P 770. The receiver does not turn over funds to anyone, including the beneficiary, without prior court authorization. *Miller v Fidelity & Deposit Co.* (1935) 3 CA2d 580, 40 P2d 951.

Usually the receiver is instructed to use the rents to pay operating expenses and to keep senior liens current. *Lovett v Point Loma Dev. Corp.* (1968) 266 CA2d 70, 71 CR 709; *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579. Some rent assignment clauses provide that turning collected rents over to the beneficiary will not cure a past default. The validity of such a provision has never been tested against public policy (which favors reinstatement and cure).

PRACTICE TIP: Even under the current rents statute, the practitioner must consider the unpredictable nature of CCP §726 case law and the language in some still citable decisions that receivers must accumulate rents until after a foreclosure has been completed (see, *e.g.*, *Turner v Superior Court* (1977) 72 CA3d 804, 140 CR 475). The conservative course of action is to avoid taking a final judgment in the specific performance action and to leave the net rents with the receiver until after foreclosure.

Current CC §2938(e) provides that the application of rents to the secured obligation satisfies it pro tanto and is credited against the amount necessary to reinstate despite contrary language in the loan documents. The statute is silent on rents collected by the receiver and not turned over to the beneficiary, but presumably the trustor could seek an order compelling such a turnover. Reinstatement has been held to occur even without a turnover if the amount collected by the receiver was sufficient to cure the arrearages (however, compensation for the receiver must first be deducted from the amount held). See *Maggiora v Palo Alto Inn, Inc.* (1967) 249 CA2d 706, 57 CR 787.

PRACTICE TIP: If the funds are sufficient to reinstate the debt, the trustor generally will make a written tender of reinstatement (identifying the funds held by the receiver) and seek a court order to turn over the funds and declare the default cured.

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§6.46 b. Postsale

The customary method of dealing with rents held by the receiver is for the beneficiary first to conduct and complete a trustee sale (see chap 2), which is then followed by the receiver's making a final accounting in the judicial action (see Cal Rules of Ct 3.1184; see also §6.48). A full credit bid by the beneficiary at the trustee sale would constitute complete satisfaction of its debt and preclude it from making any claim to the rents held by the receiver. *Eastland Sav. & Loan Ass'n v Thornhill & Bruce, Inc.* (1968) 260 CA2d 259, 66 CR 901. See §§2.82, 2.84, 2.107. It is unknown whether the beneficiary could escape the consequences of such a bid by claiming that it had been misled by others into overbidding. On full credit bid effect on postforeclosure claims, see §§2.118-2.129.

STRATEGIES: Before the sale, the beneficiary should ascertain how much of the funds held by the receiver will be available for distribution to the beneficiary at the final accounting. If the beneficiary then bids an amount equal to what it is owed less the available funds, a "shortfall" results. Although the shortfall may be uncollectible by action (because of CCP §580d), it can be used to justify the pursuit of additional security, such as the rents held by the receiver. *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 120 P2d 869. On detailed bidding strategies, see chaps 2-3.

If the amount realized at the foreclosure sale is insufficient to satisfy the secured debt owed to the beneficiary (*i.e.,* a deficiency), the court may order the receiver, after it has filed its final accounting, to pay over the rents to the beneficiary for application against the outstanding indebtedness. See §§6.45-6.46. But see §§6.41-6.42. Because the earlier trustee sale was extrajudicial, it did not constitute an "action" so as to preclude the subsequent judicial award of rents to the beneficiary (see §6.41). If a final turnover order of the rents were to occur first, however, there is a risk that judgment could bar further relief under the one-action rule. CCP §726. See *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897. But see CC §2938(e)(2). On one-action rule, see chap 4. On collecting rents in judicial foreclosure action, see discussion of *Walker* in §6.41. On order of distribution of rents, see §§6.57-6.64. On income tax considerations in distributions of rents to beneficiary, see Tax Considerations in §2.107.

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§6.47 12. Attorney Fees; Receiver Fees and Costs

Legal fees incurred by the creditor in obtaining the appointment of a receiver are recoverable from the receivership estate as an administrative expense; these fees enjoy the same priority as other expenses. However, for a creditor to charge the secured debt with attorney fees incurred in obtaining the appointment of a receiver, the applicable deed of trust or other loan contract documents must provide for attorney fees. See, *e.g., Kachlon v Markowitz* (2008) 168 CA4th 316, 85 CR3d 532 (upholding attorney fee claims by borrower against lender and trustee in equitable actions following foreclosure); *Saucedo v Mercury Sav. & Loan Ass'n* (1980) 111 CA3d 309, 168 CR 552 (applying reciprocal right to attorney fees in favor of nonassuming successor to original borrower, who had equity in property). In *Hozz v Varga* (1958) 166 CA2d 539, 333 P2d 113, the court permitted the recovery of attorney fees for obtaining a receiver in an action for specific performance of a rents and profits clause (the deed of trust presumably contained an attorney fee clause but the decision does not mention it). The court stated that, in contrast to permitting recovery of attorney fees for the creditor's obtaining appointment of the receiver, such recovery could not be allowed for an attorney representing the receiver because the receiver failed to get prior court approval to hire an attorney. 166 CA2d at 543. See Cal Rules of Ct 3.1180.

Attorney fees incurred by the receiver, when authorized by the court, are recoverable as a cost of administration. The receiver fees are an expense of administration payable from the receivership estate; they are also recoverable costs of suit. *Evans v Galardi* (1979) 93 CA3d 291, 295, 155 CR 505. On recoverability of receiver fees, see Perlman, *Avoiding Liability for Receivership Expenses,* 24 CEB Civ Lit Rep 18 (Aug. 2002).

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§6.48 13. Terminating Receivership on Completion of Foreclosure

When the foreclosure is completed and the receiver has filed a final accounting that the court approves, the court may terminate the receivership and discharge the receiver. See Cal Rules of Ct 3.1184.

Termination of the receiver's possession of the real property security may be effected ex parte at any time after the foreclosure sale by the beneficiary's filing with the court an application for an order directing the receiver to transfer possession of the real property. See forms in §§6.108-6.110. On ex parte motions, see §6.38.

The application usually includes a request for an order directing the receiver to file and serve a motion for an order approving the receiver's final accounting and discharging the receiver. The receiver may not turn over to the beneficiary remaining rental proceeds or other funds until the court approves the receiver's final accounting. Cal Rules of Ct 3.1184. On procedures for receiver's motion for final accounting and discharge, see California Civil Procedure Before Trial, chap 33 (4th ed Cal CEB 2004).

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§6.49 D. Obtaining Possession of Rents

The second alternative enforcement step—obtaining possession of the rents—derives from the traditional device of obtaining possession of the land in order to reach its rents, but the reference to "possession of the rents, issues, or profits" rather than "possession of the land" seems intended to permit a creditor to reach rents without being characterized as a mortgagee in possession. See CC §2938(c)(2). On rents collectible under current CC §2938 enforcement options, see §6.54. The statutory conversion from possession of land to possession of rents also eliminates the risk of liability for forcible entry if the creditor seeks to take possession of the land without judicial assistance. See *Jordan v Talbot* (1961) 55 C2d 597, 12 CR 488 (forcible entry by landlord after tenant's default); *Calidino Hotel Co. v Bank of America Nat'l Trust & Sav. Ass'n* (1939) 31 CA2d 295, 87 P2d 923.

Civil Code §2938(e)(1) explicitly states that none of the four enforcement devices in CC §2938(c) will make the assignee of rents a mortgagee in possession (see §§6.8, 6.43) unless the assignee takes actual possession of the real property. The one-action and antideficiency rules are similarly rendered inapplicable when this step is taken. CC §2938(e)(2)-(3).

Before the 1996 enactment of current CC §2938, the law was not clear about the effectiveness or the risk of self-help collection of rents. *In re Goco Realty Fund I* (Bankr ND Cal 1993) 151 BR 241. The risk that self-help would violate CCP §726 and cause a loss of security under *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, was small because the creditor was only seizing its additional security (*i.e.,* the assigned rents). In the circumstances, there was neither an action nor a violation of the security-first policy underlying the one-action rule in §726.

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E. Making Demand on Tenant

§6.50 1. Serving Demand

The third alternative under CC §2938(c) authorizes enforcement of assignment of rents by allowing the creditor (assignee) to demand that tenants pay past due, payable, and subsequent rent directly to it. This alternative constitutes an even safer harbor for the creditor by furnishing procedural details and a statutory form for guidance (see §§6.51, 6.107). The statutory notice must be signed under penalty of perjury, delivered to the affected tenants, and mailed to the debtor (assignor) and all other creditors with assignment of rents rights. Under earlier statutory and case law, it was never clear whether a demand on tenants alone was sufficient to make choate the creditor's claim to rents assigned as security.

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§6.51 2. Form of Demand; CC §2938(k)

The statutory notice in CC §2938(k) directs the tenant to pay rent to the creditor instead of to the landlord. The notice given to a nonresidential tenant informs the tenant that future rental payments to the previous landlord are not protected if made after receipt of the notice and the tenant may therefore have to pay the same rent twice. The notice given to residential tenants omits this statement, merely leaving the tenant with the admonition that it can safely pay the creditor instead of the previous landlord. See CC §2938(k). See form in §6.107. On rents collectible under current CC §2938(c) enforcement options, see §6.54.

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§6.52 3. Tenant's Obligations

After a tenant receives a CC §2938(k) demand, the tenant must pay to the assignee all unpaid rents, which includes past due but uncollected rents and rents due in the future. CC §2938(d). See §6.54. A nonresidential tenant that continues to pay the original landlord-debtor after having received such a demand does so at its own peril and may have to pay the rent twice. Residential tenants are not subject to this liability for noncompliance (see §6.51) and therefore may apparently ignore demands served on them by the landlord's creditors until they are served with a court order directing them to pay the rent to a receiver. See CC §2938(d).

The obligation to pay the assignee rather than the assignor endures until the court issues a contrary written notice or until the assignee gives a written cancellation of demand (CC §2938(d)); unless the tenant receives conflicting demands from another creditor (CC §2938(d)(1)); or unless the tenant has already paid (CC §2938(d)(2)). (For the guidance of the tenant, §2938(d)(2) adds that payments made after a 10-day grace period to the assignee-creditor are protected, although payments made to the assignor-debtor are not, except for residential tenancies).

By virtue of its location in the current rents statute, CC §2938(d) applies only if enforcement is by way of demand on the tenant rather than by receivership, taking possession of the rents, or demand on the trustor. However, that is probably because the other three enforcement techniques do not require tenants to make their own decisions on whom to pay; only when tenants receive conflicting demands (from nonjudicial officers) is this advice necessary.

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§6.53 F. Making Demand on Trustor

The fourth alternative enforcement step is to deliver a demand for the rents to the assignor-debtor, with copies being mailed to all other similarly secured creditors. CC §2938(c)(4). (On rents collectible under current CC §2938(c) enforcement options, see §6.54.) This fourth enforcement step appears to diverge procedurally from the third step, under CC §2938(c)(3), in three ways:

(1) The captions of the notices may be different: CC §2938(c)(4) refers to a "demand for the rents" while CC §2938(c)(3) refers to a "demand for turnover of rents" in the form "specified in subdivision k," which is titled "Demand to Pay Rent to Party Other Than Landlord." It is not known whether any other form of heading of a notice directed to the assignor rather than to its tenant will be held inadequate.

(2) The notice sent to the tenant under CC §2938(c)(3) must be signed under penalty of perjury, while the notice to the assignor under CC §2938(c)(4) apparently need not be either signed or be under oath.

(3) The CC §2938(c)(3) notice is effective when actually received by the tenant. CC §2938(d).

Although there is no statutory form or further guidance for the fourth alternative, the only potential defects in such a demand would likely concern content (*e.g.,* the property description, rents covered, proper assignee). The form in §6.107 may be readily modified for use as a notice to the trustor.

Before this statutory mechanism, judicial decisions declared that an interest in rents was perfected by demand for them made by the beneficiary to the trustor. See *Title Guar. & Trust Co. v Monson* (1938) 11 C2d 621, 81 P2d 944; *Mortgage Guar. Co. v Sampsell* (1942) 51 CA2d 180, 124 P2d 353.

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G. Rents Collectible Under CC §2938

§6.54 1. Accrued, Unpaid Rents

Current CC §2938(c) provides that the creditor is entitled to collect all rents "that have accrued but remain unpaid and uncollected" and all rents that accrue after the creditor has taken the appropriate enforcement step. That means that a receiver appointed in mid-February may collect any rents falling due on February 1 if they have not yet been paid and also all March and later rents, but it is not entitled to reach back to disgorge February rents that were paid on time or January rents that have already been paid. Civil Code §2938(d) imposes a comparable duty on the tenant on where to send the rent checks when a CC §2938(c)(3) notice (demand on the tenant) has been received. On whether receiver should be ordered to pay net rents over to creditor, see §§6.40, 6.45.

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§6.55 2. Proceeds; Improper Payments

The current CC §2938 also has a proceeds doctrine, which provides that when the debtor collects rents that have already been assigned to a creditor but before the creditor has taken an enforcement step, the creditor may sue to have the rents turned over to it (without running afoul of the one-action rule). CC §2938(f)(1). Also, that creditor has priority over any other creditors who may hold unenforced security interests in proceeds, as long as the rent proceeds are identifiable. See §6.64. The proceeds doctrines apply only after the assignment is enforced by demand (under CC §2938(c)(3)-(4)).

Neither former CC §2938 nor former CC §2938.1 addressed the question of what rents were covered. See Stats 1991, ch 501 and Stats 1992, ch 453. However, judicial decisions held that the receiver was entitled to all rents uncollected on the date the receiver took possession, even if the rents had previously accrued. *Childs Real Estate Co. v Shelburne Realty Co.* (1943) 23 C2d 263, 143 P2d 697; *Title Guar. & Trust Co. v Monson* (1938) 11 C2d 621, 81 P2d 944; *Mortgage Guar. Co. v Sampsell* (1942) 51 CA2d 180, 124 P2d 353. See Comment, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor,* 31 Hastings LJ 1433, 1442 (1980). The debtor was apparently able to retain any rents it collected, even though they were obtained after the default on the loan and even after the creditor's demand for possession, until the creditor actually acquired possession of the mortgaged property or secured appointment of a receiver. See *Childs Real Estate Co. v Shelburne Realty Co., supra*. See also 31 Hastings LJ at 1443.

Prior case law effectively established that accrued but unpaid rents did not belong to the creditor unless they were specifically mentioned in the rents assignment clause. See *Mortgage Guar. Co. v Sampsell, supra*. As a result, individual assignment of rents clauses were drafted as broadly as possible. It is unclear under the current statute whether the particular rents that a creditor may claim on default can be modified to embrace other sums not enumerated in the statute.

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§6.56 3. Gross or Net Rents

Many assignment of rents clauses purport to allow the creditor to keep "gross" rents, *i.e.,* to have no part of the rents used to pay operating expenses or debt service on senior obligations. The current version of CC §2938, however, provides that the creditor must use the rents, if requested, "to pay the reasonable costs of protecting and preserving the property, including payment of taxes and insurance and compliance with building and housing codes, if any." CC §2938(g)(1). This obligation is made explicit when enforcement is by taking possession of the rents or by making a demand on the tenant or the debtor. Although §2938 is silent on use of the rents in receivership cases, a similar result occurs under CCP §564(b)(11) and the common law (see, *e.g.*, *Turner v Superior Court* (1977) 72 CA3d 804, 140 CR 475, cited in §§6.16, 6.40, 6.45).

Three qualifications are imposed on the creditor's duty to use the rents to care for the property (see CC §2938(g)(2)):

- The duty applies only to the extent that the assignee actually receives the rents;
- Such activity does not cause the creditor to become a mortgagee in possession; and
- This obligation does not include operating or managing the property, which duty stays with the debtor-landlord.

Neither of the two former assignment statutes addressed the question of how rents were to be applied after being collected on the creditor's behalf.

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§6.57 H. Priorities of Competing Assignees

Some prior uncertainties concerning competing interests of multiple assignees are resolved by current CC §2938(h). In particular, if a junior assignee is first to enforce its right to collect rents directly from the tenants (see §§6.50-6.52), it is entitled to keep the rents collected and to continue collecting rents until a senior assignee begins enforcement. When a junior collecting rents directly from tenants receives notice that a senior has enforced its assignment, the junior must inform the tenants that its prior demand for rents has been canceled. On priorities, see §§6.57-6.64.

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1. Establishing Priority Under CC §2938

§6.58 a. Under Current Law

Current CC §2938 makes priority of competing claims to rents dependent on priority of perfection, *i.e.,* recordation. Thus, if both senior and junior deeds of trust contain assignment of rents clauses, the earlier recorded deed of trust will give the first a claim against the rents that is superior to the claim of the second. See CC §2938(b). However, because perfection is not equivalent to enforcement under the current statutes, a junior that actually enforces its claim to the rents (by taking one of the four steps described in §§6.33-6.53) is entitled to retain all rents it actually collects. See CC §2938(h). The priority given to the senior takes effect only when it enforces its own claim; thereafter, the senior may keep all future rents but may not recover from the junior the rents it collected before enforcement by the senior. On notice provisions, see §§6.57, 6.60. On enforcing priority in cash proceeds held by defaulting debtor or competing assignee, see §6.64. On junior's reinstatement rights under current law, see §6.63.

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§6.59 b. Under Prior Law

The same substantive priority rules regarding competing claims to rent (see §6.58) prevailed under prior law (*i.e.,* before the enactment of current CC §2938). If both senior and junior mortgages contained assignment of rents clauses and both creditors perfected their liens, the senior had the superior entitlement to the rents. *Baumann v Bedford* (1941) 18 C2d 366, 115 P2d 437. But the senior's actual claim was prior only when it took an enforcement step. Thus if the senior either failed to act or was rendered unable to act by the junior's reinstatement and cure of the default on the senior lien, the junior was entitled to continue collecting the rents. *Carlon v Superior Court* (1934) 2 C2d 17, 38 P2d 149. In that event, it was the junior who had the receiver appointed and had the rents applied to the junior obligation. *Mortgage Guar. Co. v Sampsell* (1942) 51 CA2d 180, 124 P2d 353.

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2. If Junior Enforces Earlier

§6.60 a. Current Law; Notice Required

Under current CC §2938, a senior creditor (on an obligation incurred on or after January 1, 1997) exercises its right to collect the rents by taking an enforcement step. See CC §2938(c). When a junior creditor has already enforced its claim and is collecting rents, the senior must give notice to the junior, which is immediately required to notify the tenants to start paying the senior instead of the junior. CC §2938(h). The junior may retain all rents collected before that time, but all rents collected after that time belong to the senior.

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§6.61 b. Prior Law

Before the enactment of the current CC §2938, there was no clear mechanism for a senior creditor to enforce its claim as against an already enforcing junior. The senior could file its own action to have a receiver appointed, or it could intervene in the junior receivership proceedings. After entry of the order appointing the receiver on behalf of the senior, the rents collected were held for the senior's account. *Baumann v Bedford* (1941) 18 C2d 366, 115 P2d 437. The senior action had no retroactive effect, however, and rents previously collected could be retained by or for the junior, even if the debtor had also defaulted on the senior lien. *Childs Real Estate Co. v Shelburne Realty Co.* (1943) 23 C2d 263, 143 P2d 697; *Carlon v Superior Court* (1934) 2 C2d 17, 38 P2d 149.

Older case law seemed to hold that a truly absolute assignment of rents to the senior did not require further enforcement (then called "perfection") and that the junior could not reach the rents even if the senior had failed to take action. This reasoning was based on an interpretation that such assignment granted the creditor immediate title to the rents. *Kinnison v Guaranty Liquidating Corp.* (1941) 18 C2d 256, 115 P2d 450; *Malsman v Brandler* (1964) 230 CA2d 922, 41 CR 438. See §§6.21-6.28, 6.30, 6.32. It also was believed that such assignment gave the secured creditor immunity against an attempt by a trustee in bankruptcy to avoid the assignment under 11 USC §544(a)(3). See *Great W. Life Assur. Co. v Rothman (In re Ventura-Louise Props.)* (9th Cir 1974) 490 F2d 1141. If the junior had an absolute assignment of rents and the senior's assignment of rents clause was merely a security assignment, it was thought that the senior would nevertheless prevail (on future rents) when there was a default and the senior then enforced its lien. *Childs Real Estate Co. v Shelburne Realty Co., supra*; *Lovett v Point Loma Dev. Corp.* (1968) 266 CA2d 70, 71 CR 709.

The recording acts applied to these situations, and if the senior assignment of rents was unrecorded, a bona fide junior that had recorded could obtain permanent priority for its claim to the rents. *Pacific Fruit Exch. v Schropfer* (1929) 99 CA 692, 279 P 170. But see *Snyder v Western Loan & Bldg. Co.* (1934) 1 C2d 697, 37 P2d 86.

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§6.62 3. If Senior Enforces Earlier

Under both former and current law, when the senior has priority in enforcement as well as perfection, all rents are collected on its behalf. None of the rents is applied toward satisfaction of the junior deed of trust until after the senior debt has been fully satisfied. Thus, if the senior underbid at the senior trustee sale, the rents held by the receiver (see §6.46) go first to satisfy the senior shortfall. Only if the final bid at the senior sale (added to the rents held by the receiver) is greater than the balance of the senior debt will any of the rents held by the receiver become surplus and available to the junior. Thus, it is often the junior who must bid at the senior sale in order to enforce the intent of the fair value provisions of the antideficiency rules. See §§2.76, 2.83, 5.17. For discussion of the procedure a junior should follow to obtain surplus rents after a senior sale, see *United Sav. & Loan Ass'n v Hoffman* (1973) 30 CA3d 306, 106 CR 275.

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§6.63 4. If Junior Reinstates Senior Debt

Because a senior creditor enforces priority of its claim to the rents only by taking an action under CC §2938(c), which usually cannot be taken until a default occurs, a junior creditor may be able to effectively disable the senior from taking such a step by making a preemptive cure of any defaults. If the debtor fails to pay the senior but the junior makes the payment before the senior takes an enforcement step against the rents, the senior is no longer in a position to sequester the rents, because there is no longer a default (see §§2.5, 2.51-2.61, 2.72, 9.59). Even if the senior has filed a notice of default, the junior can avoid senior rent collection and prevent appointment of a receiver by prompt reinstatement and cure of the default.

These acts by a junior not only cure senior defaults but also entitle the junior to claim a default under its security instrument and to take an appropriate enforcement step to reach the rents. The junior may, for instance, demand the rents or seek a receivership because of either the default on the senior loan or the failure to reimburse the junior for curing that default under the assignment of rents clause in the junior deed of trust. (The junior deed of trust typically provides that the junior may advance the funds necessary to protect the security (*i.e.,* cure the senior default) and demand reimbursement from the debtor; see §8.79.)

After a junior cures the senior default and then has a receiver appointed, the junior may arrange to have the receiver keep the senior deed of trust current through application of the rents collected. *Lovett v Point Loma Dev. Corp.* (1968) 266 CA2d 70, 71 CR 709. Meanwhile, the junior may proceed with foreclosure of its lien, adding to its debt the amounts advanced to cure the senior default. After the sale, the junior may reach any remaining rents held by the receiver as additional security if the sale fails to satisfy its entire claim. *United Sav. & Loan Ass'n v Hoffman* (1973) 30 CA3d 306, 106 CR 275. See §§2.82, 2.84, 2.107, 6.40, 6.46.

The senior need not intervene if the order appointing a receiver for the junior provides for protection of senior rights. See *Lovett v Point Loma Dev. Corp., supra*. Of course, the senior should act to protect its priority when the junior receivership does not recognize its rights.

These principles appear to apply to cases under the current statute as well as its predecessors, except that the mechanics may change when the junior enforces its claims by possession or notice rather than by receivership. In this situation, it is to be expected that the junior rather than its receiver will undertake to ensure that the senior is kept current.

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§6.64 5. Priorities in Cash Proceeds

Besides introducing a "proceeds" collection procedure into assignment of rents enforcement (see §6.55), CC §2938 also established standards for ascertaining the priority of claims among competing assignees against cash proceeds of rents already collected. Under CC §2938(f)(2), an assignee that has properly perfected and enforced its interest in the proceeds under CC §2938(c)(3)-(4) (*i.e.,* an assignee collecting rents under one of the written demand enforcement options; see §§6.50-6.53) has a continuously perfected security interest in the proceeds to the extent that they are identifiable. Thus, if the assignee's claim to the proceeds is challenged by another creditor claiming entitlement under another theory, the priority of the assignee's claim will depend on the date of recordation (perfection) of the assignment of rents and the appropriateness of its enforcement step.

If the proceeds have been commingled with other funds, priority may still be preserved if the proceeds can be traced, using the lowest intermediate balance accounting technique or persuading a court that some other method of tracing is more just and equitable. CC §2938(f)(2). (Under the lowest intermediate balance principle, the security interest survives only in the smallest balance that existed in the debtor's bank account at any time after the funds were deposited into it; see *Chrysler Credit Corp. v Superior Court* (1993) 17 CA4th 1303, 22 CR2d 37.) Trade creditors who have already been paid seem to be insulated from the rent assignee's efforts to trace and recoup these proceeds.

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I. Effect on Leases

§6.65 1. If Lease Has Priority Over Deed of Trust

If a lease was executed by the trustor before the deed of trust was executed, and if either the lease was recorded or the beneficiary may be charged with notice of the lease (*e.g.,* from the tenant's possession of the property), then the lease has priority over the deed of trust and the deed of trust is a lien only on the trustor's reversionary rights in the land (*i.e.,* the right to take back the property when the lease expires or is terminated and the right to receive rents during the term of the lease). See *Bories v Union Bldg. & Loan Ass'n* (1903) 141 C 74, 74 P 552. See also *Scheerer v Cuddy* (1890) 85 C 270, 24 P 713; *Rosenkranz v Pellin* (1950) 99 CA2d 650, 222 P2d 249.

When an assignment of rents provision is exercised, the right to collect rents may not include a right to terminate leases, even for cause. It is unclear whether (1) the trustor, as the original landlord, may nevertheless terminate the lease of a rent-defaulting tenant, (2) this power has been transferred by the assignment of rents clause to the beneficiary, or (3) the joint action of both parties is required to accomplish that end. When the tenant so defaults, the beneficiary should make a motion for the appointment of a receiver and for the court to make appropriate instructions to the receiver.

The same relationship and issues exist when the deed of trust preceded the lease but the beneficiary either subordinated its security interest to the subsequent lease or agreed with the tenant to leave its leasehold undisturbed by the foreclosure. See *Bank of America Nat'l Trust & Sav. Ass'n v Hirsch Mercantile Co.* (1944) 64 CA2d 175, 148 P2d 110. See also *Security-First Nat'l Bank v Marxen* (1938) 28 CA2d 446, 82 P2d 727.

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§6.66 2. If Deed of Trust Has Priority Over Lease

The beneficiary's interest under the deed of trust is usually superior to all tenants' interests under their leases either because the leases were all executed subsequent to recordation of the deed of trust or because the leases have clauses subordinating the leaseholds to subsequently executed deeds of trust. See *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 270 CR 183.

The deed of trust is also superior to an unrecorded prior lease if the beneficiary qualifies as a bona fide encumbrancer without notice under the recording acts (*Tropical Inv. Co. v Brown* (1919) 45 CA 205, 187 P 133), as might occur if, *e.g.,* the tenant is not visibly in possession of the property.

When an assignment of rents is exercised under a deed of trust that has priority over the lease, it is unknown whether the right to collect rents includes a right to terminate the lease for cause. On receivers' rights, see §§6.68-6.70.

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§6.67 3. If Deed of Trust Lacks Assignment Clause

If the deed of trust has no assignment of rents clause, then a receiver appointed under the narrower standards of CCP §564(b)(2) (see §6.15) has authority only to maintain and conserve the property and lacks power to terminate existing leases, even those executed subsequent to the deed of trust (see §6.16). Faced with a defaulting tenant, the receiver may stipulate with the trustor to terminate the lease or petition the court for authority to do so. A foreclosure sale will terminate leases inferior to the deed of trust, but these leases remain in full force and effect before the sale and are unaffected by the receivership. *McDermott v Burke* (1860) 16 C 580. Rents paid by the tenants are generally beyond the receiver's reach because of the lack of an assignment of rents clause (see §§6.15-6.16).

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J. Effect on Tenants

§6.68 1. Payment of Rent

The enforcement steps enumerated in CC §2938(c) (see §6.33) are available to the secured creditor, regardless of whether the security interest is superior or inferior to leases, as long as the interest includes an assignment of rents. When the creditor enforces by taking possession of the rents or by making a demand on the assignor (see §§6.49, 6.53), the tenant is unaffected and continues paying rent in the same fashion as before enforcement began, although to a different person or entity. When enforcement occurs through a demand on the tenant, CC §2938(d) sets forth the appropriate response by the tenant. See §6.52. When a receiver has been appointed and instructs the tenant to pay rents to it, the tenant must comply on receipt of a copy of the receiver's appointing order.

Former law did not provide for these procedural and notice mechanisms, but it differed in no substantive respect from the rules in the current CC §2938 affecting collection of the rent under the assignment.

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§6.69 2. Termination by Tenants

Enforcement of the rent assignment by the creditor (see §6.33) should have no effect on tenants' leases despite the relative priority of the leases and the security instrument. When the rents are collected by the original landlord (debtor) and then turned over to the creditor, the tenants are obviously unaffected. Even when enforcement is by way of demand on the tenants or appointment of a receiver, such acts should have no impact on the tenants' interests.

Because by court order the receiver (and, on demand under CC §2938(g), the creditor) is required to use the rents collected to pay reasonable costs of protecting and preserving the property—regardless of priority—enforcement should not jeopardize any tenant's interests. The situation is like a landlord's sale of a reversion, after which the tenants merely pay their rents to a new landlord. CC §§821, 1111. See *Tourny v Bryan* (1924) 66 CA 426, 226 P 21.

The landlord's default under a loan secured by the property and senior to the lease generally will not constitute a material default of or terminate the lease. Even when a receiver is appointed to collect the rents, the appointment neither dispossesses the tenants nor constitutes a breach of their leases. *Wright v Standard Eng'g Corp.* (1972) 28 CA3d 244, 104 CR 539.

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§6.70 3. Termination or Modification by Creditor

No reported California case has ruled on the power of a foreclosing beneficiary or its receiver to disaffirm undesirable junior leases and to either terminate such tenancies or compel such tenants to pay a current market rent ("occupational value") rather than the rents stated in their leases. Although inferior leases (see §6.66) will be terminated after a trustee sale is completed (see §§6.89, 6.92, 6.95; see also *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 270 CR 183), presale enforcement of the assignment clause in the deed of trust before the trustee sale should not have the same effect. The assignment itself gives the beneficiary only the right to collect the rents being paid, not the right to terminate or modify the leases regulating the rent-paying (*i.e.,* nondefaulting) tenants. (This is arguably true even for (1) a receiver appointed after a judicial foreclosure under CCP §564(b)(4) to collect rents during the redemption period and (2) a foreclosed-out trustor who is paying below-market rent during that period (see §§6.75-6.82).)

In contrast, when the deed of trust is prior to the lease (see §6.66), the beneficiary's right to possession after default is arguably superior to the tenant's right to the same possession, and therefore a receiver should be able to disaffirm leases whenever doing so is necessary to maintain a margin of security. Tenants who sign leases on encumbered property take their leasehold interests subject to this risk. See 1 Nelson & Whitman, Real Estate Finance Law §§4.38-4.39 (5th ed 2007). But see *Prudence Co. v 160 W. Seventy-Third St. Corp.* (1932) 257 NYS 691, aff'd (1932) 183 NE 365.

Although tenants under junior leases are already in jeopardy of having their leases terminated prematurely if the deed of trust is foreclosed, and although an increase in the rental income from the property would benefit the trustor as well as the beneficiary, not all defaults on secured obligations inevitably lead to foreclosure. A beneficiary may be at serious risk if the trustor reinstates its loan and finds that its leases have been terminated or modified without its consent and—in its opinion—not for the better.

WARNING: The beneficiary or its receiver should not terminate or modify bona fide existing leases, whether senior or junior to the foreclosing beneficiary, without the trustor's consent, even if the tenant consents. Likewise, without the beneficiary's or receiver's consent, the trustor probably lacks the power to revise existing leases after the beneficiary has enforced its assignment, even if the tenant consents.

Tenants who in good faith prepaid all or part of their rents are probably permitted to remain in possession according to the terms of their leases after enforcement of the rent assignment and until the title is foreclosed. If prepayment can be shown to be part of a scheme to deprive the beneficiary of rents during the default period, however, the rule may differ. *Prudence Co. v 160 W. Seventy-Third St. Corp., supra*. Furthermore, prepaid rents should be effective only until the foreclosure sale and not thereafter (see §6.80). If ousted by the foreclosure purchaser for nonpayment of current rents, the tenants would have a remedy against their former landlord for breach of the covenant of quiet enjoyment. See CC §1927; *Ohsaki v Ahern* (1923) 61 CA 787, 215 P 714. See also §6.87.

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§6.71 K. Charging Trustor Rent

An unresolved issue in California is whether the trustor in possession may be charged rent for that possession after default on the loan and enforcement of the rents clause but before the foreclosure sale. The New York rule is that a mortgagor in possession is not liable for rent in such circumstances. In *Holmes v Gravenhorst* (1933) 263 NY 148, 188 NE 285, 91 ALR 1230, the New York Court of Appeal held that a conventional assignment of rents clause entitles the beneficiary to receive only whatever rents are actually being paid, which does not include self-possession by the owner.

However, at least one authority has argued that, when the margin of security is inadequate, the beneficiary should be entitled to charge the trustor rent, which would then be applied to the debt and reduce the trustor's liability for a deficiency, if any. See 1 Nelson & Whitman, Real Estate Finance Law §4.40 (5th ed 2007). This rationale for imposing liability for rent on the trustor as an offset to a potential deficiency would likely be barred by California's security exhaustion and antideficiency statutes rules, which allocate the risk of impaired security to the beneficiary (see, *e.g., DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292; *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873). That risk may not generally be shifted back to the trustor (see *DeBerard Prop. v Lim, supra,* and discussion of security exhaustion and antideficiency laws rules in chaps 4-5). Moreover, neither California's rent statutes nor the form deeds of trust provide for trustor liability for personal rent following default, and such a provision is not likely to be enforceable in California. If the clause imposed a liability for rent on the trustor in addition to the already existing obligation to pay the debt, it would be in effect an invalid penalty requiring the debtor to pay an additional amount because of the default. See *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845. A host of other problems would follow from the effect of such a clause on, *e.g.,* the right of reinstatement or the beneficiary's right to recover the unpaid "rent" from any surplus after the sale beyond the possibility of a personal judgment for unpaid rent despite CCP §§580b and 580d.

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§6.72 V. RENTS AND POSSESSION AFTER SALE

All previous sections of this chapter have dealt with the parties' rights before the foreclosure sale. After the sale, the rights to rents and possession are entirely changed. A beneficiary's right to satisfy its obligation from the security ends with the sale. A deficiency judgment may be available after a judicial foreclosure sale, but it is not collectible from the security. See chaps 3, 5. Rights to possession and rents are transferred by the sale to the foreclosure purchaser, who often replaces the beneficiary as the trustor's adversary. None of the former or current assignment statutes addresses postsale issues.

The initial distinction to be made with regard to postsale problems is whether the foreclosure sale is judicial or extrajudicial. Consequences of a judicial sale are covered in §§6.73-6.82, and those of an extrajudicial sale are covered in §§6.83-6.89.

PRACTICE TIP: A key to successfully arguing rents and possession issues is to remember that the same person or entity may wear several "hats." For example, the former secured creditor seeking a deficiency may be the same party as the foreclosure sale purchaser. It is crucial to analyze the rights and remedies of this person, focusing on each distinct hat. Thus, the collection of future rents by that party would not constitute the recovery of a deficiency, because the right would not arise from or be based on the collection of the former, secured debt.

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A. Effect of Judicial Foreclosure Sale

§6.73 1. Trustor's Right to Possession

Despite the absence of express statutory language requiring such a conclusion, California courts have long held that the trustor and those claiming under the trustor are entitled to retain possession of the previously encumbered property during the redemption period that follows sale of the property after a judicial foreclosure action. See, *e.g., Shintaffer v Bank of Italy Nat'l Trust & Sav. Ass'n* (1932) 216 C 243, 13 P2d 668. On trustor's postsale redemption rights, see §§3.90-3.101. The combined drawbacks of redemption and possession for up to a year after the sale no doubt account for the lending industry's general aversion to judicial foreclosure, even at the expense of forgoing recovery of deficiency judgments.

If the beneficiary properly waives its right to a deficiency in a judicial foreclosure action, however, there is no redemption period and the purchaser may recover possession immediately after the foreclosure judgment, as is permitted after a trustee sale (see §§2.100, 6.74, 6.83).

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§6.74 2. Duration of Right to Possession

The purchaser at a judicial foreclosure sale is denied immediate possession of the property, and the trustor retains the right to possession until the end of the statutory redemption period if a deficiency judgment has not been waived. CCP §729.010. See §§3.8, 3.99-3.101, 6.73. This period is 3 months after the sale if the proceeds from the judicial foreclosure satisfied the debt (see CCP §729.030(a)) or 1 year if the sale proceeds were insufficient to satisfy the indebtedness and a deficiency judgment is sought (see CCP §729.030(b); see also §3.92). Because creditors typically do not pursue judicial foreclosure if the security is sufficiently valuable to generate a bid that will satisfy the debt, the 3-month redemption period rarely applies.

During the redemption period, the purchaser may restrain waste (CCP §729.090(c)) and may have a receiver appointed, but a postsale receiver is authorized only to collect rents, not to take possession (CCP §§564(b)(4), 729.090(a)).

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§6.75 3. Rents During Redemption Period

Although the trustor retains possession during the redemption period (see §6.73), the trustor is not given the right to rents, which is generally tied to the right to possession. Instead, the purchaser at the foreclosure sale is entitled by statute to receive the rents from the property. CCP §729.090(a). Rents so collected are applied as a credit on the amount needed to redeem. CCP §729.090(b); *First Nat'l Trust & Sav. Bank v Staley* (1933) 219 C 225, 25 P2d 982; *Clarke v Cobb* (1898) 121 C 595, 54 P 74.

Many problems arise from the fact that the postsale redemption statutes have been read to give the foreclosure purchaser the right to rents but not the right to possession. See CCP §729.090; *First Nat'l Trust & Sav. Bank v Staley, supra*. This separation between possessory and income rights causes uncertainty about who can seek what relief when a third party tenant does not pay the rent. The foreclosure purchaser (or a receiver) may be able to sue the tenant at law for monetary relief but is less clearly able to bring unlawful detainer or ejectment, both of which depend on a possessory right in the plaintiff. Similarly, the trustor no longer has any monetary claim to justify its bringing an action for possession.

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§6.76 4. Trustor in Possession

The trustor has no right to rent-free possession during the redemption period that follows the judicial foreclosure sale. The trustor may retain possession for the redemption period, but the purchaser can collect "the value of the use and occupation" of the premises (*i.e.,* rental value) for this occupancy. CCP §729.090(a). See §3.99.

The monthly rental value may be computed by applying 1/12 of the legal rate of interest to the redemption price (see CCP §729.060(b)), which increases by that amount each month under CCP §729.060(b)(4), and the trustor's payment may be credited to the redemption price (CCP §729.060(c)). Thus, if the trustor pays that computation every month, the redemption price will remain constant. *Murdock v Clarke* (1891) 88 C 384, 26 P 601.

If the trustor fails to pay the rent, the foreclosure sale purchaser probably cannot bring either an unlawful detainer action or an ejectment action, because the trustor has possession during the redemption period. CCP §729.090(a); *Petersen v Jurras* (1935) 2 C2d 253, 40 P2d 257; *First Nat'l Trust & Sav. Bank v Staley* (1933) 219 C 225, 25 P2d 982. The purchaser can have a receiver appointed, but the receiver would have no greater power to evict a nonpaying trustor than did the purchaser. *Stevens v De Cardona* (1879) 53 C 487. Technically, the purchaser cannot insist on monthly rent from the trustor during the redemption period as a condition for redemption, but such payment is virtually mandated in the long run because the redemption price increases by 1/12 of the legal rate each month unless rent is paid to offset it. CCP §729.060(b)(4).

NOTE: If the monthly rental value (*i.e.,* market rate rent) is significantly greater than 1/12 of the legal rate of interest on the redemption price, the purchaser may be able to recover the difference but would probably have to sue for it separately because CCP §729.060 does not require payment of that difference as a condition of redemption.

If the trustor does not redeem the property, the purchaser may be able to obtain a money judgment for the unpaid rental value during the period that the trustor was in possession. CCP §729.090(a); *First Nat'l Trust & Sav. Bank v Staley, supra*; *Reynolds v Lathrop* (1857) 7 C 43. This relief should not be considered to be a deficiency judgment, because it is based on a set of substantive rights that is completely different from and subsequent to the trustor's breach under the secured obligation. See, *e.g., Lassar & Gross Int'l, Inc. v Dunham* (1987) 196 CA3d 496, 241 CR 854 (cited with other reported cases in §5.55; permitted recovery for fraud as distinct from deficiency judgment on secured debt); *Sumitomo Bank v Taurus Developers, Inc.* (1986) 185 CA3d 211, 229 CR 719 (allowed negligent construction action against trustor by beneficiary-purchaser after it made full credit bid at trustee sale). The purchaser will gain little advantage in bringing a rent action before the redemption period expires because no remedy seems to be available to dispossess a trustor for nonpayment of rent.

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5. Rights and Duties of Tenants During Redemption Period

§6.77 a. Rent and Security Deposits

Although the courts in earlier cases held that the purchaser had no right to recover rents directly from the trustor's tenants (see *First Nat'l Trust & Sav. Bank v Staley* (1933) 219 C 225, 25 P2d 982), that rule has now been changed by amendment of the receivership statute to permit the purchaser to have a postsale receiver collect the rents. See CCP §564(b)(4). After appointment of the receiver, rent payments made directly by the tenants to the trustor are protected only if they were unaware of the receiver's appointment. *Title Ins. & Trust Co. v Pfenninghausen* (1922) 57 CA 655, 207 P 927. On receiving notice of the foreclosure sale, the tenants should pay their rent to the purchaser or to a receiver appointed at the purchaser's behest, not to the trustor. CCP §729.090(a); *Munkelt v Kumberg* (1937) 22 CA2d 369, 70 P2d 997. The debtor-landlord may either transfer the tenants' security deposits (less lawful deductions) to the purchaser (CC §§1950.5(h)(1), 1950.7(d)(1)) or return the security deposit (less lawful deductions) to the tenants (CC §§1950.5(h)(2), 1950.7(d)(2)). Deductions from and return of security deposits at the end of a residential tenancy are heavily regulated and require extensive documentation. For comprehensive discussion of security deposits, see California Landlord-Tenant Practice, chaps 4, 8 (2d ed Cal CEB 1997).

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§6.78 b. Eviction

The tenants probably have the trustor's superior right of possession against the purchaser for the redemption period (see §§6.73-6.74). Thus, the purchaser (or an appointed receiver) appears to lack the power to evict the tenants, probably even if they fail to pay rent. *Carpenter v Hamilton* (1944) 24 C2d 95, 147 P2d 563. For the same reason, nothing in the foreclosure sale relieves the tenants of their liability for rent during the redemption period. Their right to possession is undisturbed by the sale and they are not, therefore, entitled to abandon their leases (see §3.99). During the redemption period, they remain tenants of the trustor (*Metropolitan Life Ins. Co. v Childs Co.* (1921) 230 NY 285, 130 NE 295, 14 ALR 658), although their rent is owed to the purchaser.

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§6.79 c. Rent Increases

If the rents reserved in preexisting, nonsubordinated leases are below market, it is unlikely that the purchaser may raise them. Under CCP §729.090(a), the purchaser is entitled to receive the rents or the value of the use and occupation of the property, but that section neither specifies which measure should be applied when rent and occupational value differ nor provides a mechanism for raising the rents. Occupational value probably applies only when there is no stated rent (*Webster v Cook* (1869) 38 C 423; *Munkelt v Kumberg* (1937) 22 CA2d 369, 70 P2d 997), when the trustor is the person in possession (see §§6.73-6.76), or when the lease is a "sweetheart" arrangement (not at arm's length). No mechanism exists for the purchaser to raise the rents owed by the trustor's tenants during the redemption period.

In light of statutory silence on this point, a tenant's rent liability during the redemption period is probably unaffected by the relative priority of the lease and the foreclosed deed of trust. When the lease is prior in time, the deed of trust is secured only by the reversion, and the foreclosure purchaser acquires only the right to receive rents as they are owed under that lease. Even when the lease was executed after the deed of trust, the absence of a statutory mechanism for raising rents seems to produce the same results. Tenants are still probably liable only for the rent specified in their leases during the redemption period.

If the trustor—before the foreclosure sale—agrees to a rent lower than the value of the use and occupation of the property, the tenants are entitled to the benefit of the bargain for as long as the trustor's possessory right exists, *i.e.,* until the end of the redemption period. If the purchaser demands a higher rent, the tenants can be expected to assert that they at least have the option of quitting the premises rather than paying more than their leases provide. Any departure by a tenant in response to the purchaser's demand for more money, however, would have undesirable long-term effects if the trustor were later to redeem because the trustor would not be able to retrieve the departed tenants (see §6.70).

Because the tenants are entitled to undisturbed possession until the redemption period expires, the trustor is not in default with respect to its obligations to them under their leases until the redemption period has fully expired. See *Lloyd v Locke-Paddon Land Co.* (1935) 5 CA2d 211, 42 P2d 367; *Luette v Bank of Italy Nat'l Trust & Sav. Ass'n* (9th Cir 1930) 42 F2d 9. The purchaser's superior title is a future contingent interest that will not interfere with the tenant's present possessory interests until after the redemption period.

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§6.80 d. Prepaid Rents

Tenants who have prepaid all or part of their rents before foreclosure are probably entitled to enjoy their prepaid possession during the statutory redemption period unless they made the prepayments with actual knowledge of the foreclosure or if they are otherwise in collusion with the trustor-landlord (see *Harris v Foster* (1893) 97 C 292, 32 P 246; *Fowler v Lane Mortgage Co.* (1922) 58 CA 66, 207 P 919). In such circumstances, if the tenants prevail in an action to determine their rights, the defeated purchaser may be able to seek recovery (1) on fraud or other tort theories from the beneficiary or the trustee who conducted the sale if the prepayment was known and not disclosed before the bidding (see, *e.g.*, *Karoutas v HomeFed Bank* (1991) 232 CA3d 767, 283 CR 809, discussed in §2.77) or (2) possibly on unjust enrichment grounds from the trustor.

If the prepaid rent covers more than just the redemption period, and if the leases are junior to the deed of trust, prepayment will not entitle the tenants to possession against the foreclosure purchaser (see §§6.66, 6.78). If the lease is senior, the lease terms endure until its own termination, unaffected by foreclosure of the junior deed of trust (see §§6.65, 6.84).

PRACTICE TIP: When prepaid rent issues arise, creditor's counsel should review applicable tenant estoppel certificates to see whether they contain statements denying the existence of any prepaid rents. If so, the tenant may be estopped to assert the right to use the prepaid rents.

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§6.81 e. Postsale Payment of Rents

Under the common law, when accrued preforeclosure rent is not paid until after the foreclosure sale, it must be apportioned so that the increment that relates to the period before foreclosure is returned to the trustor. See *Clarke v Cobb* (1898) 121 C 595, 54 P 74. See also *Eastland Sav. & Loan Ass'n v Thornhill & Bruce, Inc.* (1968) 260 CA2d 259, 66 CR 901. However, the existence and enforcement of an assignment of rents clause under current CC §2938, giving the creditor the right to all accrued but uncollected rents (see §§6.19-6.31, 6.54), should preclude application of this principle.

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§6.82 f. Effect of Expiration of Redemption Period

The tenants' superior right of possession (see §6.78) ends on expiration of the redemption period. The relationship between the purchaser and the tenants then becomes identical to the situation in which the purchaser acquires title at a trustee sale rather than a judicial foreclosure sale (see §§6.83-6.89).

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B. Effect of Trustee Sale

§6.83 1. Effect on Trustor's Rights

Because a trustee sale is absolute with no postsale right of redemption (see §§2.10, 6.1), the trustor's possessory interest is immediately terminated when the sale is final (*i.e.,* when the trustee accepts the highest bid; see CC §2924h, discussed in §2.79). (Cases decided before the enactment of §2924h held that the trustor's interest ended on execution of the trustee's deed. See *Central Sav. Bank v Lake* (1927) 201 C 438, 257 P 521. See also *Farris v Pacific States Auxiliary Corp.* (1935) 4 C2d 103, 48 P2d 11.) Thus the metaphorical "fall of the hammer" at a trustee sale is the practical equivalent of expiration of the statutory period of redemption following a judicial foreclosure sale (see §§2.73, 3.101, 6.82).

A trustor who remains in possession after a trustee sale is subject to an immediate unlawful detainer action. CCP §1161a. See California Landlord-Tenant Practice, chaps 8-12 (2d ed Cal CEB 1997). (The same is true for any tenants of the trustor whose leases were junior to the deed of trust (see §§6.86-6.89), except that different notice periods apply. See Landlord-Tenant §§8.68-8.68E.) The relief from the forfeiture statute (CC §3275) does not apply if the property is sold at the trustee sale to a bona fide purchaser. *Moeller v Lien* (1994) 25 CA4th 822, 30 CR2d 777. See also *Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413. On effect of sale on leases superior to deed of trust, see §§6.84-6.85.

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2. Effect on Leases

a. If Lease Has Priority Over Deed of Trust

§6.84 (1) Only Lessor's Interest Foreclosed

A lease executed before the deed of trust is superior to the deed of trust. The beneficiary takes a deed of trust on leased property and acquires only a lien on the reversion. *Fahrenbaker v E. Clemens Horst Co.* (1930) 209 C 7, 284 P 905. Foreclosure of the interest conveys to the purchaser only the same reversion. See *Calidino Hotel Co. v Bank of America Nat'l Trust & Sav. Ass'n* (1939) 31 CA2d 295, 87 P2d 923. The purchaser may not, therefore, evict the tenant, nor may the tenant terminate its obligations under the lease. The purchaser becomes the new landlord and is entitled to the rents as they become due. *Fahrenbaker v E. Clemens Horst Co., supra*.

Thus the purchaser at the foreclosure sale merely acquires the right to be the landlord of the existing tenant and thereafter to receive all rents due under the lease, with the liability of performing all obligations in the lease that run with the land. Civil Code §1111 eliminates the former common law requirement that the tenant "attorn" to the new owner in order to enter into privity of estate with him or her. No party (*i.e.,* creditor, tenant, or foreclosure purchaser) can undo this result and attempt to bring about a termination of the lease because of the foreclosure. The tenant and purchaser may, of course, thereafter agree to a voluntary surrender of the leasehold, but that option is no different from what is available to parties to a lease at any time they both agree to it.

However, if the tenant under a superior lease is not visibly in possession of the property and if the lease was not recorded, the purchaser at the foreclosure sale should be able to take the property free of the lease as a bona fide purchaser. See *R-Ranch Markets #2, Inc. v Old Stone Bank* (1993) 16 CA4th 1323, 21 CR2d 21.

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§6.85 (2) If Lease Subsequently Modified

The initial priority of a lease may be adversely affected if the lease is later amended or modified after a deed of trust has been recorded against the landlord's title. For example, in *R-Ranch Markets #2, Inc. v Old Stone Bank* (1993) 16 CA4th 1323, 21 CR2d 21, an amendment to a senior lease, which permitted the tenant to assign without the landlord's consent, was held not to disturb the priority of the lease itself but to make the assignment feature inferior to the deed of trust. Thus the lease was not terminated by the foreclosure sale, but the tenant no longer had rights of free assignment. This partial change of priority was possible because of the nature of the amendment; a more radical and thorough alteration of interests under the lease might lead to complete subordination of the lease. See *Gluskin v Atlantic Sav. & Loan Ass'n* (1973) 32 CA3d 307, 108 CR 318.

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§6.86 b. If Deed of Trust Has Priority Over Lease

The purchaser may evict tenants of the former trustor if their leases are junior to the foreclosed deed of trust. *Dugand v Magnus* (1930) 107 CA 243, 290 P 309. A lease junior to the deed of trust gives the tenant only a leasehold interest in mortgaged premises, and foreclosure constitutes eviction by paramount title. *Sullivan v Superior Court* (1921) 185 C 133, 195 P 1061. Although a senior foreclosure and sale by a senior lienholder is a breach of the trustor-landlord's covenant of quiet enjoyment that may result in landlord liability to the tenant (see §§6.80, 6.82; see also §§6.66, 6.70), the tenant is not insulated from the foreclosure purchaser's superior right to possession. *Sullivan v Superior Court, supra*.

The fact that foreclosure terminates junior leases may adversely affect the purchaser if the leases are favorable to the landlord. In this situation, it is the tenants who will claim that the foreclosure sale terminated the tenancy. *Dugand v Magnus, supra*.

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§6.87 (1) In Judicial Foreclosure Actions

The effect of a foreclosure sale on existing leases is not as straightforward if they are inferior (rather than superior) to the foreclosing deed of trust. The only absolutely certain outcome is that a judicial foreclosure sale will terminate any inferior lease if the tenant was named as a party. Because a foreclosure terminates all inferior interests (*e.g.,* junior creditors, holders of easements), properly included leases also end at that time. See *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1478, 77 CR2d 479. A tenant may avoid this result by requiring the landlord to acquire from the beneficiary a nondisturbance agreement in the tenant's favor when the lease is negotiated or when the tenant is asked to subordinate the lease to a deed of trust at a later time (see §6.97).

A tenant that remains in possession after a sale terminates its lease is subject to an unlawful detainer action brought by the foreclosure purchaser if the tenant is unable to make new leasing arrangements with the purchaser (see §6.83). The remedy for any loss suffered from the premature termination of the lease is a damage action against the former landlord for breach of the covenant of quiet enjoyment (CC §1927), *i.e.,* by permitting an eviction by one who had paramount title (see §6.70). For extensive discussion of covenant of quiet enjoyment and measure of damage for breach of covenant, see California Eviction Defense Manual §§14.47, 19.18 (2d ed Cal CEB 1993); California Landlord-Tenant Practice, chap 3 (2d ed Cal CEB 1997).

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§6.88 (2) If Junior Tenant Not a Party in Senior Foreclosure Action

Old California law appeared to hold that a judicial foreclosure sale terminated a junior lease even when the tenant was not made a party to the action. *McDermott v Burke* (1860) 16 C 580. It is extremely doubtful, however, that any California court would reach that conclusion today, because this decision was limited to legal rights, whereas equitable rights dominate decisions when the "equity" of redemption is involved. In *Sullivan v Superior Court* (1921) 185 C 133, 195 P 1061, the California Supreme Court subsequently stated that tenants have rights of statutory redemption and to the surplus from the sale. Furthermore, at common law, attornment was necessary to create privity of estate, so that even senior tenants might have been able to terminate their leases by refusing to attorn; currently, CC §1111 eliminates that requirement.

In addition, both statutory laws and due process principles would undoubtedly prohibit the termination of a tenant's property rights by means of a lawsuit in which the tenant is not a party. For example, CCP §726(c) provides that a judicial foreclosure sale does not affect the interest of one who holds a recorded conveyance or has a lien on a fee or an estate "for years" if that person is not included in the action. It is doubtful that a different rule would be applied to a tenant whose lease was unrecorded but whose possession of the property gave constructive notice of its leasehold rights. See also *Goodenow v Ewer* (1860) 16 C 461 (discussed in §§1.34, 2.50, 3.24, 3.33, 9.123) (co-owner's property not affected by foreclosure action that does not name it as a party). As to the due process issue, it is unlikely that any court would hold that a tenant can be deprived of its leasehold without notice and an opportunity to be heard, *i.e.,* by being omitted from an action foreclosing the title to the property.

Despite the above, the survival of a junior lease is not entirely clear. When a junior lienholder is omitted from a senior foreclosure action, the purchaser (as assignee of the former senior lien) may later bring a second, strict foreclosure action and thereby terminate the junior lien if no redemption from the senior lien is made. This procedure was recently extended to an omitted holder of an easement in the foreclosed property. In *Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 77 CR2d 581, the court of appeal held that, although an omitted junior dominant tenant's easement was not destroyed by foreclosure of a senior deed of trust, nevertheless a subsequent foreclosure action could be brought to terminate it. If that reasoning is also applied to leases, it would give the foreclosure purchaser the power to later decide whether to continue or reject preexisting junior leases. It is most likely not in the interests of either the purchaser or the junior tenant to render the tenant's existence so precarious or to subject it to economic hindsight (*i.e.,* cherry-picking the leases) (see §§3.15, 3.25).

PRACTICE TIP: A lender might be able to preserve junior leases in a judicial foreclosure by (1) omitting the tenant as a party and (2) praying in the complaint that only the reversion be foreclosed and that (some or all) leaseholds be affirmed. Notice without joinder to the junior tenant may also be helpful. (It is not apparent how an informed junior tenant could justify intervening in the senior foreclosure action to destroy its own lease.) In a shopping center context, however, a tenant may argue that a radical change of the tenant mix denies it the benefit of its bargain, particularly if its lease expressly or impliedly requires the landlord to maintain other tenants' leases for its benefit. See California Eviction Defense Manual §19.21 (2d ed Cal CEB 1993).

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§6.89 (3) If Senior Foreclosure Is by Trustee Sale

It is unclear how the beneficiary should act in order to make junior leases survive a senior trustee sale. Because a trustee sale is nonjudicial, the device of omitting the tenants as parties to the action (see Practice Tip in §6.88) is unavailable. Because foreclosure of only the reversion can probably be accomplished by way of partial judicial foreclosure, there seems to be no fundamental reason why it should be denied to a beneficiary who prefers to foreclose by trustee sale rather than by judicial action.

Civil Code §2924b(c)(2)(D) requires that tenants receive notices of default and of sale, but the significance of that requirement is lessened by the statement in CC §2924c(b)(2) that noncompliance does not affect the validity of a sale. Thus it appears that simple failure to send notice of default or notice of sale to a junior tenant would nevertheless transfer title free of that interest at a duly conducted trustee sale.

STRATEGY: Exclusion of leaseholds may possibly be achieved by describing in the notice of sale (and trustee's deed) the reversion and right to rents but not the leasehold estate, because the estates are legally separable. *Commonwealth Mem., Inc. v Telophase Soc'y of Am.* (1976) 63 CA3d 867, 134 CR 58. This strategy is analogous to foreclosing and selling only one of two lots included as security in the deed of trust. See form in Sheneman, California Foreclosure: Law and Practice, App 5-1, "Form 5-4: Notice of Beneficiary's Election Regarding Certain Tenant Leases" (1991).

The trustor should have no valid objection to this device, because there is no liability for a deficiency under CCP §580d and the possibility of a surplus is increased by omitting a favorable leasehold from the sale. The tenants cannot complain either, because their right to quiet enjoyment is preserved. This device is consistent with the doctrine of marshaling assets in inverse order of alienation. See CC §2899. See also §§9.2-9.25 on multiple security.

Although it is true that priorities may not be changed unilaterally, it is also true that the secured creditor is not required to dispose of all its security in any particular trustee sale. If the creditor is willing to accept the consequence that the omitted security may be lost and that there may be no personal liability afterward if the debtor protests by way of an affirmative defense (see *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897), it may sell less than it has. The surviving tenants come into privity of estate with the foreclosure purchaser without attornment and are bound and benefited by all covenants that run with the land. CC §§1111. See also CC §§818-834 (incidents of ownership); *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 270 CR 183 (dictum that beneficiary should not have unilateral choice on whether junior lease survives).

Thoughtful articles have been written by commentators on both sides of the issue of survival of junior leases. Compare Geiger & Frobes, *Lenders and Leases,* 7 Cal Real Prop J 1 (Fall 1989) with Stillman, *The Secured Lender's Right to Enforce Subordinate Leases,* 8 Cal Real Prop J 32 (Spring 1990).

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§6.90 C. Provisions Affecting Priority of Leases and Loans

Absent special provisions in either the loan or the lease documents, priority of right depends on the date of execution or creation, subject to the operation of the recording act. See CC §2897. Under CC §1214, a subsequently executed instrument that is recorded first may take priority over one previously executed but recorded later. Because California adopted a race-notice system (see §§9.42-9.43), however, priority of recording is effective only when the second instrument is recorded without actual or constructive notice of the first. See CC §1217. See also §§9.41-9.49. Furthermore, because constructive notice can come from possession as well as from the public records, the priority of a tenant whose lease was executed first but not recorded is not defeated by a subsequent creditor whose deed of trust is recorded, as long as the tenant is in actual possession of the property and its possession is conspicuous and inconsistent with record title.

The parties are also free to reorder their priorities by agreement and commonly do so. Three types of provisions relating to this issue frequently appear in the relevant documents:

- Subordination (see §§6.91-6.96);
- Nondisturbance (see §6.97); and
- Attornment (see §6.98).

In addition to the discussion in §§6.91-6.98, further discussion and sample provisions that reorder the priority of leases and secured financing are in Office Leasing: Drafting and Negotiating the Lease, chap 28 (Cal CEB 1996); Retail Leasing: Drafting and Negotiating the Lease, chap 44 (Cal CEB 2007).

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§6.91 1. Subordination Agreements

The relative priority of a deed of trust and a lease can be altered by the parties' mutual consent. Thus, the holder of a senior deed of trust may agree to reduce its priority (*i.e.,* subordinate its deed of trust) to make it inferior to a later executed lease. See §6.97 on nondisturbance agreements. Similarly, the holder of a senior lease can agree to reduce its priority to make it inferior to a later executed mortgage (see §§9.73-9.84).

What makes the issue so problematic is that creditors generally demand absolute priority over leases so as to be free of all claims asserted by aggrieved tenants, but they do not want to suffer the consequence of seeing subordinate leases terminated by foreclosure sales, especially when the rent reserved exceeds the current market value. A creditor may not want its deed of trust to be automatically and permanently prior to all leases but may prefer that relative priority be optional. See Bernhardt, *When First Might Be Worst,* 31 CEB Real Prop L Rep 75 (May 2008). The creditor may then have the tenant subordinate to the mortgage but reserve the right to "optionally unsubordinate" if the creditor so chooses (see §§6.95-6.96).

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a. Types of Subordination Clauses

§6.92 (1) Automatic Subordination

Many leases contain a clause that automatically subordinates the lease to a later executed mortgage, *e.g.:*

> This Lease is, and at all times hereafter shall be, subject and subordinate (i) to any and all ground and underlying leases which now exist or may hereafter be executed affecting the Building or the land on which the Building is situated or both, and (ii) to the lien of any mortgages or deeds of trust in any amount or amounts whatsoever now or hereafter placed on or against said land and Building or either of them or on Landlord's interest or estate therein, or on or against any ground or underlying lease, and to all renewals, consolidations, replacements and extensions thereof, and to all loans or advances heretofore or hereafter made on the security thereof, all without the necessity of the execution and delivery of any further instruments on the part of Tenant to effectuate said subordination….

See *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1475 n2, 77 CR2d 479, from which this clause is quoted. See also *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 270 CR 183, for a comparable, somewhat differently worded clause. See Bernhardt, *Midcourse Corrections: When First Might Be Worst,* 31 CEB Real Prop L Rep 75 (May 2008).

By virtue of such a clause, subordination occurs automatically and without the need for the execution of further documentation. Inclusion of such a clause in every lease spares the landlord from having to plead with existing tenants to subordinate when the landlord refinances the property or to cooperate in executing the appropriate documents to accomplish the reordering even though the tenant may have previously agreed to do so. The clause has no significance for leases executed after the deed of trust was recorded, because the deed of trust has priority in any event, but its presence does no harm.

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§6.93 (2) Executory Subordination

Some leases contain other subordination clauses, *e.g.:*

> Upon written request of Landlord, or any first mortgagee, first deed of trust beneficiary of Landlord, or ground lessor of Landlord, Tenant shall, in writing, subordinate its rights hereunder to the lien of any first mortgage, first deed of trust, or the interest of any lease in which Landlord is lessee, and to all advances made or hereafter to be made thereunder….

See *Miscione v Barton Dev. Co.* (1997) 52 CA4th 1320, 1323, 61 CR2d 280, from which this clause is quoted.

Under such a clause, subordination does not occur until after the creditor has given proper notice to the tenant and the tenant then executes an effective subordination agreement. Consequently, such a clause gives the creditor discretion about whether to be senior or junior to prior leases.

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§6.94 b. Validity of Subordination Clauses

No California court has yet held invalid either an automatic or an executory subordination clause. In other areas, express subordination arrangements have been upheld as long as they were sufficiently specific to define and minimize the subordinator's risks; see, *e.g., Handy v Gordon* (1967) 65 C2d 578, 55 CR 769 (contract of sale).

Some commentators disagree on the fairness of subordination clauses. See Andrew, *A Further Thought on* Aviel v Ng: *Enforcement of an Automatic Lease-Subordination Provision,* 31 CEB Real Prop L Rep 155 (Sept. 2008). Compare Geiger, Dover Mobile Estates v. Fiber Form Products Inc.: *The Subordinate Tenant Walks and the Court Enforces an Automatic Subordination Provision in a Lease,* 8 Cal Real Prop J 30 (Fall 1990) with Stillman, *The Secured Lender's Right to Enforce Subordinate Leases,* 8 Cal Real Prop J 32 (Spring 1990).

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§6.95 c. Optional Unsubordination

Automatic subordination clauses often include optional "unsubordination" provisions, *e.g.:*

> … provided, that if any mortgage or beneficiary elects to have this Lease superior to its mortgage or deed of trust and gives notice of its election to Tenant, then this Lease shall be superior to the lien of any such mortgage or deed of trust and all renewals, replacements and extensions thereof, whether this Lease is dated or recorded before or after the mortgage or deed of trust.

See *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 1496 n1, 270 CR 183. Because such a clause in the tenant's lease permits the creditor to make a priority election, there appears to be no reason why the election may not be made unilaterally by the creditor at any time before foreclosure and without the need for the tenant's further assent. See *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 77 CR2d 479. Written notice to the tenant should accomplish the same purpose. *240 N. Brand Partners v Colony GFP Partners, LP (In re 240 N. Brand Partners)* (BAP 9th Cir 1996) 200 BR 653, 658.

Unsubordination cannot be accomplished without the prior consent of the subordinated tenant. It is unknown whether the courts will permit a party to unilaterally alter its priority status—even downward—without the current or advance consent of the party whose rights may be affected.

The presence of valid, optional unsubordination provisions in leases allows the creditor to elect to terminate or continue existing leases on an individual basis. (For protective clauses needed by tenants in such situations, see §6.97.) The election should be made before the foreclosure sale because, if no timely unsubordination has occurred, a foreclosure will terminate the subordinate leases and entitle those tenants to abandon their estates. See *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 270 CR 183 (foreclosure purchaser's argument that it should have option to make postforeclosure decision on survival of leases rejected in favor of automatic termination rule for junior leases).

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§6.96 d. Combined Subordination and Unsubordination

The use and exercise of both subordination and unsubordination clauses merely restore the creditor and preexisting tenant to the positions they would have occupied without either clause. When long-term leases constitute the more valuable security component of the loan, some attorneys advise their creditor clients to dispense with both clauses (assuming that it can be done for leases executed before the deed of trust). Priority often has other ramifications, however, apart from foreclosure. The deed of trust and the lease may contain inconsistent provisions on the treatment of insurance proceeds (*e.g.,* on whether the funds will be used to rebuild the premises or to reduce the loan principal) or on the right to prepay rents. The resolution of such conflicts will turn on the relative priorities of the two documents. Thus, a creditor generally prefers the deed of trust to have priority over any leases unless there is a pending foreclosure and the lease is valuable.

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§6.97 2. Nondisturbance Agreements

Tenants' economic interests differ from those of creditors. Generally, a tenant who bargains for a 10-year lease does not want to have that expectation frustrated by a premature termination because of foreclosure of a senior deed of trust. A nondisturbance agreement has the effect of preserving a lease through foreclosure, even though the lease is junior to the mortgage. Neither the foreclosing creditor nor the foreclosure purchaser has any option but to accept that the tenant is entitled to remain as long as it meets the obligations of its lease. *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 1500, 270 CR 183.

A pure subordination (with or without unsubordination) does nothing to further the tenant's interests, and the tenant is not likely to accept it unless some compensating advantage or protection is given to the leasehold estate. Commercial tenants therefore generally require the inclusion of a nondisturbance clause in their leases. The clause in the lease in *Miscione v Barton Dev. Co.* (1997) 52 CA4th 1320, 1324, 61 CR2d 280, provided that

> … before signing any subordination agreement, Tenant shall have the right to obtain from any lender or lessor of Landlord requesting that subordination, an agreement in writing providing that, as long as Tenant is not in default hereunder, this Lease shall remain in effect for the full Term. The holder of any security interest may, upon written notice to Tenant, elect to have this Lease prior to its security interest regardless of the time of the granting or recording of that security interest.

A nondisturbance clause has the effect of giving the tenant assurance that its leasehold will not be eliminated by foreclosure of the deed of trust. *Chumash Hill Props. v Peram* (1995) 39 CA4th 1226, 1229, 1232, 46 CR2d 366. There is not complete judicial agreement on whether this is accomplished by reordering the priorities of the two interests (see *Miscione v Barton Dev. Co., supra*) or by an agreement that a senior beneficiary will ratify or accept a junior tenancy after foreclosure (see *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 77 CR2d 479). Under either approach, such a clause accomplishes its key purpose. See Fisher & Goldman, *The Ritual Dance Between Lessee & Lender—Subordination, Nondisturbance and Attornment,* 30 Real Prop Prob & Tr J 355 (1995). See also Bernhardt, *Midcourse Corrections: When First Might Be Worst,* 31 CEB Real Prop L Rep 75 (May 2008).

A carefully drafted clause should also resolve problems that may arise because of inconsistencies between the lease and the deed of trust. See, *e.g.,* form in Geiger & Frobes, *Lenders and Leases,* 7 Cal Real Prop J 1 (Fall 1989).

Nondisturbance provisions are often drafted as part of a subordination agreement, with one feature being the trade-off for the other. When nondisturbance depends on subordination, a nondisturbance clause will not benefit a tenant whose lease was created after the mortgage, because the priority of the mortgage was not established by the subordination agreement. See *Miscione v Barton Dev. Co., supra*. Although only a tenant must execute a "dependent" nondisturbance provision (as a condition under which subordination will occur), both the beneficiary and the tenant must execute an "independent" nondisturbance agreement, no matter how the deed of trust came to have priority.

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§6.98 3. Attornment Agreements

At common law, when a landlord sold its reversionary interest, the tenants were required to attorn to the new purchaser in order to create a privity of estate (*i.e.,* a landlord-tenant relationship) between them. Despite the fact that CC §1111 provides that attornment is unnecessary in a grant of rents or reversion, attornment is frequently included as a third component in deed of trust and lease provisions dealing with subordination, and the promise to attorn is often made in consideration of the beneficiary's promise to allow the tenant's lease to survive foreclosure (nondisturbance). Such clauses are often generically referred to as "SNDAs" (subordination, nondisturbance, and attornment). A modern landlord may want attornment from the tenants—not to create feudal rights but to guarantee that the tenants will not defend based on their having signed their leases with a different owner. For form subordination, nondisturbance, and attornment agreements, see Office Leasing: Drafting and Negotiating the Lease, Apps N-O (Cal CEB 1996) and Retail Leasing: Drafting and Negotiating the Lease, Apps G-H (Cal CEB 2007).

The agreement to attorn may also be independent of subordination and nondisturbance. In that event, the tenant may lose the right to quit after a foreclosure even though it was not excluded from the foreclosure proceeding and even though the beneficiary did not promise to protect its possession. Compare *Miscione v Barton Dev. Co.* (1997) 52 CA4th 1320, 1323, 61 CR2d 280, with *Chumash Hill Props. v Peram* (1995) 39 CA4th 1226, 1229, 1232, 46 CR2d 366. A typical attornment provision declares the following:

> In the event that Landlord at any time sells or conveys its estate in the Building and/or the related land and real property, or any part thereof, to any other party, or in the event that Landlord's estate therein is at any time acquired by any other party upon the foreclosure of any mortgage or deed of trust, or upon any termination of any ground or underlying lease to which this Lease is subordinated … or by reason of any merger or consolidation or otherwise by operation of law, (i) Tenant shall, upon request, attorn to such successor in interest and, upon request, enter into a new lease, containing all of the terms and provisions of this Lease, with such successor in interest for the remainder of the term hereof, or at the election of such successor in interest, this Lease shall automatically become a new Lease between Tenant and such successor in interest, upon all the terms and conditions hereof, and (ii) Landlord shall be relieved of any further obligations hereunder, provided that such successor in interest assumes all of such obligations of Landlord, but such successor in interest shall not become liable for any default hereunder theretofore committed by Landlord.

See *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1475 n2, 77 CR2d 479.

It is not apparent what difference there is between a tenant attorning to the new owner under the existing lease and a tenant entering into a new lease with that new owner under the same terms and conditions as the old lease or making this result occur automatically, as this provision contemplates. The provision appears in the landlord-tenant lease, but it may be enforceable by the beneficiary or foreclosure purchaser as a third party beneficiary. See *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1484, 77 CR2d 479.

Attornment agreements may completely eliminate beneficiaries' concerns about how to avoid terminating junior leases. They purport to give the purchaser a second opportunity to enforce or repudiate junior leases. Assuming that a beneficiary already has the power to terminate a lease by including or excluding the leasehold from its foreclosure proceeding, the clause gives the foreclosure purchaser a second similar opportunity by enforcing or waiving the attornment clause. Indeed, the attornment decision may be exercisable only by the purchaser and may not be waivable by any presale decision made by the beneficiary. See *Miscione v Barton Dev. Co.* (1997) 52 CA4th 1320, 1330, 61 CR2d 280. See also Bernhardt, *The Disturbed Subtenant,* 26 CEB Real Prop L Rep 77 (Mar. 2003).

It remains to be seen to what extent the judiciary will permit foreclosing beneficiaries unbridled discretion to destroy the tenants' legitimate investment needs. Although a strong protenant policy was articulated in *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 270 CR 183, the later decisions in *Miscione* and *Principal* appear to have discarded that approach.

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VI. FORMS

§6.99 A. Form: Complaint for Specific Performance of Assignment of Rents

▶ To download **Word** version, right click and choose *Save Target As*

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**COMPLAINT FOR SPECIFIC PERFORMANCE OF ASSIGNMENT OF RENTS**
vs	)	
_ _[*Name(s)*]_ _, **Defendant(s)**	)	

Plaintiff alleges:

1. _ _[*See complaint form in §3.102 for introductory allegations*]_ _**.**

2. _ _[*Allegation concerning execution of note; see §3.102*]_ _**.**

3. _ _[*Allegation concerning execution and recordation of deed of trust; see §3.102*]_ _**.**

4. _ _[*Allegation concerning plaintiff's present ownership of note and beneficial interest under deed of trust; see §3.102*]_ _**.**

5. _ _[*Allegation concerning nature of default; see §3.102. Plaintiff need not allege an election to accelerate balance due but should allege that demand was made to cure default*]_ _**.**

6. The deed of trust described in paragraph 3 provides that defendant, _ _[*name*]_ _**, as trustor, assigned to plaintiff the rents, issues, and profits of the property as additional security for the loan evidenced by the note described in paragraph 2**.

7. In addition to the foregoing provision, the deed of trust provides, among other things, that plaintiff may obtain the appointment of a receiver to enforce the assignment provision.

8. Plaintiff has no adequate remedy at law to enforce the provisions of the deed of trust described in paragraphs 6-7.

WHEREFORE, plaintiff demands judgment as follows:

1. That the Court enter its order appointing a receiver, pendente lite, to take possession and control of the real property and to conserve, maintain, and manage it, and to collect any and all its rents from and after _ _[*date*]_ _**, the date of default;**

2. That the Court enter its judgment directing defendant and anyone in possession of the real property to deliver possession of the property to the receiver; and

3. That the Court award plaintiff costs and all other appropriate relief.

Date: _ _ _ _ _ _ _ _[*Name of firm*]_ _

By: __[*Signature*]__

_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: For second cause of action for foreclosure, see §3.102. On procedures for action, see §§6.34-6.40, 6.46 and additional forms in §§6.100-6.102.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/§6.100 B. Form: Notice of Motion for Appointment of Receiver

§6.100 B. Form: Notice of Motion for Appointment of Receiver

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**NOTICE OF MOTION FOR APPOINTMENT OF RECEIVER; SUPPORTING MEMORANDUM; SUPPORTING DECLARATIONS**
vs	)	
_ _[*Name(s)*]_ _, **Defendant(s)**	)	
	)	
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____	)	**Trial date:** _ _[*if set*]_ _

To defendants and their attorneys:

PLEASE TAKE NOTICE that on _ _[*date and time*]_ _, or as soon thereafter as counsel can be heard, in _ _[*e.g., Department No. _ _*]_ _ of the above-titled Court, located at _ _[*address*]_ _, California, plaintiff, _ _[*name*]_ _, will move for an order from the court appointing a receiver to take possession and control of, and to conserve, maintain, and manage, the real property located in the County of _ _ _ _ _ _, California, commonly known as _ _[*street address or other designation*]_ _, and described as:

[*Provide legal description*]

This motion will be made on the grounds that defendant has defaulted in _ _[*his/her/its*]_ _ obligations under the deed of trust as alleged in the complaint on file in this action and that appointment of a receiver is necessary to collect rents from the property as provided in the deed of trust.

The motion will be based on this notice, on the allegations of the _ _[*complaint/verified complaint*]_ _ on file in this action, on plaintiff's _ _[*supporting affidavits/declarations*]_ _, _ _[*and*]_ _ on plaintiff's supporting memorandum _ _[*, and on such oral and documentary evidence that may be presented at the hearing on this motion*]_ _.

Date: _ _ _ _ _ _ _ _[*Name of firm*]_ _

By: __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: The notice of motion must be accompanied by a supporting memorandum (Cal Rules of Ct 3.1113) and supporting declarations (Cal Rules of Ct 3.1175-3.1177). For form declaration, see §6.101. The proper court department in which to move for the appointment of a receiver is established by local court rules. For notice periods for hearing, see CCP §1005. The beneficiary may proceed by order to show cause instead of following the motion procedure. Using an order to show cause may be advantageous when time is important because the order can be issued before the defendant appears in the action; a motion can be used only after the defendant has appeared. In an emergency, the beneficiary can make an ex parte application for appointment of a receiver, followed by a hearing to confirm the appointment on an order to show cause. Cal Rules of Ct 3.1175-3.1177. See §§6.37-6.39, 6.103-6.104.

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§6.101 C. Form: Declaration in Support of Application for Receivership

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**DECLARATION OF**
vs	)	_ _[*NAME*]_ _ **IN SUPPORT**
	)	**OF APPLICATION FOR**
_ _[*Name(s)*]_ _, **Defendant(s)**	)	**RECEIVERSHIP**
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*name*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____	)	**Trial date:** _ _[*if set*]_ _

I declare that I have personal knowledge of the following facts and that I can competently testify about them if called as a witness:

1. I am _ _[*insert description of declarant as plaintiff or authorized representative of plaintiff*]_ _ **in the above-titled action. To secure payment of the principal sum and interest on a promissory note, and as part of the same transaction, defendant** _ _[*name of trustor*]_ _ **made, executed, and delivered to** _ _[*name of plaintiff or plaintiff's predecessor*]_ _**, as beneficiary, a deed of trust, which was recorded on** _ _[*date*]_ _**, under** _ _[*state book and page or instrument number*]_ _ **in the Official Records of** _ _ _ _ _ _ **County, California. Copies of the note and the deed of trust are attached to this Declaration as Exhibits A and B, respectively, and incorporated by reference.**

2. The following defaults have been committed by defendant _ _[*name of trustor*]_ _ **under the note and the deed of trust securing it:**

[*Describe defaults with specific facts*]

3. The deed of trust included an assignment of rents produced by the real property described in the deed of trust, and this action was filed to obtain specific performance of that assignment. See assignment of rents clause in paragraph _ _[*number*]_ _ **of Exhibit B. The real property consists of** _ _[*e.g., a four-unit apartment building*]_ _ **that produces an income of approximately** _ _[*dollar amount*]_ _ **per month, which defendant is presently collecting and withholding from plaintiff.**

4. _ _[*Name of proposed receiver*]_ _**, located at** _ _[*address*]_ _**, is a disinterested and qualified person in that** _ _[*describe nominee's experience as receiver, familiarity with particular property or type of property, and special skills that make nominee appropriate for the subject property*]_ _**.** _ _[*He/She*]_ _ **is willing to be appointed receiver on (a) filing an undertaking, in a sum to be approved by the Court, to the effect that** _ _[*he/she*]_ _ **will faithfully discharge** _ _[*his/her*]_ _ **duties as receiver in this action and obey the orders of the Court; and (b) taking an oath to faithfully perform the duties of receiver.**

[*If appropriate, add following paragraph and augment as necessary; see discussion of ex parte appointment of receiver in §6.38*]

5. The value of the property is being damaged by vandalism, theft, physical neglect, and nonpayment of insurance or property taxes. _ _[*Add relevant, factually supportive details here.*]_ _ **Consequently, plaintiff will suffer irreparable injury during the time necessary for a noticed hearing on plaintiff's request for the appointment of a receiver. A receivership will not seriously interfere with defendant's business operations.**

[*Continue*]

[*If applicable, add one or more of the following options; see discussion of waste and insufficient security in §6.15*]

[*Option 1: Waste*]

[6.] The value of the property is being damaged by vandalism, theft, physical neglect, and nonpayment of insurance or property taxes. _ _[*Add relevant, factually supportive details here.*]**_ _ Consequently, the plaintiff will suffer irreparable injury during the time it takes to complete foreclosure on the property.**

[*Option 2: Insufficient Security*]

[7.] A condition of the deed of trust has not been performed *and* the value of the property is less than the unpaid balance of the note. Consequently, the plaintiff will suffer irreparable injury during the time it takes to complete foreclosure on the property.

[*Continue*]

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]**_ _.**

__[*Signature of declarant*]__
_ _[*Typed name*]_ _

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: Paragraph 5 is necessary when a receivership is requested on an ex parte basis. See Cal Rules of Ct 3.1113. Optional paragraphs 6 and 7 are available to support the request for receivership whether or not the deed of trust contains an assignment of rents clause. If no assignment of rents clause exists but the facts in paragraph 6 or 7 or both apply, the beneficiary may have a receiver appointed to protect the property as discussed in §6.15; in that event, delete paragraph 3. More than one declaration may be needed (*e.g.,* declaration of counsel and others on the service attempts and the urgency situation justifying an ex parte application). See §§6.37-6.39.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/§6.102 D. Form: Order Appointing Receiver

§6.102 D. Form: Order Appointing Receiver

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	
	)	**ORDER APPOINTING**
vs	)	_ _[*NAME*]_ _ **TO ACT**
	)	**AS RECEIVER**
_ _[*Name(s)*]_ _, **Defendant(s)**	)	
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____	)	**Trial date:** _ _[*if set*]_ _

The motion of _ _[*name of plaintiff*]_ _ **for the appointment of a receiver came on regularly for hearing on** _ _[*date*]_ _**, in the above-titled court, the Honorable** _ _[*name of judge*]_ _ **presiding. Plaintiff appeared by and through** _ _[*name of plaintiff's attorney*]_ _**, and defendant** _ _[*name of trustor*]_ _ **appeared by and through** _ _[*name of trustor's attorney*]_ _**; defendant** _ _[*name of trustee*]_ _ **did not appear.**

The court, having read and considered the moving papers, pleadings, and evidence in this matter; having heard argument of counsel; and being apprised of the premises; and it appearing to the court that:

A. Plaintiff is payee of a promissory note executed by defendant _ _[*name of trustor*]_ _ **on or about** _ _[*date*]_ _**, in the original principal amount of** _ _[*dollar amount*]_ _ **(the "Note");**

B. The Note is secured by a deed of trust of even date (the "Deed of Trust"), executed by defendant _ _[*name of trustor*]_ _ **in favor of plaintiff as beneficiary, on certain real property commonly known as** _ _[*address*]_ _**, the rents, issues, royalties, and profits therefrom, any personal property located thereon, together with all buildings, improvements, and fixtures now or hereafter placed thereon ("Subject Property"), the real property of which is described as follows:**

[*Add legal description of record here or in exhibit*]

C. The Deed of Trust was recorded in the Official Records of the County of _ _ _ _ _ _**, California, on** _ _[*date*]_ _**, as** _ _[*insert instrument number, or book and page numbers, or both*]_ _**;**

[*If applicable, add the following option to paragraph C*]

A UCC-1 financing statement giving notice of plaintiff's security interest in all equipment, including, but not limited to, furniture, furnishings, and fixtures now or hereafter owned or acquired by _ _[*name of trustor*]_ _ **located at** _ _[*address*]_ _ **was filed with the Secretary of State on** _ _[*date*]_ _**, as Filing No.** _ _[*number*]_ _**;**

[*Continue*]

D. Defendant _ _[*name of trustor*]_ _ **has defaulted on its obligations under the Note and Deed of Trust (hereinafter, collectively the "Loan Documents") in that defendant failed to make payments due thereunder since** _ _[*date*]_ _**, and failed to make payments on** _ _[*specify, e.g., senior deed of trust, property taxes, or insurance*]_ _ **since** _ _[*date*]_ _**;**

E. The Deed of Trust contains a provision whereby all rents, issues, royalties, and profits of the Subject Property are assigned to plaintiff as additional security on the Note; and

F. The Deed of Trust contains certain provisions in which defendant _ _[*name of trustor*]_ _ **consented to the**

appointment of a receiver for the Subject Property in the event of default under the Loan Documents;

THEREFORE, IT IS HEREBY ORDERED THAT:

1. The court grants plaintiff's motion for the appointment of a receiver and appoints _ _[*name of receiver*]_ _ as receiver ("Receiver") in this action, such appointment to be effective on the filing of the Receiver's oath of office and the filing of an undertaking or bond to the State of California in the penal sum of _ _[*dollar amount*]_ _ ("Effective Date"). Said Receiver shall be authorized and empowered to (and when required by this order must) do the following:

(a) Take control of the Subject Property and possession of the rents, issues, profits, and proceeds of the Subject Property, together with all related documents, books, records, papers, and accounts of defendant _ _[*name of trustor*]_ _;

(b) Within 30 days after taking control and possession under this order, Receiver shall file an inventory itemizing all personal property of which _ _[*he/she*]_ _ has taken control or possession and shall promptly file supplemental inventories of any personal property subsequently coming into the receivership estate;

(c) Subject to further orders of this Court, operate, manage, control, and conduct the Subject Property and its business and incur the expenses necessary in such operation, management, control, and conduct in the ordinary and usual course of business, and do all things and incur the risks and obligations ordinarily incurred by owners, managers, and operators of similar properties, and no such risks or obligations so incurred shall be the personal risk or obligation of Receiver, but shall be a risk or obligation of the receivership estate;

(d) Shall keep payments current on _ _[*specify, e.g., senior deed of trust, property taxes, or insurance*]_ _;

(e) Enter into contracts for the leasing and maintenance of the Subject Property;

(f) Employ agents and employees as Receiver believes, in _ _[*his/her*]_ _ business judgment, necessary to carry out the appointed duties, including _ _[*name*]_ _, as property manager, and to pay said agents and employees at ordinary and usual rates and prices, under appropriate contracts, from the funds that Receiver shall collect;

(g) Pay all lawful debts of the business, open and maintain checking and savings accounts and the like, and do all things and incur the risks and obligations ordinarily incurred by owners, managers, and operators of similar businesses and enterprises, and no risk or obligation so incurred shall be the personal risk or obligation of Receiver but shall be a risk or obligation of the receivership estate; provided, however, that the income from the Subject Property may not be used for purposes other than normal, day-to-day operating expenses, which do not include deferred maintenance or capital improvements of a nonemergency nature;

(h) Rent or lease from time to time any part of the Subject Property; provided, however, that any new or rollover leases or tenant improvements are to be preapproved in writing by plaintiff;

(i) Open and maintain bank accounts in the name of the receivership estate, in a federally insured lending institution;

(j) Demand, collect, and receive all rents, subrents, and profits for the Subject Property or any part of it that are owed, unpaid, and uncollected as of the Effective Date of this order, or hereafter to become due;

(k) Employ _ _[*name*]_ _ or a similar company to institute and prosecute all proper actions to collect rents owing on the Subject Property _ _[*and to remove tenants in default, or other persons, from the Subject Property and to recover possession thereof (see §§6.40, 6.44-6.46, 6.65-6.70, 6.75, 6.78)*]_ _;

(l) Subject to further order of this Court, institute and prosecute all suits as may be reasonably necessary in Receiver's judgment to protect the Subject Property, and to defend all such suits and actions as may be instituted against Receiver;

(m) Obtain and pay any reasonable price for any lawful license and, to the extent permitted by law, exercise the privileges of any existing license issued in connection with the Subject Property or any business transacted with respect to it, until further order of the Court, and to do all things necessary to protect and

maintain said licenses;

(n) Pay and discharge out of the funds, income, and revenue coming into Receiver's hands all expenses of receivership and costs and expenses of operations and maintenance of the Subject Property, as authorized by the Court, including all taxes and assessments lawfully imposed on the Subject Property and accruing during the receivership;

(o) Shall hold and retain all money that may come into Receiver's possession, custody, and control by virtue of _ _[*his/her*]_ _ appointment and not expended for any other authorized purpose, until further order of this Court, or until the sale of the Subject Property under the terms of the Loan Documents;

(p) Shall maintain adequate insurance over the Subject Property to the same extent and in the same manner as it has heretofore been insured, or as in the judgment of Receiver may seem fit and proper, and to cause all presently existing policies to be amended by adding Receiver and the receivership estate as an additional insured. If there is inadequate insurance or insufficient funds in the receivership estate to procure adequate insurance, Receiver is directed to immediately petition the court for instructions. During the period in which the Subject Property is uninsured or underinsured, Receiver shall not be personally responsible for any claims arising therefor; and

(q) Shall prepare and deliver to all parties periodic interim statements of money received and disbursed and of Receiver's fees and expenses, including those of _ _[*his/her*]_ _ employees and court-approved professionals, which statements shall be accompanied by a notice that advises parties that any objections to the statement must be made in writing within 10 days. Despite the periodic payment of Receiver's fees and administrative expenses, a statement of these fees and expenses shall be submitted to the Court for its approval and confirmation, in the form of a noticed interim report and request for fees, a stipulation among the parties, or Receiver's final account and report.

2. In addition to all of the powers set forth in this Order, Receiver is hereby vested with all of the general powers of receivers in cases of this kind, subject to the direction of this Court.

3. Receiver and the parties to this action may, from time to time and on due notice to the entitled parties, petition this Court for further instructions and for further powers necessary to enable Receiver to properly perform _ _[*his/her*]_ _ duties.

4. Receiver may generally do such other things as may be necessary or incidental to the foregoing specific powers, directions, and general authority, and take actions relating to the Subject Property, provided that Receiver obtains prior court approval for any actions beyond the scope stated in this Order.

5. Defendant _ _[*name of trustor*]_ _, its agents, servants, directors, officers, affiliates, attorneys, representatives, employees, and all other persons and entities who are successors in interest to or who are acting in concert with one or more of them, or participating with them (hereinafter, collectively, "Defendants"), shall surrender to Receiver all rents, issues, and profits that accrued but remained unpaid and uncollected as of the Effective Date of this order, wherever located and in whatever mode maintained, and now in the possession, custody, or control of Defendants or their agents, and make available to Receiver all records, books of account, ledgers, and all documents and papers pertaining to the operation of the Subject Property by 5 p.m. on the date that this Order is served, whether in the possession and control of Defendant _ _[*name of trustor*]_ _ or said Defendant's agents, servants, or employees.

6. Defendants to this action, including without limitation their agents, servants, directors, officers, affiliates, attorneys, representatives, employees, and all persons who are successors in interest to or who are acting in concert with one or more of them, or participating with them, are restrained and enjoined from engaging in or performing, directly or indirectly, any of the following acts:

(a) Collecting, expending, disbursing, transferring, assigning, selling, conveying, devising, pledging, mortgaging, creating a security interest in, or disposing of the whole or any part of the Subject Property, or otherwise transferring or making same unavailable; provided, however, that nothing in this Order shall prohibit or restrain plaintiff from initiating and completing a sale by judicial or nonjudicial foreclosure of the Subject Property, or any portion of it, and thereafter taking title to and possession of it;

(b) Interfering in any manner, directly or indirectly, with the Subject Property or Receiver's control of it. The

prohibited interference includes, without limitation, communicating with or contacting any of Receiver's employees or contractees, exercising or attempting to exercise any control or management functions in connection with the Subject Property, or otherwise engaging in acts inconsistent with Receiver's sole authority to operate, manage, and control the Subject Property;

(c) Destroying, concealing, transferring, or failing to preserve any document that evidences, reflects, or pertains to defendant's disposition of the Subject Property, or any part of it; and

(d) Committing waste of any kind on the Subject Property, or doing any act that will or will tend to impair, defeat, divert, prevent, or prejudice the preservation of the Subject Property, including the rents, or plaintiff's interests in the Subject Property and in the rents.

11. Immediately on reinstatement of the loan secured by the Deed of Trust, or on completion of a valid foreclosure sale of the Subject Property by plaintiff or any assignee of plaintiff, or on acquisition of the Subject Property by plaintiff or any assignee of plaintiff by a deed in lieu of foreclosure, and on plaintiff's furnishing Receiver with evidence of the foregoing, and without further order of this Court, Receiver shall relinquish control of the Subject Property to the party reinstating the loan, to the successful bidder at the foreclosure sale or, if a deed in lieu of foreclosure is accepted, to plaintiff or plaintiff's assignee, pending approval of Receiver's final report and account and the exoneration of _ _[*his/her*]_ _ bond. On relinquishing control of the Subject Property, Receiver shall be discharged from all further duties, liabilities, and responsibilities in relation to the Subject Property.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the _ _[*title of court*]_ _

[*If appropriate, add signature of counsel approving form of order*]

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: A proposed order should be prepared and submitted either with the moving papers (Cal Rules of Ct 3.1113(m)) or within 5 days of the ruling (Cal Rules of Ct 3.1312(a)). Unless the parties waive notice or the court directs otherwise, after the hearing the prevailing party must prepare the order and allow the other party opportunity to either approve the order as "conforming to the court's order" or to object to its form and content. Cal Rules of Ct 3.1312. (Note: Rule 3.1312 does *not* usually apply if the motion was unopposed and a proposed order was submitted with the moving papers. Cal Rules of Ct 3.1312(d).) Absent a showing of good cause, any objections to the report must be made within 10 days of notice of the report. Cal Rules of Ct 3.1183(b). After it is executed by the judge, the order must be served on the losing party by the prevailing party. CCP §1019.5. See also Cal Rules of Ct 3.1109 (on clerk's serving notice of decision on submitted matter). On powers of receiver pending foreclosure, see §§6.34-6.37, 6.39-6.46, 6.70.

This sample order does not require the receiver to pay any of the rents collected to the foreclosing beneficiary until after the foreclosure sale. This order follows the procedure and limitations of current CC §2938. Therefore, by the language of the order, the receiver is not granted possessory rights in the property and is not given the power to receive any rents that the trustor collected before the effective date of the order. See §§6.34-6.46, 6.54-6.56. This order should be modified if used when a receiver is appointed (1) to preserve the property pending a foreclosure when there is no assignment of rents (see §§6.15-6.18) or (2) to collect rents during the redemption period following judicial foreclosure (see §§6.35, 6.74-6.75, 6.77).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/ E. Optional Judicial Council Forms/§6.103 1. Form: Ex Parte Order Appointing Receiver and Order to Show Cause and Temporary Restraining Order--Rents, Issues, and Profits (Receivership) (Judicial Council Form RC-200)

E. Optional Judicial Council Forms

§6.103 1. Form: Ex Parte Order Appointing Receiver and Order to Show Cause and Temporary Restraining Order—Rents, Issues, and Profits (Receivership) (Judicial Council Form RC-200)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, state bar number, and address)*:	*FOR COURT USE ONLY*
TELEPHONE NO.: FAX NO. *(Optional)*: E-MAIL ADDRESS *(Optional)*: ATTORNEY FOR *(Name)*:	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
PLAINTIFF: DEFENDANT:	
EX PARTE ORDER APPOINTING RECEIVER AND ORDER TO SHOW CAUSE ☐ AND TEMPORARY RESTRAINING ORDER—RENTS, ISSUES, AND PROFITS	CASE NUMBER:

NOTICE OF HEARING

Date:	Time:	Dept.:	Room:

The address of the court ☐ is shown above ☐ is *(specify)*:

ORDER TO SHOW CAUSE

1. **To defendant** *(name each)*:

2. **THE COURT ORDERS** the defendants named in item 1 to appear in this court at the date, time, and place shown in the box above to give any legal reason
   a. Why a receiver should not be confirmed to
      (1) take possession and continue in possession of the property described in Attachment 2a *(attach a description of the real and personal property subject to the receivership) (the "property")*, and
      (2) manage the property in accordance with this order until further order of this court.
   b. Why you should not be prohibited from controlling or receiving any income from the property described in Attachment 2a.

ORDER APPOINTING RECEIVER

THE COURT ORDERS, pending the hearing on the Ex Parte Order to Show Cause, the following:

3. **Receiver.** *(Name)*:
   is appointed as receiver to take possession of the property described in Attachment 2a.

4. **Receiver's oath and bond.** The receiver shall immediately, and before performing any duties:
   a. execute and file a receiver's oath, and
   b. file the bond required by Code of Civil Procedure section 567(b) in the amount of: $

5. **Receiver's fees.** The receiver may charge for the receiver's services no more than *(check all that apply)*:
   a. ☐ $ ☐ per month ☐ per hour ☐ other *(specify)*:
   b. ☐ percent of gross monthly rents
   c. ☐ the greater of a or b
   d. ☐ $ as a one-time start-up fee

Form Approved for Optional Use
Judicial Council of California
RC-200 [Rev. January 1, 2007]

EX PARTE ORDER APPOINTING RECEIVER AND ORDER TO SHOW CAUSE AND TEMPORARY RESTRAINING ORDER—RENTS, ISSUES, AND PROFITS
(Receivership)

Code of Civil Procedure, §§ 527, 529, 564(b)(10); Cal. Rules of Court, rules 3.1175, 3.1176, 3.1177
www.courtinfo.ca.gov

PLAINTIFF *(Name)*:	CASE NUMBER:
DEFENDANT *(Name)*:	

6. ☐ **Management company.** The receiver may employ the management company of *(name)*:

   a. ☐ The receiver may pay the company not more than
      (1) ☐ $ ☐ per month ☐ per hour ☐ other *(specify)*:
      (2) ☐ percent of gross monthly rents
      (3) ☐ the greater of (1) or (2)
      (4) ☐ $ as a one-time start-up fee
   b. ☐ Management company fees are included in receiver's fees in item 5.

7. **Disclosure.** The receiver shall immediately disclose to all parties any financial relationship between the receiver and any company hired to assist in the management of the receivership property.

8. **Plaintiff's ex parte bond.** Plaintiff shall immediately file an applicant's bond under Code of Civil Procedure section 566(b) in the amount of: $

9. **General duties.** After qualifying, the receiver
   a. shall take possession of and manage the property,
   b. shall collect the income from the property,
   c. shall care for the property and may incur the expenses necessary for that care, and
   d. may change the locks on the property.

10. **Prohibited agreements.** The receiver shall not enter into an agreement with any party to this action about the administration of the receivership or about any postreceivership matter.

11. **Inventory.** Within 30 days after qualifying, the receiver shall file an inventory of all property possessed under this order.

12. **Expenditures.** The receiver shall expend money coming into his or her possession to operate and preserve the property and only for the purposes authorized in this order. Unless the court orders otherwise, the receiver shall to the extent practical hold the balance in interest-bearing accounts in accordance with Code of Civil Procedure section 569.

13. **Leases and rentals.** The receiver may without court approval enter into leases for a term not exceeding one year, obtain and evict tenants, and set and modify the amounts and terms of leases.

14. **Security deposits.** Unless the security deposit has been turned over or paid to the receiver, the receiver shall not refund a deposit to a tenant.

15. **Monthly accounting of receiver's income, expenses, and fees.**
   a. The receiver shall each month prepare and serve on the parties, but not file, an accounting of the income and expenses incurred in the administration of the receivership property, including the receiver's fees and expenses.
   b. The receiver may pay the receiver's own fees and expenses only by the following procedures:
      (1) By serving on all parties a notice of intent to pay to which no objection is served on the receiver within 20 days of the date the notice is served.
      (2) By serving and filing a request for interim payment, which the court then approves.
      (3) By obtaining and filing an agreement among all the parties approving the payment, which the court then approves.
      (4) By filing the receiver's final accounting and report, which the court then approves.
   c. The receiver shall not reimburse the receiver for the receiver's general office administration expenses or overhead without court approval. These expenses include, for example, office supplies and employee payroll, benefits, and taxes.

16. **Management.**
   a. The receiver shall operate the property and take possession of all accounts relating to the property.
   b. The receiver may
      (1) employ agents, employees, clerks, accountants, and property managers to administer the receivership property, and
      (2) purchase materials, supplies, and services reasonably necessary to administer the receivership property.
   c. The receiver may do all the things, and incur the risks and obligations, ordinarily done or incurred by owners, managers, and operators of businesses and property similar to that possessed by the receiver; *except* the receiver shall not make any capital improvements to the property without prior court approval.

PLAINTIFF *(Name)*:	CASE NUMBER:
DEFENDANT *(Name)*:	

17. **Bank accounts.** The receiver
    a. may establish accounts at any financial institutions insured by an agency of the United States government that are not parties to this proceeding,
    b. shall deposit in those accounts funds received in connection with the receivership property, and
    c. shall deposit in interest-bearing accounts money not expended for receivership purposes.

18. **Court instructions.** The receiver and the parties may at any time apply to this court for further instructions and orders and for additional powers necessary to enable the receiver to perform the receiver's duties properly.

19. **Insurance.**
    a. The receiver shall determine upon taking possession of the property whether there is sufficient insurance coverage.
    b. The receiver shall notify the insurer that the receiver is to be named as an additional insured on each insurance policy on the property.
    c. If the receiver determines that the property does not have sufficient insurance coverage, the receiver shall immediately notify the parties and shall procure sufficient all-risk and liability insurance on the property (excluding earthquake and flood insurance).
    d. If the receiver does not have sufficient funds to obtain insurance, the receiver shall seek instructions from the court on whether to obtain insurance and how it is to be paid for.

20. **Employment of attorneys.**
    a. The receiver may employ unlawful detainer attorneys and eviction services without a court order.
    b. ☐ The receiver may employ counsel *(name)*:
       at the hourly rate of: $
    c. ☐ Except as provided in items 20a and 27d, before employing counsel the receiver shall apply to the court for an order authorizing the receiver to employ counsel.

21. **Taxpayer ID numbers.** The receiver may use any federal taxpayer identification numbers relating to the property for any lawful purpose.

22. **Duty to turn over possession.** Upon receipt of a copy of a recorded trustee's deed upon foreclosure or written notice from plaintiff that defendant has cured the defaults existing under plaintiff's loan documents or that plaintiff has accepted a deed in lieu of foreclosure, the receiver shall, without further order of the court, turn over possession of the property to the successful purchaser or defendant or plaintiff respectively.

23. **Plaintiff's notification of termination.** Plaintiff shall notify the receiver in writing within 48 hours of any event within plaintiff's knowledge that terminates the receivership.

24. **Receiver's final report and account and discharge.**
    a. *Motion required.* Discharge of the receiver shall require a court order upon noticed motion for approval of the receiver's final report and account and exoneration of the receiver's bond.
    b. *Time.* Not later than 60 days after the receivership terminates, the receiver shall file, serve, and obtain a hearing date on a motion for discharge and approval of the final report and account.
    c. *Notice.* The receiver shall give notice to all persons of whom the receiver is aware who have potential claims against the receivership property.
    d. *Contents of motion.* The motion to approve the final report and account and for discharge of the receiver shall contain the following:
       (1) *Declaration or declarations.* A declaration or declarations: (i) stating what was done during the receivership, (ii) certifying the accuracy of the final accounting, (iii) stating the basis for the termination of the receivership (such as foreclosure or reinstatement), and (iv) stating the basis for an order for the distribution of any surplus or payment of any deficit.
       (2) *Accounting summary.* A summary of the receivership accounting, which shall include (i) the total revenues received, (ii) the total expenditures identified and enumerated by major categories, (iii) the net amount of any surplus or deficit, and (iv) evidence of necessary supporting facts.

PLAINTIFF *(Name)*:	CASE NUMBER:
DEFENDANT *(Name)*:	

25. **Plaintiff's notice to receiver.** Plaintiff shall promptly notify the receiver in writing of the names, addresses, and telephone numbers of all parties who appear in the action and their counsel. The parties shall give notice to the receiver of all events that affect the receivership.

26. **Bankruptcy Plaintiff's duty to give notice.** If a defendant files a bankruptcy case during the receivership, plaintiff shall give notice of the bankruptcy case to the court, to all parties, and to the receiver by the close of the next business day after the day on which plaintiff receives notice of the bankruptcy filing.

27. **Bankruptcy Receiver's duties.** If the receiver receives notice that a bankruptcy has been filed and part of the bankruptcy estate includes property that is the subject of this order, the receiver shall have the following duties:
    a. *Turn over property if no relief from stay will besought.* The receiver shall immediately contact the party who obtained the appointment of the receiver and determine whether that party intends to move in the bankruptcy court for an order for (1) relief from the automatic stay, and (2) relief from the receiver's obligation to turn over the property (11 U.S.C. § 543). If the party has no intention to make such a motion, the receiver shall immediately turn over the property to the appropriate entity either to the trustee in bankruptcy if one has been appointed or, if not, to the debtor in possession - and otherwise comply with 11 United States Code section 543.
    b. *Remain in possession pending resolution.* If the party who obtained the receivership intends to seek relief immediately from both the automatic stay and the receiver's obligation to turn over the property, the receiver may remain in possession and preserve the property pending the ruling on those motions (11 U.S.C. § 543(a)). The receiver's authority to preserve the property shall be limited as follows:
        (1) The receiver may continue to collect rents and other income;
        (2) The receiver may make only those disbursements necessary to preserve and protect the property;
        (3) The receiver shall not execute any new leases or other long-term contracts; and
        (4) The receiver shall do nothing that would effect a material change in the circumstances of the property.
    c. *Turn over property if no motion for relief is filed within 10 days after notice of the bankruptcy.* If the party who obtained the receivership fails to file a motion within 10 court days after his or her receipt of notice of the bankruptcy filing, the receiver shall immediately turn over the property to the appropriate entity either to the trustee in bankruptcy if one has been appointed or, if not, to the debtor in possession and otherwise comply with 11 United States Code section 543.
    d. *Retain bankruptcy counsel.* The receiver may petition the court to retain legal counsel to assist the receiver with issues arising out of the bankruptcy proceedings that affect the receivership.

28. **Failure to turn over property.** A receiver who fails to turn over the property in accordance with this order shall not be paid for time and expenses after the date on which the receiver should have turned the property over.

29. ☐ **Other orders.** *(Additional orders may include authority of the receiver to do any other acts arising from special circumstances.)* Other orders ☐ are specified in Attachment 29 ☐ are as follows *(specify):*

Print

PLAINTIFF *(Name)*:	CASE NUMBER:
DEFENDANT *(Name)*:	

☐ TEMPORARY RESTRAINING ORDER

30. **THIS ORDER EXPIRES AT THE DATE AND TIME OF THE HEARING SHOWN IN THE BOX ON PAGE ONE (UNDER "NOTICE OF HEARING") UNLESS EXTENDED BY THE COURT.**

31. **THE COURT ORDERS DEFENDANT** to do the following:
    a. **Turn over property.** Immediately turn over possession of the property described in Attachment 2a to the receiver when the appointment becomes effective, including any security deposits, prepaid rent, other rental or lease payments, and funds in property management bank accounts for the property.
    b. **Turn over related items.** Immediately turn over to the receiver all keys, books, documents, and records relating to the property and advise the receiver of federal taxpayer identification numbers relating to the property.
    c. **Insurance.**
        (1) Immediately advise the receiver about the nature and extent of insurance coverage on the property;
        (2) Immediately name the receiver as an additional insured on each insurance policy on the property; and
        (3) DO NOT cancel, reduce, or modify the insurance coverage.
    d. **Restraints.** Refrain from
        (1) committing or permitting any waste on the property or any act on the property in violation of law or removing, encumbering, or otherwise disposing of any of the fixtures on the property;
        (2) demanding, collecting, or in any other way diverting or using any of the rents from the property;
        (3) interfering in any manner with the discharge of the receiver's duties under this order;
        (4) selling, transferring, disposing, encumbering, or concealing the property without a prior court order; and
        (5) doing any act that will impair the preservation of the property or plaintiff's interest in the property.
    e. ☐ **Other** *(specify):*

32. **THE COURT ORDERS PLAINTIFF** to immediately file a temporary restraining order bond under Code of Civil Procedure section 529 in the amount of: $

33. ☐ **OTHER ORDERS** ☐ are specified in Attachment 33 ☐ are as follows *(specify):*

SERVICE AND BRIEFING SCHEDULE

34. By *(date):* **PLAINTIFF IS ORDERED** to personally serve on each defendant or counsel and any other appearing parties, and to file proof of service of, the summons and complaint, the memorandum of points and authorities, these orders, and all declarations and supporting papers.

35. By *(date):* **DEFENDANT IS ORDERED** to personally serve on each plaintiff or counsel and any other appearing parties, and to file proof of service of, any opposition to these orders.

36. By *(date):* **PLAINTIFF IS ORDERED** to personally serve on each defendant or counsel, and to file proof of service of, any reply to defendant's opposition to these orders.

37. Number of pages attached: _____

Date:

JUDGE OF THE SUPERIOR COURT

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: On ex parte appointment of receiver, see §6.38. California Rules of Court 3.1312 (requiring prevailing party to prepare order and allowing opposing party opportunity either to approve order or object to form or content) does *not* usually apply to ex parte orders. After it is executed by the judge, the order must be personally served on the defendants by the plaintiff. See Cal Rules of Ct 3.1176(a)-(b).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/§6.104 2. Form: Order Confirming Appointment of Receiver and Preliminary Injunction--Rents, Issues, and Profits (Receivership) (Judicial Council Form RC-210)

§6.104 2. Form: Order Confirming Appointment of Receiver and Preliminary Injunction—Rents, Issues, and Profits (Receivership) (Judicial Council Form RC-210)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, state bar number, and address)*:	*FOR COURT USE ONLY*
TELEPHONE NO.: FAX NO. *(Optional)*: E-MAIL ADDRESS *(Optional)*: ATTORNEY FOR *(Name)*:	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
PLAINTIFF: DEFENDANT:	
ORDER CONFIRMING APPOINTMENT OF RECEIVER AND PRELIMINARY INJUNCTION—RENTS, ISSUES, AND PROFITS	CASE NUMBER:

ORDER CONFIRMING APPOINTMENT OF RECEIVER

1. The court on ex parte application appointed as receiver:
   a. *(Name)*:
   b. On *(date)*:
   c. For the property described in Attachment 1 *(attach description)*.
2. A hearing on the *Ex Parte Order to Show Cause* was held as follows:
   Date: Time: Dept.: Room:
3. The receiver has filed the receiver's oath as ordered by the court.
4. The receiver has filed a receiver's bond as ordered by the court *(check one)*:
   a. ☐ No further bond is required. The previously filed bond shall remain in effect.
   b. ☐ The receiver shall immediately file additional bond under Code of Civil Procedure section 567(b) for: $
5. **THE COURT ORDERS** that the appointment of the receiver is confirmed as specified in the *Ex Parte Order Appointing Receiver* filed on *(date)*:
6. **THE COURT ORDERS PLAINTIFF** to immediately file a Code of Civil Procedure section 529 bond (injunction undertaking) in the amount of: $

PRELIMINARY INJUNCTION

7. **THE COURT ORDERS DEFENDANT** to do the following:
   a. Turn over property. Immediately turn over possession of the property described in Attachment 1 to the receiver when the appointment becomes effective, including any security deposits, prepaid rent, other rental or lease payments, and funds in property management bank accounts for the property.
   b. Turn over related items. Immediately turn over to the receiver all keys, books, documents, and records relating to the property and advise the receiver of federal taxpayer identification numbers relating to the property.
   c. **Insurance.**
      (1) Immediately advise the receiver about the nature and extent of insurance coverage on the property;
      (2) Immediately name the receiver as an additional insured on each insurance policy on the property; and
      (3) DO NOT cancel, reduce, or modify the insurance coverage.

Form Approved for Optional Use
Judicial Council of California
RC-210 [Rev. January 1, 2007]

Code of Civil Procedure, §§ 527, 529, 564(b)(1 0),
Cal. Rules of Court,rules 3.1175, 3.1176, 3.1177
CEB
www.courtinfo.ca.gov

PLAINTIFF *(Name)*: DEFENDANT *(Name)*:	CASE NUMBER:

7. d. **Restraints.** Refrain from
   (1) committing or permitting any waste on the property or any act on the property in violation of law or removing, encumbering, or otherwise disposing of any of the fixtures on the property;
   (2) demanding, collecting, or in any other way diverting or using any of the rents from the property;
   (3) interfering in any manner with the discharge of the receiver's duties under this order;
   (4) selling, transferring, disposing, encumbering, or concealing the property without a prior court order; and
   (5) doing any act that will impair the preservation of the property or plaintiff's interest in the property.

   e. ☐ **Other** *(specify):*

8. ☐ **OTHER ORDERS** ☐ are specified in Attachment 8 ☐ are as follows *(specify):*

9. Number of pages attached: _____

Date:

JUDGE OF THE SUPERIOR COURT

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: A proposed order should be prepared and submitted either with the moving papers (Cal Rules of Ct 3.1113(m)) or within 5 days of the ruling (Cal Rules of Ct 3.1312(a)). Unless the parties waive notice or the court directs otherwise, after the hearing the prevailing party must prepare the order and allow the other party opportunity either to approve the order as "conforming to the court's order" or to object to its form and content. Cal Rules of Ct 3.1312(a). (Note: Rule 3.1312 does *not* usually apply if the motion was unopposed and a proposed order was submitted with the moving papers. Cal Rules of Ct 3.1312(d).) After it is executed by the judge, the order must be served on the losing party by the prevailing party. CCP §1019.5. See also Cal Rules of Ct 3.1109 (on clerk's serving notice of decision on submitted matter). On powers of receiver pending foreclosure, see §§6.34-6.37, 6.39-6.46, 6.70.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/§6.105 3. Form: Order to Show Cause and Temporary Restraining Order--Rents, Issues, and Profits (Receivership) (Judicial Council Form RC-300)

§6.105 3. Form: Order to Show Cause and Temporary Restraining Order—Rents, Issues, and Profits (Receivership) (Judicial Council Form RC-300)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, state bar number, and address)*:	*FOR COURT USE ONLY*
TELEPHONE NO. *(Optional)*: FAX NO. *(Optional)*: E-MAIL ADDRESS *(Optional)*: ATTORNEY FOR *(Name)*:	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
PLAINTIFF: DEFENDANT:	
ORDER TO SHOW CAUSE AND TEMPORARY RESTRAINING ORDER—RENTS, ISSUES, AND PROFITS	CASE NUMBER:

NOTICE OF HEARING

Date:	Time:	Dept.:	Room:

The address of the court ☐ is shown above ☐ is *(specify)*:

ORDER TO SHOW CAUSE

1. **To defendant** *(name each)*:

2. **THE COURT ORDERS** the defendants listed in item 1 to appear in this court at the date, time, and place shown in the box above to give any legal reason
   a. Why a receiver should not be appointed to
      (1) take possession of the property described in Attachment 2a *(attach a description of the real and personal property subject to the receivership) (the "property")*, and
      (2) manage the property as ordered by this court.
   b. Why you should not be prohibited from controlling or receiving any income from the property described in Attachment 2a.

TEMPORARY RESTRAINING ORDER

3. **THIS ORDER EXPIRES AT THE DATE AND TIME OF THE HEARING SHOWN IN THE BOX ABOVE UNLESS EXTENDED BY THE COURT.**

4. **DEFENDANT IS ORDERED** to refrain from
   a. **Committing waste.** Committing or permitting any waste on the property or any act on the property in violation of law or removing, encumbering, or otherwise disposing of any of the fixtures on the property.
   b. **Diverting rent.** Diverting any of the rents from the subject property. The defendant may collect rents, but must use them only for the purpose of paying the expenses of the subject property.

Form Approved for Optional Use
Judicial Council of California
RC-300 [Rev. January 1, 2007]

CEB

Code of Civil Procedure, §§ 527, 529, 564(b)(10);
Cal. Rules of Court, rules 3.1175, 3.1176, 3.1177
www.courtinfo.ca.gov

PLAINTIFF: DEFENDANT:	CASE NUMBER:

4. c. **Selling property.** Selling, transferring, disposing, encumbering, or concealing the property without a prior court order.
   d. **Impairing interests.** Doing any act that will impair the preservation of the property or plaintiff's interest in the property.
   e. **Canceling insurance.** Canceling, reducing, or modifying the insurance coverage on the property.

5. **PLAINTIFF IS ORDERED** to immediately file a temporary restraining order bond under Code of Civil Procedure section 529 for: $

6. ☐ **OTHER ORDERS** ☐ are specified in Attachment 6 ☐ are as follows *(specify):*

SERVICE AND BRIEFING SCHEDULE

7. By *(date):* **PLAINTIFF IS ORDERED** to personally serve on each defendant or counsel and any other appearing parties, and to file proof of service of, the summons and complaint, the memorandum of points and authorities, those orders, and all declarations and supporting papers.

8. By *(date):* **DEFENDANT IS ORDERED** to personally serve on each plaintiff or counsel and any other appearing parties, and to file proof of service of, any opposition to these orders.

9. By *(date):* **PLAINTIFF IS ORDERED** to personally serve on each defendant or counsel, and to file proof of service of, any reply to defendant's opposition to these orders.

10. Number of pages attached: _____

Date:

_____
JUDGE OF THE SUPERIOR COURT

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: An order to show cause is used when the defendant has not yet appeared in the action; therefore it must be personally served on the defendant. See §6.38.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/§6.106 4. Form: Order Appointing Receiver After Hearing and Preliminary Injunction--Rents, Issues, and Profits (Receivership) (Judicial Council Form RC-310)

§6.106 4. Form: Order Appointing Receiver After Hearing and Preliminary Injunction—Rents, Issues, and Profits (Receivership) (Judicial Council Form RC-310)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, state bar number, and address)*:	*FOR COURT USE ONLY*
TELEPHONE NO.: FAX NO. *(Optional)*: E-MAIL ADDRESS *(Optional)*: ATTORNEY FOR *(Name)*:	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
PLAINTIFF: DEFENDANT:	
ORDER APPOINTING RECEIVER AFTER HEARING AND PRELIMINARY INJUNCTION — RENTS, ISSUES, AND PROFITS	CASE NUMBER:

ORDER APPOINTING RECEIVER AFTER HEARING

1. **Hearing date and property description.** A hearing on the *Order to Show Cause* for the appointment of a receiver of the property described in Attachment 1 *(attach description of real and personal property)* was held as follows:
   Date: Time: Dept.: Room:

THE COURT ORDERS the following:

2. **Receiver.** *(Name)*:
   is appointed as receiver to take possession of the property described in Attachment 1.

3. **Receiver's oath and bond.** The receiver shall immediately, and before performing any duties:
   (1) execute and file a receiver's oath, and
   (2) file the bond required by Code of Civil Procedure section 567(b) in the amount of: $

4. **Receiver's fees.** The receiver may charge for the receiver's services no more than
   a. ☐ $ ☐ per month ☐ per hour ☐ other *(specify)*:
   b. ☐ percent of gross monthly rents
   c. ☐ the greater of a or b
   d. ☐ $ as a one-time start-up fee

5. ☐ **Management company.** The receiver may employ the management company of *(name)*:
   a. ☐ The receiver may pay the company not more than
      (1) ☐ $ ☐ per month ☐ per hour ☐ other *(specify)*:
      (2) ☐ percent of gross monthly rents
      (3) ☐ the greater of (1) or (2)
      (4) ☐ $ as a one-time start-up fee
   b. ☐ Management company fees are included in receiver's fees in item 4.

6. **Disclosure.** The receiver shall immediately disclose to all parties any financial relationship between the receiver and any company hired to assist in the management of the receivership property.

Form Approved for Optional Use
Judicial Council of California
RC-310 [Rev. January 1, 2007]

Code of Civil Procedure §§ 527, 529, 564(b)(10); Cal. Rules of Court, rules 3.1175, 3.1176, 3.1177
www.courtinfo.ca.gov

PLAINTIFF *(Name)*: DEFENDANT *(Name)*:	CASE NUMBER:

7. **General duties.** After qualifying, the receiver
   a. shall take possession of and manage the property,
   b. shall collect the income from the property,
   c. shall care for the property and may incur the expenses necessary for that care, and
   d. may change the locks on the property.

8. **Prohibited agreements.** The receiver shall not enter into an agreement with any party to this action about the administration of the receivership or about any post receivership matter.

9. **Inventory.** Within 30 days after qualifying, the receiver shall file an inventory of all property possessed under this order.

10. **Expenditures.** The receiver shall expend money coming into his or her possession to operate and preserve the property and only for the purposes authorized in this order. Unless the court orders otherwise, the receiver shall to the extent practical hold the balance in interest-bearing accounts in accordance with Code of Civil Procedure section 569.

11. **Leases and rentals.** The receiver may without court approval enter into leases for a term not exceeding one year, obtain and evict tenants, and set and modify the amounts and terms of leases.

12. **Security deposits.** Unless the security deposit has been turned over or paid to the receiver, the receiver shall not refund a deposit to a tenant.

13. **Monthly accounting of receiver's income, expenses, and fees.**
   a. The receiver shall each month prepare and serve on the parties, but not file, an accounting of the income and expenses incurred in the administration of the receivership property, including the receiver's fees and expenses.
   b. The receiver may pay the receiver's own fees and expenses only by the following procedures:
      (1) By serving on all parties a notice of intent to pay to which no objection is served on the receiver within 20 days of the date the notice is served.
      (2) By serving and filing a request for interim payment, which the court then approves.
      (3) By obtaining and filing an agreement among all the parties approving the payment, which the court then approves.
      (4) By filing the receiver's final accounting and report, which the court then approves.
   c. The receiver shall not reimburse the receiver for the receiver's general office administration expenses or overhead without court approval. These expenses include, for example, office supplies and employee payroll, benefits, and taxes.

14. **Management.**
   a. The receiver shall operate the property and take possession of all accounts relating to the property.
   b. The receiver may
      (1) employ agents, employees, clerks, accountants, and property managers to administer the receivership property, and
      (2) purchase materials, supplies, and services reasonably necessary to administer the receivership property.
   c. The receiver may do all the things, and incur the risks and obligations, ordinarily done or incurred by owners, managers, and operators of businesses and property similar to that possessed by the receiver; *except* the receiver shall not make any capital improvements to the property without prior court approval.

15. **Bank accounts.** The receiver
   a. may establish accounts at any financial institutions insured by an agency of the United States government that are not parties to this proceeding,
   b. shall deposit in those accounts funds received in connection with the receivership property, and
   c. shall deposit in interest-bearing accounts money not expended for receivership purposes.

16. **Court instructions.** The receiver and the parties may at any time apply to this court for further instructions and orders and for additional powers necessary to enable the receiver to perform the receiver's duties properly.

PLAINTIFF *(Name)*: DEFENDANT *(Name)*:	CASE NUMBER:

17. **insurance.**
    a. The receiver shall determine upon taking possession of the property whether there is sufficient insurance coverage.
    b. The receiver shall notify the insurer that the receiver is to be named as an additional insured on each insurance policy on the property.
    c. If the receiver determines that the property does not have sufficient insurance coverage, the receiver shall immediately notify the parties and shall procure sufficient all-risk and liability insurance on the property (excluding earthquake and flood insurance)
    d. If the receiver does not have sufficient funds to obtain insurance, the receiver shall seek instructions from the court on whether to obtain insurance and how it is to be paid for.

18. **Employment of attorneys.**
    a. The receiver may employ unlawful detainer attorneys and eviction services without a court order.
    b. ☐ The receiver may employ counsel *(name):*
    at the hourly rate of: $
    c. ☐ Except as provided in items 18a and 25d, before employing counsel the receiver shall apply to the court for an order authorizing the receiver to employ counsel.

19. **Taxpayer ID numbers.** The receiver may use any federal taxpayer identification numbers relating to the property for any lawful purpose.

20. **Duty to turn over possession.** Upon receipt of a copy of a recorded trustee's deed upon foreclosure or written notice from plaintiff that defendant has cured the defaults existing under plaintiff's loan documents or that plaintiff has accepted a deed in lieu of foreclosure, the receiver shall, without further order of the court, turn over possession of the property to the successful purchaser, or defendant, or plaintiff, respectively.

21. **Plaintiff's notification of termination.** Plaintiff shall notify the receiver in writing within 48 hours of any event within plaintiff's knowledge that terminates the receivership.

22. **Receiver's final report and account and discharge.**
    a. *Motion required*. Discharge of the receiver shall require a court order upon noticed motion for approval of the receiver's final report and account and exoneration of the receiver's bond.
    b. *Time*. Not later than 60 days after the receivership terminates, the receiver shall file, serve, and obtain a hearing date on a motion for discharge and approval of the final report and account.
    c. *Notice*. The receiver shall give notice to all persons of whom the receiver is aware who have potential claims against the receivership property.
    d. *Contents of motion*. The motion to approve the final report and account and for discharge of the receiver shall contain the following:
        (1) *Declaration or declarations*. A declaration or declarations: (i) stating what was done during the receivership, (ii) certifying the accuracy of the final accounting, (iii) stating the basis for the termination of the receivership (such as foreclosure or reinstatement), and (iv) stating the basis for an order for the distribution of any surplus or payment of any deficit.
        (2) *Accounting summary*. A summary of the receivership accounting, which shall include (i) the total revenues received, (ii) the total expenditures identified and enumerated by major categories, (iii) the net amount of any surplus or deficit, and (iv) evidence of necessary supporting facts.

23. **Plaintiff's notice to receiver.** Plaintiff shall promptly notify the receiver in writing of the names, addresses, and telephone numbers of all parties who appear in the action and their counsel. The parties shall give notice to the receiver of all events that affect the receivership.

PLAINTIFF *(Name)*:	CASE NUMBER:
DEFENDANT *(Name)*:	

24. **Bankruptcy — Plaintiff's duty to give notice.** If a defendant files a bankruptcy case during the receivership, plaintiff shall give notice of the bankruptcy case to the court, to all parties, and to the receiver by the closing of the next business day after the day on which plaintiff receives notice of the bankruptcy filing.

25. **Bankruptcy Receiver's duties.** If the receiver receives notice that a bankruptcy has been filed and part of the bankruptcy estate includes property that is the subject of this order, the receiver shall have the following duties:
    a. *Turn over property if no relief from stay will besought.* The receiver shall immediately contact the party who obtained the appointment of the receiver and determine whether that party intends to move in the bankruptcy court for an order for (1) relief from the automatic stay, and (2) relief from the receiver's obligation to turn over the property (11 U.S.C., § 543). If the party has no intention to make such a motion, the receiver shall immediately turn over the property to the appropriate entity either to the trustee in bankruptcy if one has been appointed or, if not, to the debtor in possession and otherwise comply with 11 United States Code section 543.
    b. *Remain in possession pending resolution.* If the party who obtained the receivership intends to seek relief immediately from both the automatic stay and the receiver's obligation to turn over the property, the receiver may remain in possession and preserve the property pending the ruling on those motions (11 U.S.C., § 543(a)). The receiver's authority to preserve the property shall be limited as follows:
        (1) The receiver may continue to collect rents and other income;
        (2) The receiver may make only those disbursements necessary to preserve and protect the property;
        (3) The receiver shall not execute any new leases or other long-term contracts; and
        (4) The receiver shall do nothing that would effect a material change in the circumstances of the property.
    c. *Turn over property if no motion for relief is filed within 10 days after notice of the bankruptcy.* If the party who obtained the receivership fails to file a motion within 10 court days after his or her receipt of notice of the bankruptcy filing, the receiver shall immediately turn over the property to the appropriate entity — either to the trustee in bankruptcy if one has been appointed or, if not, to the debtor in possession — and otherwise comply with 11 United States Code section 543.
    d. *Retain bankruptcy counsel.* The receiver may petition the court to retain legal counsel to assist the receiver with issues arising out of the bankruptcy proceedings that affect the receivership.

26. **Failure to turn over property.** A receiver who fails to turn over the property in accordance with this order shall not be paid for time and expenses after the date the receiver should have turned the property over.

27. ☐ **Other orders.** *(Additional orders may include authority of the receiver to do any other acts arising from special circumstances.)* Other orders ☐ are specified in Attachment 27 ☐ are as follows *(specify):*

PRELIMINARY INJUNCTION

28. **THE COURT ORDERS DEFENDANT** to do the following:
    a. **Turn over property.** Immediately turn over possession of the property described in Attachment 1 to the receiver when the appointment becomes effective, including any security deposits, prepaid rent, other rental or lease payments, and funds in property management bank accounts for the property.
    b. **Turn over related items.** Immediately turn over to the receiver all keys, books, documents, and records relating to the property and advise the receiver of federal taxpayer identification numbers relating to the property.
    c. **Insurance.**
        (1) Immediately advise the receiver about the nature and extent of insurance coverage on the property;
        (2) Immediately name the receiver as an additional insured on each insurance policy on the property; and
        (3) DO NOT cancel, reduce, or modify the insurance coverage.

PLAINTIFF *(Name)*:	CASE NUMBER:
DEFENDANT *(Name)*:	

28. d. **Restraints.** Refrain from
    (1) committing or permitting any waste on the property or any act on the property in violation of law or removing, encumbering, or otherwise disposing of any of the fixtures on the property;
    (2) demanding, collecting, or in any other way diverting or using any of the rents from the property;
    (3) interfering in any manner with the discharge of the receiver's duties under this order;
    (4) selling, transferring, disposing, encumbering, or concealing the property without a prior court order; and
    (5) doing any act that will impair the preservation of the property or plaintiff's interest in the property.

    e. ☐ **Other** *(specify)*:

29. **THE COURT ORDERS PLAINTIFF** to immediately file a preliminary injunction bond under Code of Civil Procedure section 529 in the amount of: $

30. ☐ **OTHER ORDERS** ☐ are specified in Attachment 30 ☐ are as follows *(specify)*:

31. Number of pages attached: _____

Date:

JUDGE OF THE SUPERIOR COURT

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: See Comment to form in §6.104.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/§6.107 F. Form: Notice to Tenant of Demand to Pay Rent

§6.107 F. Form: Notice to Tenant of Demand to Pay Rent

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DEMAND TO PAY RENT TO PARTY OTHER THAN LANDLORD
(SECTION 2938 OF THE CIVIL CODE)

Tenant: _ _[*Name of Tenant*]_ _
Property Occupied by Tenant: _ _[*Address of Leased Premises*]_ _
Landlord: _ _[*Name of Landlord*]_ _
Secured Party: _ _[*Name of Secured Party*]_ _
Address: _ _[*Address for Payment of Rent to Secured Party and for Requesting Further Information*]_ _
The secured party named above is the assignee of leases, rents, issues, and profits under _ _[*name of document*]_ _ **dated** _ _ _ _**, and recorded at** _ _[*add recording information*]_ _ **in the official records of** _ _ _ _ _ _ **County, California. You may request a copy of such assignment from the secured party at** _ _[*Address of Secured Party for Further Information*]_ _**.**

THIS NOTICE AFFECTS YOUR LEASE OR RENTAL AGREEMENT RIGHTS AND OBLIGATIONS. YOU ARE THEREFORE ADVISED TO CONSULT AN ATTORNEY CONCERNING THOSE RIGHTS AND OBLIGATIONS IF YOU HAVE ANY QUESTIONS REGARDING YOUR RIGHTS AND OBLIGATIONS UNDER THIS NOTICE.

IN ACCORDANCE WITH SUBDIVISION (C) OF SECTION 2938 OF THE CIVIL CODE, YOU ARE HEREBY DIRECTED TO PAY TO THE SECURED PARTY, _ _[*NAME OF SECURED PARTY (capitalized)*]_ _ **AT** _ _[*ADDRESS*]_ _**, ALL RENTS UNDER YOUR LEASE OR OTHER RENTAL AGREEMENT WITH THE LANDLORD OR PREDECESSOR IN INTEREST OF LANDLORD, FOR THE OCCUPANCY OF THE PROPERTY AT** _ _[*ADDRESS OF RENTAL PREMISES*]_ _ **WHICH ARE PAST DUE AND PAYABLE ON THE DATE YOU RECEIVE THIS DEMAND, AND ALL RENTS COMING DUE UNDER THE LEASE OR OTHER RENTAL AGREEMENT FOLLOWING THE DATE YOU RECEIVE THIS DEMAND UNLESS YOU HAVE ALREADY PAID THIS RENT TO THE LANDLORD IN GOOD FAITH AND IN A MANNER NOT INCONSISTENT WITH THE AGREEMENT BETWEEN YOU AND THE LANDLORD. IN THIS CASE, THIS DEMAND NOTICE SHALL REQUIRE YOU TO PAY TO THE SECURED PARTY,** _ _[*NAME OF SECURED PARTY*]_ _**, ALL RENTS THAT COME DUE FOLLOWING THE DATE OF THE PAYMENT TO THE LANDLORD.**

IF YOU PAY THE RENT TO THE UNDERSIGNED SECURED PARTY, _ _[*NAME OF SECURED PARTY*]_ _**, IN ACCORDANCE WITH THIS NOTICE, YOU DO NOT HAVE TO PAY THE RENT TO THE LANDLORD. YOU WILL NOT BE SUBJECT TO DAMAGES OR OBLIGATED TO PAY RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT SECURED PARTY.**

[*For other than residential tenants*]**. IF YOU PAY ANY RENT TO THE LANDLORD THAT BY THE TERMS OF THIS DEMAND YOU ARE REQUIRED TO PAY TO THE SECURED PARTY, YOU MAY BE SUBJECT TO DAMAGES INCURRED BY THE SECURED PARTY BY REASON OF YOUR FAILURE TO COMPLY WITH THIS DEMAND, AND YOU MAY NOT BE DISCHARGED FROM YOUR OBLIGATION TO PAY SUCH RENT TO THE SECURED PARTY. YOU WILL NOT BE SUBJECT TO SUCH DAMAGES OR OBLIGATED TO PAY SUCH RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT ASSIGNEE.**

Your obligation to pay rent under this demand shall continue until you receive either (1) a written notice from a court directing you to pay the rent in a manner provided therein, or (2) a written notice from the secured party named above canceling this demand.

The undersigned hereby certifies, under penalty of perjury, that the undersigned is an authorized officer or agent of the secured party and that the secured party is the assignee, or the current successor to the assignee, under an assignment of leases, rents, issues, or profits executed by the landlord, or a predecessor in interest, that is being enforced pursuant to and in accordance with Section 2938 of the Civil Code.

Executed at _ _[*city*]_ _**, California, on** _ _[*date*]_ _**.**

_ _[*NAME OF SECURED PARTY*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Copies: Original (served on tenant); copies for trustor-assignor and each assignee of record; office copies (see §6.50).

Comment: This statutory form should be signed by an authorized representative of the secured party (assignee) named in the form, and the language should not be modified. See CC §2938(c)(3), (k), discussed in §§6.50-6.52. See also §§6.54-6.56. Under CC §2938(c)(3), the notice must be "delivered" to the tenant and the trustor (which implies personal service) and be "mailed" to assignees of record (other than the secured party giving notice).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/ G. Forms for Terminating Receivership/§6.108 1. Form: Application for Order Directing Receiver to Transfer Possession of Real Property and File Final Accounting

G. Forms for Terminating Receivership

§6.108 1. Form: Application for Order Directing Receiver to Transfer Possession of Real Property and File Final Accounting

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**APPLICATION OF**
vs	)	_ _[*NAME*]_ _ **FOR ORDER**
	)	**DIRECTING RECEIVER TO**
_ _[*Name(s)*]_ _, **Defendant(s)**	)	**TRANSFER POSSESSION OF**
	)	**REAL PROPERTY AND FILE**
	)	**FINAL ACCOUNTING**
	)	
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____	)	**Trial date:** _ _[*if set*]_ _

1. I am an active member of the State Bar of California and am attorney of record in this action for Plaintiff _ _[*name*]_ _ ("Plaintiff").

2. _ _[*Name*]_ _ was appointed receiver in this action by Order Appointing _ _[*name*]_ _ to Act as Receiver, entered on _ _[*date*]_ _. A copy of the Order is attached to this application as Exhibit A and incorporated by reference.

3. The Declaration of _ _[*name*]_ _ attached to this application shows that a trustee sale of the real property described in the complaint on file in this action was held on _ _[*date*]_ _, and that Plaintiff became the purchaser of that property.

4. Because of the foregoing facts, there is no longer any need for a receiver to collect the rents, issues, and profits from the real property described in the complaint.

WHEREFORE, _ _[*name of purchaser at sale*]_ _ requests that this court enter its order directing the receiver, _ _[*name*]_ _, to transfer possession of the real property described in the complaint to Plaintiff and to file a final accounting.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _.

__[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: On procedures for application for transfer of possession, see §6.48. On procedures for receiver's motion for final accounting and discharge, see California Civil Procedure Before Trial, chap 33 (4th ed Cal CEB 2004). See also Cal Rules of Ct 3.1184.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/§6.109 2. Form: Declaration in Support of Application for Order Directing Receiver to Transfer Possession of Real Property

§6.109 2. Form: Declaration in Support of Application for Order Directing Receiver to Transfer Possession of Real Property

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**DECLARATION OF**
vs	)	_ _[*NAME*]_ _ **IN SUPPORT**
	)	**OF APPLICATION FOR**
_ _[*Name(s)*]_ _, **Defendant(s)**	)	**ORDER DIRECTING**
	)	**RECEIVER TO TRANSFER**
	)	**POSSESSION OF REAL**
	)	**PROPERTY**
	)	
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____	)	**Trial date:** _ _[*if set*]_ _

1. I am employed by _ _[*name*]_ _**, the trustee under a deed of trust recorded on** _ _[*date*]_ _**, under** _ _[*state book and page or instrument number*]_ _ **in the Official Records of** _ _ _ _ _ _ **County, California, against a parcel of real property commonly known as** _ _[*address of property*]_ _**. A copy of the deed of trust is attached to this declaration as Exhibit A and incorporated by reference.**

2. On _ _[*date*]_ _**, the trustee conducted a trustee sale foreclosing the Deed of Trust.** _ _[*Name of purchaser*]_ _ **was the successful bidder at the sale. On** _ _[*date*]_ _**,** _ _[*name of trustee*]_ _ **delivered to** _ _[*name of purchaser*]_ _ **the Trustee's Deed, a copy of which is attached to this declaration as Exhibit B and incorporated by reference.**

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _**.**

__[*Signature of declarant*]__
_ _[*Typed name*]_ _

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.
Comment: See Comment to form in §6.108.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/6 Rents, Receiverships, and Leases/§6.110 3. Form: Order Directing Receiver to Transfer Possession of Real Property and File Final Accounting

§6.110 3. Form: Order Directing Receiver to Transfer Possession of Real Property and File Final Accounting

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**ORDER DIRECTING**
vs	)	**RECEIVER TO TRANSFER**
	)	**POSSESSION OF REAL**
_ _[*Name(s)*]_ _, **Defendant(s)**	)	**PROPERTY AND FILE FINAL ACCOUNTING**
	)	
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____)		**Trial date:** _ _[*if set*]_ _

On review of the Application of Plaintiff for Order Directing Receiver to Transfer Possession of Real Property and File Final Accounting, and good cause appearing therefor,

IT IS HEREBY ORDERED that:

1. The receiver, _ _[*name*]_ _, shall forthwith deliver to _ _[*name of purchaser*]_ _ possession of that certain real property described in the Order Appointing _ _[*name*]_ _ to Act as Receiver, entered on _ _[*date*]_ _ in this action.

2. The receiver shall file a final accounting within _ _[*e.g., 45*]_ _ calendar days after the date of service of this Order and shall give notice to all parties who have appeared in this action of the filing of such final accounting and of the motion to be discharged.

3. A copy of this Order shall be served on the receiver no later than _ _[*date*]_ _.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

Copies: Original (filed with court clerk); copies for service (one for each defendant to be served); office copies.
Comment: See Comment to form in §6.108.

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7

Debtor Strategies

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§7.1 I. INTRODUCTION

This chapter discusses various strategies the trustor's attorney may pursue when the client is faced with foreclosure. There could be any number of reasons that the loan has gone into default. General economic or local market conditions may result in tenant troubles or slow rentals or sales. Unemployment may prevent a borrower from paying the loan. In many areas of the country, including California, both residential and commercial property may be "underwater" or have "negative value"; this means the property is secured by a loan or loans having a total principal balance greater than the market value of the property. Systemic problems in the credit markets may render it difficult for the borrower to obtain financing to repay a maturing loan. In some situations, the lender may be willing to enter into a loan modification with the borrower. See chap 10. In others, the lender may agree to a short sale. See §7.21A.

If the situation is deemed hopeless, the trustor may attempt to convey the property to the beneficiary rather than suffer an inevitable and embarrassing trustee sale (see chap 2) or a judicial foreclosure (see chap 3). Deeds in lieu of foreclosure (deeds in lieu) as a debtor strategy are discussed in §§7.2-7.21.

When a foreclosure seems unjustified, the trustor may challenge it, either beforehand by an action to enjoin the sale (see §§7.22-7.55) or afterward by an action to set aside the sale (see §§7.56-7.77). Finally, the trustor may file an action for damages against the beneficiary (see §§7.78-7.83) or may take advantage of the debtor protections under the Bankruptcy Code (see 11 USC §§101-1330; see also §§7.84-7.125; chap 11). Another important topic in debtor's counseling (see §§2.9, 2.103, 2.106) is the debtor-homeowner's right to be paid surplus proceeds after a foreclosure sale without assistance from third party consultants, who frequently charge exorbitant fees for little or no service. See CC §§2924j-2924k, 2945(a).

California's anti-SLAPP statute (CCP §§425.16-425.18) may be applicable to California mortgage cases. See, *e.g., HMS Capital, Inc. v Lawyers Title Co.* (2004) 118 CA4th 204, 12 CR3d 786 (dispute between title company and mortgage broker over cancellation fees for title services), and *Jacobs v Lawler* (Apr. 20, 2004, H024924; not certified for publication) 2004 Cal App Unpub Lexis 3855, 2004 WL 838061 (malicious prosecution action arising out of secured transactions dispute). But see *Garretson v Post* (2007) 156 CA4th 1508, 68 CR3d 230, cited in §7.23.

WARNING: Both debtor's and creditor's counsel should be familiar with how courts have applied the anti-SLAPP provisions before finalizing a litigation strategy. See Making and Opposing Special Motions to Strike Under the California Anti-SLAPP Statute (Cal CEB Action Guide Spring 2007). That issue is not covered here.

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§7.2 II. DEEDS IN LIEU OF FORECLOSURE

A deed given by the trustor to the beneficiary to avoid the inconveniences suffered on both sides by a formal foreclosure is often called a "deed in lieu of foreclosure" or a "deed in lieu." The transfer of title to the party holding a lien on that title destroys the lien under the doctrine of merger (*i.e.,* the property owner and the creditor are one and the same). Thus the beneficiary takes title free and clear of its former lien. As with other conveyances, the transferee (*i.e.,* the creditor-beneficiary) must accept the deed in order for delivery to be complete, and the debtor cannot force the deed on the creditor. Acceptance may be presumed, however, if the creditor records or retains the deed. Special provisions exist for a secured creditor to record a notice of nonacceptance of such a deed. CC §1058.5. Because a deed in lieu transaction is necessarily consensual, it can involve various economic arrangements. Sometimes the note is canceled and the deed of trust reconveyed at the same time that the deed in lieu is delivered. Occasionally, a part of the debt remains outstanding and some part of the security is left in place, unaffected by the deed in lieu. On deeds in lieu in context of loan workouts, see §§10.29-10.32.

It is customary for the parties to cancel both the promissory note and the security instrument in order to entirely terminate their previous loan relationship. Theoretically, the transfer does not affect the validity of any underlying debt relationship between the parties, but it is rare to see one part of this transaction occur without the other.

It is also possible for the trustor to pay additional consideration to the beneficiary as part of such a transaction if the trustor's personal liability would exceed the amount received on foreclosure. Although some practitioners fear that doing so may constitute an impermissible deficiency recovery (arguably made at the time of "renewing" the loan), the voluntary payment of money from debtor to creditor bears little resemblance to the liability a debtor has when the debtor does not pay the funds. On waiver of antideficiency protections, see §§5.64-5.70.

CAUTION: Providing a new note in the course of a deed in lieu transaction may have adverse consequences to the borrower should the borrower subsequently file for bankruptcy. The new note implies that the borrower has the intent, means, and ability to pay the debt as it comes due. Although the original obligation, without more, might have been dischargeable in bankruptcy, the new obligation may fall afoul of 11 USC §523(a)(2), which prohibits discharge of extensions or renewals of credit obtained under false pretenses or through fraud. See §11.145.

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§7.3 A. Benefits and Risks

A deed in lieu transaction may be advantageous to both parties. By accepting a deed from the trustor, a beneficiary avoids the delays and costs of foreclosure. Instead of paying trustee or attorney fees and waiting 4 months for the trustee sale to occur (or typically longer for a judicial foreclosure), the beneficiary receives title to the property immediately with negligible transaction costs. If the property value exceeds the amount of the debt, the beneficiary may get more than expected from a public sale, when any surplus from an overbid would go to juniors or the trustor. See §§2.102-2.103, 3.83. When a trustor is irretrievably in default and has no appreciable equity in the property, using a deed in lieu may protect the trustor to some extent from the embarrassment and impaired credit rating a public foreclosure sale produces, and it gives the trustor immunity from a possible deficiency judgment.

A beneficiary runs certain risks in accepting a deed in lieu. The trustor-grantor may later regret the act and sue to set aside the deed; see §7.7. Junior lienholders may claim that the deed extinguished or impaired their claims; see §§7.17-7.19. A bankruptcy court may regard the deed as an act of bad faith, a fraudulent conveyance, or a preference (see §§7.111-7.112, 11.25, 11.82, 11.86; but see §§11.129, 11.140), and defending such charges is generally excluded from title insurance coverage. Title insurers are more willing to delete the exclusion if title was acquired by foreclosure sale than by a deed in lieu. Full coverage may be obtainable only by purchasing an owner's policy with a special endorsement. See California Title Insurance Practice §§6.32, 6.48 (2d ed Cal CEB 1997).

CAUTION: The credit benefits to the trustor of using a deed in lieu transaction have been somewhat eroded by sophisticated loan applications that now inquire about prior deeds in lieu as well as past foreclosures. Credit scoring is a science unto itself and counsel should be careful in advising the trustor on its impact.

In addition to the risks mentioned above, deed in lieu transactions pose a danger of loss of priority to juniors. Although foreclosure deeds (*i.e.,* trustee's deeds and sheriff's deeds) "relate back" to the date of the security instrument giving rise to the foreclosure and thus eliminate junior interests, deeds in lieu are treated as contemporaneous conveyances with no relation back. Thus, a creditor who might have eliminated a junior interest with a foreclosure sale and deed may be subject to that interest if the title is derived from a deed in lieu. Several techniques are available to minimize this priority risk; see §§7.17-7.19.

On risks to lender of accepting deed in lieu, see 1 Nelson & Whitman, Real Estate Finance Law §6.19 (5th ed 2007).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.4 B. Tax Effects

§7.4 B. Tax Effects

For a trustor, the tax effects of a deed in lieu of foreclosure are equivalent to a foreclosure sale at which the beneficiary bids the unpaid balance of the note. See §§2.82, 2.84, 2.110-2.112. The Mortgage Forgiveness Debt Relief Act of 2007 (Pub L 110-142, 121 Stat 1803) amends provisions of IRC §108 to exclude from gross income the discharge of indebtedness on a borrower's principal residence. See IRC §108(a)(1)(E).

CAUTION: The borrower must consider issues of capital gains taxation if the transfer is at a value in excess of the borrower's adjusted basis in the property (whether or not the property is the borrower's principal residence). Forgiveness of indebtedness and capital gains are two very different issues, and counsel, if not well versed in both state and federal tax codes, should refer the borrower to an experienced tax professional.

For the beneficiary, the tax effects of a deed in lieu are equivalent to collecting the debt to the extent of the fair market value of the property. *Commissioner v Spreckels* (9th Cir 1941) 120 F2d 517. If the property is worth less than the principal loan balance, no interest income results to the beneficiary from the deed in lieu. See *Helvering v Missouri State Life Ins. Co.* (8th Cir 1934) 78 F2d 778; *Manhattan Mut. Life Ins. Co.* (1938) 37 BTA 1041. For further discussion, see §§2.113-2.117.

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§7.5 C. Form and Contents

A deed in lieu of foreclosure does not necessarily differ in form from any other deed passing a fee title. It may take the form of a quitclaim deed (*Hamud v Hawthorne* (1959) 52 C2d 78, 338 P2d 387; *Smith v Sharp* (1924) 70 CA 336, 233 P 374), a grant deed, or any other valid deed (*Beeler v American Trust Co.* (1944) 24 C2d 1, 147 P2d 583; *Bastajian v Brown* (1943) 57 CA2d 910, 135 P2d 374; *Corcoran v Hinkel* (1893) 4 CU 360, 34 P 1031).

Title insurers customarily require either special recitals in the deed in lieu declaring that the conveyance was freely and fairly made or an estoppel affidavit from the trustor to that effect before they will insure the transaction. See §10.32. If the trustor was personally liable on the debt, there should be a recital that the conveyance was made in full satisfaction of the debt. If the trustor was not personally liable for the debt, a recital may be required stating that consideration equal to the fair value of the equity was paid. The affidavit is admissible, but not conclusive, evidence of its contents (*Beeler v American Trust Co., supra*), which is probably also true for the recitals. The purpose of these assertions is to avoid having the deed construed as a further equitable mortgage.

Not only should the concerns of title insurers be considered, but also whether a trustee in bankruptcy could seek to avoid the transfer as an avoidable fraudulent conveyance under 11 USC §548. (See chap 11.) If the deed in lieu is avoided, the debt obligation may "spring back" to the borrower.

PRACTICE TIP: From the borrower's perspective, the documents should express, among other terms, that the obligation is released or is based on the original representations made at the time of the making of the note rather than those made at the time of the deed in lieu. The beneficiary's interests are served by expressly preserving the ability to collect from the borrower, even if the borrower files for bankruptcy. On fraudulent conveyance, avoidance, and bankruptcy generally, see §§7.85-7.125; chap 11.

For further discussion of form and contents of deeds in lieu, see §§10.29-10.32.

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§7.6 D. Actions Accompanying Deeds in Lieu

The beneficiary usually sends a letter to the trustor stating the terms and conditions under which it will accept the deed in lieu of foreclosure. See §10.31. The beneficiary usually executes a reconveyance of the deed of trust (*Miller v Taber* (1957) 149 CA2d 792, 309 P2d 110) and cancels the trustor's note to reduce the chance of having the deed construed as a further mortgage. See *Holmes v Warren* (1904) 145 C 457, 78 P 954; *Chapman v Hicks* (1919) 41 CA 158, 182 P 336. Although technically unnecessary, this step tends to refute a debtor's later contention that a loan relationship still exists. Sometimes the note is converted to nonrecourse status rather than canceled. *Shusett, Inc. v Home Sav. & Loan Ass'n* (1964) 231 CA2d 146, 41 CR 622.

It is common for the beneficiary to require the trustor to quit possession of the premises because continued occupancy is generally inconsistent with transfer of ownership, even if the parties characterize it as a leaseback.

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§7.7 E. Challenges by Trustor

Trustors sometimes regret having made the transfer and later challenge the deeds in lieu of foreclosure that they gave to their creditors. Two contrary principles govern the validity of these deeds. On one hand, in support of the validity of a deed in lieu is the principle that a trustor's title to encumbered property is freely alienable. See CC §711. The trustor may convey the interest to anyone, including the beneficiary of the deed of trust encumbering the property. *Phelan v De Martin* (1890) 85 C 365, 24 P 725; *Gronenschild v Ritzenthaler* (1947) 81 CA2d 138, 183 P2d 720. A deed can be set aside or reformed only when grounds exist that would support contract cancellation or reformation. *Phelan v De Martin, supra*. On cancellation of instruments, see California Real Property Remedies and Damages, chap 6 (2d ed Cal CEB 2002); on reformation, see Real Property Remedies, chap 2.

On the other hand, undercutting the validity of a deed in lieu is the fact that the trustor has an equity of redemption in the property, *i.e.,* the right to pay the debt late and the right to receive any surplus from a foreclosure sale (CC §§2903-2905, 2924c; see §§2.51, 2.73, 2.102, 3.63, 3.83), and a deed in lieu, if effective, terminates both rights without formal foreclosure or sale. *Bradbury v Davenport* (1896) 114 C 593, 46 P 1062; *Winklemen v Sides* (1939) 31 CA2d 387, 88 P2d 147. Civil Code §2889 invalidates all contracts that forfeit property subject to a lien or that restrain the right of redemption. A deed in lieu appears to fall squarely within the statutory prohibition and thus may be declared invalid even when its execution is absolutely free from fraud or any other defect. *Hamud v Hawthorne* (1959) 52 C2d 78, 338 P2d 387. See 1 Nelson & Whitman, Real Estate Finance Law §§3.3, 6.18 (5th ed 2007).

California decisions are confusing on this issue. Most reported opinions have upheld deeds in lieu on the principle that the trustor's interest is freely alienable (see, *e.g., Rogers v Mulkey* (1944) 63 CA2d 567, 147 P2d 62; *Borden v Boyvin* (1942) 55 CA2d 432, 130 P2d 718; *Davis v Stewart* (1939) 31 CA2d 574, 88 P2d 734), while other courts have found deeds in lieu invalid as violating the principles underlying CC §2889 (see, *e.g., Hamud v Hawthorne, supra;* see also *First Fed. Trust Co. v Sanders* (1923) 192 C 194, 219 P 440). The California Supreme Court's decision in *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292, disallowing a postdefault contractual waiver of CCP §580b, could be used to argue that deeds in lieu involve impermissible contractual waivers. Many deed in lieu transactions are beneficial to the debtor, and there is a real distinction, often overlooked by the courts, between valid and invalid deeds in lieu of foreclosure. On such distinction, see §§7.8-7.12.

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§7.8 1. Instrument as Deed or Mortgage

A deed in lieu of foreclosure may be intended to function as either a deed or a mortgage. When a deed in lieu is intended to function solely as a deed, the trustor's real intent and belief is to entirely divest ownership of the property by conveying it to someone else, who in this instance is the beneficiary of the mortgage. In this situation, the deed should be entirely valid unless it is tainted by fraud or a similar defect. See *Gronenschild v Ritzenthaler* (1947) 81 CA2d 138, 183 P2d 720. The deed in lieu is no different from any other deed, and the fact that the grantee is the former beneficiary does not affect its current validity.

When the deed in lieu is intended as a mortgage, it does not constitute the trustor's true exit from the scene but is merely another step in working out and extending the trustor's involvement in the property. The parties' expectations are that the trustor will ultimately cure the defaults and the instrument will never become operative. In this situation, the deed in lieu should be held invalid because it attempts to divest the trustor of the equity of redemption in the property, which, under CC §2889, cannot be waived. (The trustor may give the beneficiary a second deed of trust on the property, but this still leaves the trustor with the right either to pay late or to receive the surplus from a sale, *i.e.,* the equity of redemption. *Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549.)

The test of whether a deed in lieu is intended as a deed or as a mortgage is not very different from the traditional test used to determine whether a deed absolute is intended as a deed or a mortgage (see §§3.44, 4.33, 5.51). The issue should be whether the parties view the trustor as still owning the property with the right to cure any default and to receive any surplus above the obligation in a foreclosure sale. If so, the deed in lieu is a mortgage, not a deed; as such, it cannot function to divest the trustor of title except by foreclosure and sale. Conversely, if the trustor is seen as merely a former owner with no further claim on or interest in the property, then the deed is a true deed, not a disguised security instrument, and should be valid. *Greene v Colburn* (1958) 160 CA2d 355, 325 P2d 148; *Mealy v Sunland Ref. Corp.* (1950) 96 CA2d 700, 216 P2d 59; *Jensen v Friedman* (1947) 79 CA2d 494, 179 P2d 855.

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§7.9 2. Immediate or Executory Deed

Whether a deed in lieu of foreclosure is a mortgage or an absolute deed can be most clearly distinguished when comparing a prospective deed in lieu with one that is to take effect immediately. Most deed in lieu transactions are variations of one of these two situations.

When a trustor in default gives the beneficiary a deed that will take effect in 6 months if the default is not cured, the deed is really a mortgage rather than a deed because its effect is to divest the owner of the property if a future obligation is not later satisfied. *McGuigan v Millar* (1931) 117 CA 739, 4 P2d 607. In contrast, if the deed is immediately effective and the trustor receives, in exchange, debt forgiveness or cash consideration equal to the value of the equity in the property (if any), no mortgage features are involved and the transaction is a true conveyance with validity tested in the same manner as with any deed. The distinction generally depends on timing, but it can be confused by a second time-related variable: whether the deed is executed contemporaneously with the making of the original loan or whether it is executed at some time after the original loan was made. See §§7.10-7.11.

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§7.10 3. Deed Executed When Making Loan

Civil Code §2889 applies automatically to invalidate (1) a deed in lieu of foreclosure made at the time of executing the original loan or (2) a provision for a deed in lieu in the loan documents. *Bradbury v Davenport* (1896) 114 C 593, 46 P 1062. See *Adams v Hopkins* (1904) 144 C 19, 77 P 712. A beneficiary is categorically prohibited from taking both a deed of trust and a deed absolute to take effect at some future date if the note is not paid. *Hamud v Hawthorne* (1959) 52 C2d 78, 338 P2d 387. The equity of redemption is granted to trustors by law, not by agreement, and provisions that seek to waive or restrict it are invalid. *Green v Butler* (1864) 26 C 595; *McMillan v Richards* (1858) 9 C 365. In such cases, the deed in lieu is nothing but an attempted waiver of the right of redemption, because it operates only in a prospective fashion (*i.e.,* as a security instrument).

Invalidity of such a deed in lieu is automatic. The beneficiary cannot defend the deed in lieu by claiming that the loan was made on more generous terms because of it. *Beeler v American Trust Co.* (1944) 24 C2d 1, 147 P2d 583. The prohibition of CC §2889 undoubtedly covers any disguised form of a deed in lieu provision in the original loan documents. Any provision in the loan documents, however worded, that enables the beneficiary to obtain title on the trustor's default without a foreclosure and sale will fail.

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§7.11 4. Deed Executed After Loan Origination

A deed in lieu of foreclosure executed after the original loan was made is not automatically invalid. *Bradbury v Davenport* (1896) 114 C 593, 46 P 1062. Although a trustor is not permitted to waive the right of redemption in advance, California law does permit some waivers at any time after the trustor has received the loan proceeds (presumably because the original purpose for the borrowing is now gone). Deeds in lieu that are executed after the loan was made are upheld as long as they are fair, regardless of when they were given. *Bradbury v Davenport* (1898) 120 C 152, 52 P 301; *Watson v Edwards* (1894) 105 C 70, 38 P 527. Thus, courts have upheld deeds in lieu given when the trustor was already in default (see *Watson v Edwards, supra*) and those given after the beneficiary had obtained a judgment of foreclosure and was awaiting the sale (see *Hines v Ward* (1898) 121 C 115, 53 P 427).

It is sensible to distinguish between deeds in lieu of foreclosure given simultaneously with mortgages and deeds in lieu that are given later because a contemporaneous deed in lieu inevitably functions only prospectively; it is intended to be a security device. However, a deed in lieu of foreclosure given at a later time could be intended to function either as a true deed or as a mere mortgage device. That it was given after the original loan was made takes it out of the automatic invalidity category but should not guarantee its enforceability if it was also intended to operate only prospectively. This point is often overlooked in court opinions; prospective deeds in lieu of foreclosure are often not subjected to the same critical judicial scrutiny and treatment that other mortgage substitutes receive. See §7.8.

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§7.12 5. Validity as a Deed

For a deed in lieu of foreclosure to be effective as a deed, it must be treated by the parties as a final and complete passage of title from trustor to beneficiary and as a cancellation of all related financial obligations between them. *Beeler v American Trust Co.* (1944) 24 C2d 1, 147 P2d 583. Any arrangement that permits the trustor's continued connection with the property may lead a court to conclude that the deed is a disguised mortgage (also called a "mortgage substitute" or a "hidden mortgage"; see §§5.46, 5.51). Thus, in *Beeler,* even though the deed was accompanied by a trustor's affidavit that the deed was only a deed, the supreme court held it to be a mortgage because the beneficiary-grantee immediately leased the property back to the trustor with an option to repurchase and failed to cancel the trustor's earlier promissory note. See *Strike v Trans-West Discount Corp.* (1979) 92 CA3d 735, 155 CR 132 (deed absolute, given after deed of trust, held to be security instrument when given as part of agreement under which (1) trustor was to remain in possession and pay taxes and assessments and (2) beneficiary-grantee was to reconvey when trustor brought loan current).

The burden is on the trustor to prove that a deed absolute was intended to be a mortgage; if the instrument makes no reference to a mortgage, such proof must be made by clear and convincing evidence. *Beeler v American Trust Co., supra*.

Deeds in lieu have been upheld in other cases involving leasebacks and options primarily because the facts did not establish that the parties intended the transaction to be a disguised mortgage or because the parties did not raise the disguised mortgage issue at trial. See, *e.g., In re San Francisco Indus. Park, Inc.* (ND Cal 1969) 307 F Supp 271; *Shusett, Inc. v Home Sav. & Loan Ass'n* (1964) 231 CA2d 146, 41 CR 622; *Jensen v Burton* (1931) 117 CA 66, 3 P2d 324.

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F. Third Parties

§7.13 1. Nominee of Beneficiary

Some lenders designate related third parties or auxiliaries to be grantees under deeds in lieu of foreclosure. See *Alden Hotel Co. v Kanin* (NY Sup Ct 1976) 387 NYS2d 948. The purpose of this arrangement is to avoid the merger of title that would occur if title to the encumbered property and the encumbrance on it came into the same hands. If there is no merger, the argument for survival of the debt despite the deed in lieu is stronger. (That, however, may reduce the prospects of having the document treated as a deed rather than a mortgage.)

If merger can be avoided and the lender can keep both the deed in lieu and the original security interest in a nonmerged condition, then the lender can foreclose the security interest if necessary. The creditor thus eliminates its title derived from the deed in lieu, but if it is the successful bidder, its new foreclosure deed will relate back to the date on which the security interest was established and will eliminate junior interests as well.

NOTE: If the original lender has assigned its interest in the loan documents, including the promissory note and deed of trust, it may be difficult to contact the assignee directly to negotiate a deed in lieu, especially if the default or foreclosure is in the hands of an entity such as MERS (Mortgage Electronic Registration Systems) as a servicing agent, indenture trustee, or nominee of the beneficiary. See §7.15.

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§7.14 2. Former Beneficiary

No merger occurs if the trustor conveys to the original beneficiary as long as the beneficiary has already transferred the note and deed of trust to a third person. Rather than paying off the debt, the effect of the transaction may be to vest title in the former beneficiary, subject to the lien of a deed of trust held by the transferee of that interest. *Rodgers v Peckham* (1898) 120 C 238, 52 P 483. As secondary market or mortgage-backed securities transactions become increasingly common, the hazards of paying or conveying to the wrong creditor obviously increase.

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§7.15 3. Secondary Market Purchaser

A trustor may lose the ability to claim that the deed in lieu of foreclosure was merely another security instrument if the beneficiary has conveyed title to a bona fide purchaser (BFP) as a holder in due course. CC §2925. On holder in due course, see §§12.37, 12.103. The BFP is protected, and the trustor's only remedy may be against the beneficiary for damages for wrongfully depriving the trustor of the equity of redemption. See *Munger v Moore* (1970) 11 CA3d 1, 89 CR 323.

In many current loan collection activities, the original lender assigned its interest in the promissory note and deed of trust. It may be extremely difficult to contact the assignee, especially if the default or foreclosure is in the hands of an entity such as MERS as a servicing agent or indenture trustee. The original loan may be held in a pool with similar loans, with interests in the pool sold off as mortgage-backed securities. Trustors may find this structure makes it difficult to effectuate a deed in lieu of foreclosure, a workout, or any other remedy short of bankruptcy.

NOTE: MERS is an entity whose purpose is to act as mortgagee of record for mortgage loans that are registered on the Mortgage Electronic Registration Systems, a national electronic registry of mortgage loans owned and operated by MERS's parent company, MERSCORP, Inc.

The decision in *In re Kwan Jin Hwang* (Bankr CD Cal 2008) 393 BR 701, rehearing granted and opinion modified at (Bankr CD Cal 2008) 396 BR 757, sheds doubt on the ability of the beneficiary's assignee or its servicing agent to establish legal standing during the bankruptcy case to obtain relief from the automatic stay on foreclosure. In *Hwang*, a promissory note and deed of trust were sold and assigned in the secondary loan market a number of times, with one of the interim purchasers continuing to service the loan on behalf of the final purchaser. When the borrower filed bankruptcy, the loan servicer sought relief from the automatic stay (see §§7.99, 11.33) as a party in interest under 11 USC §362(d). The bankruptcy court refused to lift the stay, ruling that (1) the servicer did not actually "hold" the promissory note, (2) it was not the "real party in interest" under Fed R Civ P 17, and (3) it had no legal right to enforce the note and deed of trust against the borrower.

On the motion for reconsideration in *Hwang*, the court stated that after trial on the stay relief motion, the court was unable to factually resolve to whom the debt was owed (*i.e.,* who actually owned the promissory note) when the motion was filed. The court therefore denied the motion on procedural grounds, ruling that (1) the loan servicer was not the real party in interest under Fed R Civ P 17 and (2) the owner of the note should have been joined in the motion under Fed R Civ P 19. Subject to those procedural infirmities, the court modified its original findings and instead found that (1) the moving party loan servicer was entitled to enforce the note under California law and the Uniform Commercial Code and (2) the loan servicer remained the holder of the note, notwithstanding the sale, because it had possession of the note and the note was payable to its predecessor. 396 BR at 760. Similarly, a loan servicer may have standing to bring a stay relief motion if it is acting as an agent for the holder of the note, assuming that the servicer can prove both agency status and that the principal is the actual holder. See, *e.g., In re Vargas* (Bankr CD Cal 2008) 396 BR 511.

One issue not addressed by the court in *Hwang* was the effect on a loan servicer's standing after recordation of a substitution of trustee.

On recurring issues in stay relief motions involving securitized loans filed by loan servicers (such as MERS), see §7.105. See also Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine,* 35 Creighton L Rev 50 (Apr. 2002).

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§7.16 4. Deed From Nontrustor

A deed the beneficiary acquires from a third person who is not the mortgagor is not likely to be a mortgage substitute and is therefore probably a valid deed. *Lineker v McColgan* (1921) 54 CA 771, 202 P 936. Of course, any deed can be shown to be a mortgage if it camouflages an underlying debt; this principle applies to deeds received by beneficiaries of other loans as well as by other parties.

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G. Deeds in Lieu and Junior Creditors

§7.17 1. Effect on Juniors; Merger Doctrine

A conveyance by a trustor through a deed in lieu of foreclosure (as opposed to a foreclosure deed) passes title to the transferee subject to all existing liens. *Streiff v Darlington* (1937) 9 C2d 42, 68 P2d 728. Thus, if the title is encumbered by two deeds of trust, a third party grantee takes subject to both. If the grantee is the beneficiary under the junior deed of trust, its junior lien may be eliminated by merger and it takes subject to the senior deed of trust. If the grantee is the beneficiary under the senior deed of trust, under traditional merger concepts, its lien would normally merge into its title and be destroyed, but this would have the effect of making its title subject to the (former) junior deed of trust, which is clearly not the result that the parties intend. See *Sheldon v La Brea Materials Co.* (1932) 216 C 686, 15 P2d 1098. Thus, before accepting a deed in lieu, a lender must search the records to be sure that there are no junior interests that might be elevated into a new and superior position if the transaction is completed. If such junior interests are found, their consent and subordination to the deed in lieu arrangement must be obtained.

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§7.18 2. Drafting Considerations; Title Insurance

Mishandled deeds in lieu of foreclosure are always troublesome and generally lead to litigation. A beneficiary should not accept a deed in lieu unless it is absolutely certain that there are no junior liens of record or that all necessary steps have been taken to eliminate threats by juniors whose interests will not be cut off by the deed in lieu.

If the creditor is concerned about keeping open the option to foreclose and wipe out junior interests, inclusion of a "nonmerger" clause or recital in the deed in lieu or related agreement is advisable, either as an alternative or in addition to having title conveyed to a nominee.

Given the heightened risk of the deed in lieu being construed as a mortgage when the debt and the potential for future foreclosure are preserved, the creditor should also consider the alternative of obtaining a new title insurance policy against junior interests that would have been eliminated by a foreclosure but were left in place by the deed in lieu. The title policy should insure the creditor-beneficiary against not only liens that appear on title but also those that may not immediately appear, such as mechanics' liens and tax liens for which the borrower may be liable. The borrower should make a representation to the best of its knowledge as to the state of possible liens not appearing on title for which it would indemnify the beneficiary. The borrower may also wish to consider title insurance to protect itself in the event of unknown liens.

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§7.19 3. Avoiding Application of Merger Doctrine

The courts generally hold that the senior beneficiary's lien and title do not merge when a deed in lieu of foreclosure is given if there are junior lienholders of record. See *Anglo-Californian Bank, Ltd. v Field* (1905) 146 C 644, 80 P 1080. But see *Jensen v Burton* (1931) 117 CA 66, 3 P2d 324 (declared equitable merger of title and extinguishment of debt owed to seller after seller, who had financed sale and subordinated its mortgage to another mortgage, subsequently became owner under a quitclaim deed and afterward lost title to property in senior foreclosure). Even when the deed was intended as a true deed and consideration was paid for it or the beneficiary went into possession or both, a merger will still be averted if it would harm the beneficiary. *Anglo-Californian Bank, Ltd. v Field, supra*.

Instead, the junior lienholder may be treated as a party who has been omitted from a judicial foreclosure sale: The junior's rights are unimpaired, but the sale is otherwise valid. See *Carpentier v Brenham* (1870) 40 C 221. The junior lienholder should be allowed to redeem from the senior lien (under CC §§2903-2905), and the senior should be allowed to bring a foreclosure action against the junior if the junior does not pay the senior debt. Alternatively, the senior should be able to act as trustor-owner and redeem from the junior lien, paying what is owed on it. See §3.33 on effect of omitting junior from judicial foreclosure action.

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§7.20 H. Effect of Deed in Lieu Being Declared Mortgage

The issue of whether the deed in lieu of foreclosure is a deed or a mortgage (see §7.8) is generally raised when the trustor sues to have the deed in lieu declared a mortgage or to have it canceled altogether. If the trustor prevails, the relief is granted, but the trustor remains liable for the debt. (To claim that the instrument was not a true deed, the trustor must plead that the debt still exists and the title remains encumbered. *Beeler v American Trust Co.* (1944) 24 C2d 1, 147 P2d 583.) Such liability remains even if the previous mortgage or deed of trust has been released or reconveyed. *Beeler v American Trust Co., supra*. The court may set a time within which the trustor may redeem the property (see §7.69), or it may merely declare that the instrument is a mortgage, allowing the beneficiary to enforce its claim. See, *e.g., Hodgkins v Wright* (1900) 127 C 688, 60 P 431. A grantee seeking possession will be forced to foreclose first if the deed is recharacterized as a mortgage. See *Strike v Trans-West Discount Corp.* (1979) 92 CA3d 735, 155 CR 132. The burden on the creditor in such cases has been lightened by CCP §§726(b) and 729.010, even if judicial foreclosure is the only available alternative (such as when the instrument containing the power of sale has been reconveyed). In light of those statutes, the creditor can now waive a deficiency and foreclose without allowing a right of redemption. Waiving a deficiency is typically not onerous in such cases, because a deed in lieu would typically not have been accepted if a deficiency were an issue in the first place.

A further possible consequence of executing what is apparently a deed in lieu but is in fact a mortgage is that the court may impose a constructive trust in favor of the grantor. *Woodard v Hennegan* (1900) 128 C 293, 60 P 769; *Vance v Lincoln* (1869) 38 C 586. See *Windt v Covert* (1907) 152 C 350, 93 P 67.

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§7.21 I. Rejecting Deed in Lieu

When the trustor records a deed in lieu of foreclosure without the beneficiary's consent, CC §1058.5(a) permits recordation of a counter "notice of nonacceptance." The apparent effect is to nullify the record transfer created by the deed in lieu, although the Civil Code is silent on that issue. It has always been the rule, however, that a deed must be accepted by the grantee in order to be effective. 12 Witkin, Summary of California Law, *Real Property* §§291-300, 314-315 (10th ed 2005). (Acceptance is generally presumed only when the grantee has knowledge of the grant and it is beneficial to it.) It may be necessary to file a declaratory relief or quiet title action in order to conform title to the intent of the parties. The decision to sue may ultimately be driven by the difficulty in obtaining title insurance for a subsequent transfer.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.21A III. SHORT SALES

§7.21A III. SHORT SALES

When real property is secured by a loan or loans having a total principal balance greater than the market value of the property, the property is described as being "underwater" or having "negative value." If the borrower is in default and wishes to protect its credit rating by avoiding a foreclosure, it may attempt a short sale on the market, in which the lender agrees to execute a deed of reconveyance in return for less than the full balance due on the obligation. This is known as a "short sale" because the selling price is short of the sum required to pay the liens on the property. Counsel should carefully review all documents related to the short sale. Among the issues that must be considered are the following:

Listing agreement. The usual listing agreement provides that the broker is entitled to a commission from the seller on producing a ready, willing, and able buyer. A borrower (as seller) who signs such a listing may be liable to the broker for a commission even if the lender refuses to approve the deal. Counsel should modify the listing agreement. In particular, the agreement should provide that the commission is earned only if the broker produces a buyer whose offer is acceptable to all lenders and lienholders as well as the seller.

Federal assistance. In November 2009, the United States Treasury Department modified rules and guidelines first issued last May to encourage streamlined short sales of residential property. See https://www.hmpadmin.com/portal/docs/hamp_servicer/sd0909.pdf and http://www.treas.gov/press/releases/docs/05142009FactSheet-MakingHomesAffordable.pdf. The Making Home Affordable Foreclosure Alternatives Program simplifies the short sale and deed in lieu process by providing a standard process flow, minimum performance time frames, and standard documentation. Treasury provides incentives to borrowers, servicers, and investors to pursue short sales and deeds in lieu, including relocation expenses of up to $1500 for selling borrowers.

Senior lienholders. Counsel for borrower (as seller) should carefully review any agreement regarding the loan repayment from escrow offered by the holder of the first deed of trust. Even though the senior lender may release its deed of trust, it may fail to also cancel the underlying obligation. Borrower's counsel should insist that the agreement and escrow instructions provide for a release of the underlying obligation as well as the lien. Without the release, the lender may seek a personal judgment by proceeding on the note. Some lenders or their servicers will ask the borrower to sign a new note as a condition to approval of the short sale. The lender then may attempt to secure what is tantamount to a deficiency judgment by arguing that there was new consideration for the new note.

Counsel should carefully evaluate whether the client is better off letting the property sell at a trustee sale. Although this will severely impact the borrower's credit rating, the recordation of the notice of default also caused the credit rating of the borrower to decline. Any agreement requiring the borrower to pay additional sums should be conditioned on letters from the creditor to the credit-reporting agencies stating that the loan was not in default and that there was a good faith dispute between the parties that was amicably resolved.

Junior lienholders. The junior lienholders may be unwilling to execute a deed of reconveyance. This will deny the buyer clear title and quash the short sale. Often, junior lienholders will insist on token payments to consent to giving a deed of reconveyance. An agreement to execute and record a deed of reconveyance does not solve all the borrower's problems. In the alternative, the junior lienholder may agree to release only its security without canceling the note. This will allow the junior lienholder the right to sue as an unsecured creditor, *i.e.,* a sold-out junior. See chaps 4-5. In the alternative, an "up front" payment of cash may be demanded. The short sale agreement should thoroughly address the future rights of the junior lienholders.

Also, counsel should recognize that some junior liens are created initially by senior lienholders at the inception of the first loan by the practice of splitting the first loan to evade the Truth in Lending Act (TILA) (15 USC §§1601-1667f), discussed in §12.59, and California's antideficiency laws, discussed in chaps 4-5. Lenders will divide the loan into an allegedly "closed-end" loan secured by a first deed of trust and an "open-ended" Home Equity Line of Credit (HELOC). The HELOC may be assigned in an effort to create a bona fide purchaser (BFP). See, *e.g., Merriam v Chase Manhattan Mortgage Corp.* (*In re Merriam)* (WD NY 2005) 333 BR 22, cited in §12.70A (denying HELOC status to

nominal second note and deed of trust even though it was subsequently assigned). This type of violation may give borrower's counsel additional leverage in negotiating short sales with both the first and junior lienholders.

Tax consequences. Approval of a "short sale" by the lender involves cancellation of indebtedness income for the borrower-seller, as does a workout. Whether the seller has to recognize this income is a serious tax issue. See §§2.110-2.112, 10.24, 10.30.

Escrow and payoff demands. All borrowers have rights in pending short sale agreements under CC §2943, as amended by Stats 2009, ch 43. This amendment is scheduled to sunset on January 1, 2014. On receipt of a short-pay request, the lender or its authorized agent must within 21 days of the receipt of the request prepare and deliver either a short-pay demand statement (setting forth the exact amount the lender is willing to accept; see CC §2943(a)(7)) or a statement that the lender refuses to proceed with the short sale. But if the loan is subject to a recorded notice of default or a judicial foreclosure action, the lender has no obligation to prepare and deliver the statement, unless the request is received before the first publication of a notice of sale or the notice of the first date of a court-ordered sale. See CC §2943(c)(1)-(2).

Credit rating. Approval of a short sale should partially preserve the credit rating of the borrower (as seller). A short sale is better than loss of the property in a foreclosure sale, provided that the short sale agreement with the lender provides that the borrower will not be liable for any loan deficiency owing.

Title insurance. The new buyer and the new lender on a short sale should request title insurance policies and endorsements that cover the risks in a short sale. Specifically, the escrow company may fail to secure all required deeds of reconveyance before closing escrow. In that event, junior liens are entitled to priority over the new loan secured by the buyer at the short sale. Counsel for the seller should prepare escrow instructions that clearly require the escrow company to secure documentation of the cancellation of all obligations secured by the property and to record all respective deeds of reconveyance.

Also, there may be tax liens on the property that may survive a Chapter 7 bankruptcy petition. See, *e.g., In re Isom* (9th Cir 1990) 901 F2d 744. If the buyer or lender cannot procure title insurance that will cover the defense of these kinds of liens or pay the liens if the defense is unsuccessful, the seller's counsel must advise the seller of the possibility of claims for breach of contract or indemnity after the closing.

For further discussion of short sales, see California Real Estate Brokers: Law and Litigation §§2.59-2.66 (Cal CEB 2009); California Real Property Sales Transactions §§6.28A, 6.106A, 6.106C (4th ed Cal CEB 2007).

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IV. OPTIONS FOR ATTACKING FORECLOSURE SALE

§7.22 A. Judicial Versus Nonjudicial Foreclosure

How a trustor challenges a pending foreclosure proceeding depends on whether the threatened sale is judicial or nonjudicial. When the beneficiary is pursuing a judicial foreclosure (see chap 3), most of the grounds discussed in this chapter are raised by a defense or cross-complaint in that action. In a nonjudicial trustee sale (see chap 2), there is no opportunity for such defensive pleading and the trustor must go to court for the desired relief. In either situation, if the process is started early enough, and especially if there is evidence of lender liability, the trustor may have an opportunity to negotiate a forbearance or loan workout agreement. See chap 10.

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B. Enjoining or Setting Aside Trustee Sale

§7.23 1. Requires Court Action

There is no automatic judicial review or supervision of a trustee sale. Judicial review of a trustee sale usually occurs when the trustor or another interested party brings an action attacking the sale, either by seeking to stop it from being completed or to have a completed sale set aside. See *Smith v Allen* (1968) 68 C2d 93, 65 CR 153; *Meadows v Bakersfield Sav. & Loan Ass'n* (1967) 250 CA2d 749, 59 CR 34; *Py v Pleitner* (1945) 70 CA2d 576, 161 P2d 393. When the trustor remains on the premises after the sale, the trustor may get judicial review in the foreclosure purchaser's action to recover possession. Sale may also be subject to later judicial review if the purchaser seeks judicial assistance to obtain possession of the property. CCP §1161a; *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826. See *MCA, Inc. v Universal Diversified Enters. Corp.* (1972) 27 CA3d 170, 103 CR 522.

WARNING: Before launching an effort to enjoin or set aside a trustee sale in state court on the basis of California law, borrower's counsel should review the loan documents to determine if, as is typical, they contain a prevailing party attorney fee clause. If so, counsel must caution the client that an unsuccessful challenge to the sale could leave the client exposed to a large attorney fee award, which will not be limited by CC §2924c(c)-(d) or §2924d(b) and for which the antideficiency laws might not provide protection. See *Passanisi v Merit-McBride Realtors, Inc.* (1987) 190 CA3d 1496, 236 CR 59. On attorney fees in lending liability cases filed under federal law, see §12.102.

Creditor efforts to use the anti-SLAPP statute, CCP §425.16, to thwart attacks on allegedly wrongful foreclosures are not always successful. For example, in *Garretson v Post* (2007) 156 CA4th 1508, 68 CR3d 230, a creditor was not able to obtain an order striking a borrower's complaint for wrongful foreclosure. The anti-SLAPP statue was held inapplicable given the purely private contractual nature of nonjudicial foreclosure and despite the fact that the procedure is extensively regulated by statute. See Warning in §7.1.

On setting aside prebankruptcy foreclosures using avoidable preference doctrine in debtor's bankruptcy proceeding, see §7.112.

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§7.24 2. Bringing Action Before or After Sale

The relief available to a person aggrieved by a trustee sale depends first on whether the action attacking the sale is filed before or after the sale. A plaintiff who files suit before the sale may seek to enjoin it until the court can rule on the underlying issues, *e.g.,* whether a default occurred, whether the amount claimed to be owed is correct, whether a lien exists at all, or whether proper presale notice procedures were followed. See §§7.25-7.38. The relief ultimately granted depends on what is proved at trial. An injunction is not available if the sale has already been concluded, but a completed sale can nevertheless be set aside by a court (see §§7.56-7.77).

WARNING: A major disadvantage of waiting until after the sale to mount a challenge is the possibility that third party (*e.g.,* purchaser) rights will be created, which may make specific relief more difficult or impossible to obtain. See §§7.53, 7.60-7.66.

To determine whether to bring the action before or after the sale, or even at all, a thorough analysis of the facts is required, especially if a lis pendens (see §§7.53, 7.74) is contemplated. Challenging and expunging a lis pendens may result in an award of attorney fees against counsel responsible for recording it. On the other hand, recordation of a lis pendens provides notice to, and protection against, a bona fide purchaser.

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V. ENJOINING TRUSTEE SALE

§7.25 A. Legal and Factual Bases for Enjoining Sale

The statutory requirement of a 3-month period between the notice of default and the notice of sale, followed by an additional 20-day period between the notice of sale and the actual trustee sale (CC §§2924, 2924f; see §§2.62, 2.70), gives the trustor ample time to file an action to enjoin the sale. Even more time is provided for California homeowners on secured loans made between January 1, 2003, and December 31, 2007, because the trustee, beneficiary, or authorized agent must first meet and confer with the homeowner to assess his or her financial situation and explore options to avoid foreclosure. Then the trustee, beneficiary, or authorized agent must wait 30 days after contacting the homeowner before recordation of the notice of default. This requirement expires December 31, 2012. See CC §2923.5, cited in §§2.37-2.38, 2.49, 2.63. For discussion of requirements and procedures for obtaining injunctive relief, see §§7.26-7.27, 7.43-7.53. See also California Civil Procedure Before Trial, chaps 11-13, 32 (4th ed Cal CEB 2004).

Attacks based on improper trustee sale procedures are more commonly made by plaintiffs seeking to set aside completed foreclosure sales rather than to enjoin pending ones. If the defect is in a pending sale, relief is generally limited to an order that the sale not proceed until proper procedures are followed. Even so, the trustor may gain some advantage from the delay. See Warnings in §§7.23-7.24.

WARNING: An injunction may require the trustor to post the amount in default that is not subject to dispute with the court. Counsel for both the trustor and beneficiary should be aware that, under CC §1500, this deposit of funds believed to be owed to the beneficiary may be deemed a proper tender and could reinstate the trustor's financial obligation. See Practice Tip in §7.41. If so, the beneficiary would be unable to collect default interest and attorney fees. On reinstatement, see §2.57.

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§7.26 1. Statutory Grounds

Civil Code §3422 authorizes permanent injunctive relief to prevent the breach of an obligation when (1) pecuniary compensation would not afford adequate relief, (2) money damages are inadequate or difficult to ascertain, (3) relief will prevent a multiplicity of judicial proceedings, or (4) the obligation arises from a trust. See CCP §526(a) (discussed in §7.27), which is virtually identical to CC §3422 and supports both permanent and temporary injunctive relief.

Most attacks on trustee sales are based on the argument that money damages are inadequate as a remedy for the loss of the property through foreclosure. Ordinarily, a court will not issue a preliminary injunction unless the plaintiff shows a reasonable likelihood of prevailing on the merits at trial.

Civil Code §3368 provides independent authority for injunctive relief when necessary to prevent a party "from doing that which ought not to be done." See *City of Pasadena v Superior Court* (1910) 157 C 781, 109 P 620 (§3368 conforms with general grant of equity jurisdiction in California Constitution).

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§7.27 2. Provisional Relief

Under CCP §526(a), a court may issue provisional injunctive relief (*i.e.,* a temporary restraining order or a preliminary injunction) when the plaintiff alleges acts that do any of the following:

- Threaten waste or great or irreparable injury (CCP §526(a)(2));
- Violate another party's rights in the subject of the action and tend to render final judgment ineffectual (CCP §526(a)(3));
- Produce injury for which money damages are inadequate or extremely difficult to ascertain (CCP §526(a)(4)-(5));
- Threaten to cause a multiplicity of judicial proceedings (CCP §526(a)(6)); or
- Violate a trust obligation (CCP §526(a)(7)).

In an action to enjoin a pending trustee sale, both irreparable injury and the inadequacy of money damages are usually complemented by an allegation that the property is unique. See CC §3387; *Wheat v Thomas* (1930) 209 C 306, 287 P 102; *Wright v Rodgers* (1926) 198 C 137, 243 P 866. See also *United Sav. & Loan Ass'n v Reeder Dev. Corp.* (1976) 57 CA3d 282, 129 CR 113. The presumption of uniqueness under §3387 is conclusive for single-family residences. For all other real property, the presumption is rebuttable; *i.e.,* the burden of proof is on the party contending that pecuniary compensation is adequate. *Jessen v Keystone Sav. & Loan Ass'n* (1983) 142 CA3d 454, 191 CR 104 (preliminary injunction against foreclosure of some investment condominium units denied because money damages would be adequate and because success in main action was unlikely). See *Garfinkle v Superior Court* (1978) 21 C3d 268, 276 n13, 146 CR 208 (possibility of denial of discretionary injunction against trustee sale did not make sale unconstitutional). See also Bird, *Toward Understanding California's Rebuttable Presumption That Land is Unique,* 1 Cal Real Prop J 21 (Summer 1983).

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§7.28 3. Factual Grounds

Grounds for enjoining trustee sales fall into two general categories: (1) challenges to the claim itself and (2) challenges to the collection procedures. The first category includes challenging the beneficiary's right to foreclose on substantive grounds (see §§7.25-7.36). If time permits, a demand letter (see form in §7.30) may provide the trustor with needed prelitigation discovery as well as provide counsel for trustor with better facts upon which to decide whether a cause of action can be sustained. Both beneficiaries and trustors must be aware of the case of *Muktarian v Barmby* (1965) 63 C2d 558, 47 CR 483, and its progeny for the proposition that the trustor is not bound by any statute of limitations if it remains in possession of the real property, and as long as it is in possession, only on a demand from the beneficiary must the trustor act affirmatively to quiet title.

Typical grounds for enjoining a trustee sale include any of the following:

- There was no default on the obligation (see, *e.g., Salot v Wershow* (1958) 157 CA2d 352, 320 P2d 926; *Rice v Union Trust Co.* (1920) 50 CA 643, 195 P 720);
- The beneficiary has no valid lien against the property;
- There was fraud in the original loan transaction (*Stockton v Newman* (1957) 148 CA2d 558, 307 P2d 56; *Daniels v Williams* (1954) 125 CA2d 310, 270 P2d 556); or
- The amount the beneficiary claimed to be owed is incorrect (see §§7.29, 7.35; chap 8).

The second category, challenges to the collection procedures, includes attacks on foreclosure based on procedural grounds such as the following:

- There were defects in the notice of default or notice of sale (see *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826; see also §§2.50, 2.69-2.71, 7.37-7.38);
- The scheduling of the sale was improper;
- The posting or publication of the sale was defective; or
- The intended conduct at the sale will be improper. For instance, plaintiffs may complain that parties are planning to collude on the bidding so that the expected sale price of the property will be far lower than its value and that this demonstrates the impropriety of the upcoming sale. In *BFP v Resolution Trust Corp.* (1994) 511 US 531, 545, 128 L Ed 2d 556, 457, 114 S Ct 1757, the United States Supreme Court ruled that the price bid at a foreclosure sale is fair and reasonable as long as all the requirements of the state's foreclosure law have been met.

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§7.29 4. Contractual Defenses; Payment; Waiver

Foreclosure of a deed of trust may be challenged on the same kinds of grounds that are potentially available as defenses against enforcement of an ordinary obligation, *e.g.,* unenforceability under the Statute of Frauds, failure of consideration, or fraud. A secured creditor is put to the same proof regarding the existence and validity of the debt as is required of an unsecured creditor. See generally California Law of Contracts (Cal CEB 2007).

A creditor loses the right both to sue on the obligation and to foreclose on the security if the obligation is unenforceable. *Savings Bank v Asbury* (1897) 117 C 96, 48 P 1081 (failure to lend full amount destroys right to accelerate); *Benson v Andrews* (1955) 138 CA2d 123, 292 P2d 39 (failure of consideration); *Trowbridge v Love* (1943) 58 CA2d 746, 137 P2d 890 (forgiveness of debt); *Burd v Downing* (1923) 60 CA 493, 213 P 287 (release of obligation). See generally 1 Nelson & Whitman, Real Estate Finance Law, chaps 2, 6 (5th ed 2007).

The trustor may challenge the existence and validity of either the security or the obligation. A valid underlying obligation does not automatically validate a defective security arrangement, and the creditor may end up with an enforceable, but unsecured, obligation.

Common defenses raised by trustors against the obligation and the security are discussed in §§7.28-7.34.

Payment in full completely discharges both the obligation and the security. A mortgage is extinguished by payment because it is merely a lien that depends for its existence on the continuation of an underlying obligation. See CC §2909; *McMillan v Richards* (1858) 9 C 365. A deed of trust, although theoretically a title transaction rather than a lien, exists only as long as there is a valid trust purpose. See Prob C §§15407, 15409. See also *MacLeod v Moran* (1908) 153 C 97, 94 P 604. If an obligation has been entirely performed but the record title has not been cleared, the landowner may bring an appropriate action to compel reconveyance of the deed of trust. See CC §2941. Wrongful refusal to clear the title can result in civil and criminal penalties. CC §§2941-2941.5. On disputes regarding loan payment, loan acceleration, due-on-transfer clauses, late charges, default interest, prepayment penalties, required insurance, payment of taxes, and reconveyances, see chap 8.

Some loan servicers hold the late payments in a suspense account and then charge late charges multiple times. This may be an unfair debt collection practice, and the borrower should be able to recover damages under CC §2954.4(b) or the Fair Debt Collection Practices Act (15 USC §1692f(1)).

Issues abound when the deed of trust secures the obligation of another, either through a guaranty or as a surety. In a Chapter 13 or Chapter 11 bankruptcy case, a determination may be made that the value of the real property is inadequate to wholly secure a junior deed of trust. When the trustor's debts are discharged at the close of the bankruptcy, the deed of trust, no longer having a valid purpose, must be voided and title cleared. See §§7.103, 11.5, 11.25, 11.81, 11.96, 11.119, 11.144. On proposed legislation to amend Bankruptcy Code to empower bankruptcy judges to modify principal amount and terms of loans and loan documents secured only by debtor's principal residence, see Note in §7.118.

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§7.30 5. Form: Demand Letter Requesting Lender or Loan Servicer to Provide Documentation of Loan Claim

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

_ _[*Date*]_ _

_ _[*Name of lender or loan servicer*]_ _
_ _[*Address*]_ _

Demand Letter Requesting Lender or Loan Servicer to Provide Documentation of Loan Claim

This office is counsel for _ _[*name of client*]_ _ (Client). This letter is being issued with respect to your claim. This letter constitutes a "qualified written request" for documents, documentation, and information that is being made under California Civil Code §2943(b), the Real Estate Settlement Procedures Act (12 USC §§2601-2617), the federal Truth in Lending Act (15 USC §§1601-1667f), the Fair Debt Collection Practices Act (15 USC §§1692-1692p), and the Fair Credit Reporting Act (15 USC §§1681-1681x). In summary, we request that you provide us with documents and documentation supporting your collection and enforcement efforts, including, without limitation, all documents and documentation in support of the enforcement of the Promissory Note dated _ _[*date*]_ _ in the amount of $_ _[*amount*]_ _ from Client to _ _[*name of original lender*]_ _ (Note), and the Deed of Trust dated _ _[*date*]_ _ from Client to _ _[*name of trustee*]_ _ and _ _[*name of beneficiary*]_ _, securing the Note, _ _[*add identifying references to other notes, deeds of trust, and security documents if applicable,*]_ _ and all of those documents and disclosures made or presented to or signed by Client or any other party to the transaction at the time of making of the loan evidenced by the Note or thereafter, including notices of assignment of the Note and Deed of Trust and the names of the original lender and all assignees, as well as any reporting of this account internally and to credit bureaus. This request is made specifically on behalf of Client, who may also be referred to in those documents as "Borrower."

Client further states that until a written response is given, Client disputes the amount owing because there are or may be charges, fees, costs, or other line items for which Client is unaware of contractual or legal authority. No calls should be made to Client; any correspondence or calls by you must cease or be directed only to this office.

Your attention to this matter is greatly appreciated. We look forward to hearing from you in response to this letter, and we will calendar _ _[*date*]_ _ as a reminder date if we do not hear from you by then. Thank you for your anticipated cooperation. Should you have any questions, please call me at the telephone number in the above letterhead.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Comment: See description and suggested uses in §§7.28, 12.69.

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§7.31 6. Passage of Time

Using the passage of time as the basis for enjoining a trustee sale is complicated because the statute of limitations and other related defenses apply differently to deeds of trust and mortgages. In fact, the only remaining substantive difference between a deed of trust and a mortgage with a power of sale lies in application of the statute of limitations. Each instrument secures an obligation that, if not performed, generates a cause of action for 4 years after a breach of a written obligation (see CCP §337) or for 2 years after a breach of an oral obligation (see CCP §339). *San Jose Safe Deposit Bank of Sav. v Bank of Madera* (1904) 144 C 574, 78 P 5. However, the lapse of 4 years does not have the same effect on a deed of trust that it has on a mortgage (see §§7.32-7.34).

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§7.32 a. Mortgages

A mortgage is considered to be a lien on the mortgagor's title to the property. CC §2920; *Adler v Sargent* (1895) 109 C 42, 41 P 799. Civil Code §2911 provides that a lien is extinguished by the lapse of time during which an action could have been brought on the underlying obligation. If the lender takes no action, the mortgage is extinguished 4 years after the borrower defaults on the obligation (in the case of nonnegotiable notes). *Wells v Harter* (1880) 56 C 342. Because a power of sale in a mortgage is regarded as a mere incident of the mortgage lien, it too is lost 4 years after nonpayment. *Faxon v All Persons* (1913) 166 C 707, 137 P 919. Thus a lender loses all collection rights under the note or mortgage 4 years after a default. Consequently, the mortgagor (borrower) may assert the passage of time as the basis for enjoining a trustee sale.

NOTE: Although the limitations period on written mortgages has traditionally been 4 years, Com C §3118 provides for a 6-year limitations period for actions on negotiable instruments. See §3.17. This provision probably means that notes that qualify as negotiable instruments and that are secured by mortgages rather than deeds of trust will have a 6-year life (rather than 4) before nonjudicial foreclosure is time-barred.

The previous right to foreclose or to sell is not extended by giving the lender possession of the premises, although a lender in possession may retain possession until the mortgage balance is paid. *Spect v Spect* (1891) 88 C 437, 26 P 203. See §§6.3-6.7. See also *U.S. v Thornburg* (9th Cir 1996) 82 F3d 886 (effect of CC §2911 on federal lender).

A creditor holding a mortgage rather than a deed of trust must pay close attention to the time periods involved. The creditor cannot compel the debtor to execute an indefinite waiver of the statute of limitations, because CCP §360.5 limits such waivers to 4 years. If the renewal agreement is made after the limitation period has run, all the formalities for creating a mortgage in the first instance must be met. CC §2922; *Wells v Harter, supra*. See *Easton v Ash* (1941) 18 C2d 530, 116 P2d 433, for an example of an acceptable renewal form.

If the borrower's subsequent grantees are involved, they too must consent to any extensions. *Curtis v Holee* (1921) 184 C 726, 195 P 395; *Cotcher v Barton* (1920) 49 CA 251, 193 P 169. Junior lienholders present special problems because there is little pressure the mortgagee can bring to induce them to consent. But unless the juniors also consent, they are not affected by an extension agreement between the first mortgagee and the mortgagor, and they may plead the statute of limitations as a bar to any foreclosure action or sale undertaken by the first mortgagee. *Ekmann v Plumas County Bank* (1932) 215 C 671, 12 P2d 433. The junior's right to strict compliance with the statute of limitations is entirely independent of the mortgagor's right, and even if the senior's statutory period is suspended by some disability, a junior may still successfully object to late foreclosure. See *Wood v Goodfellow* (1872) 43 C 185.

If the time to enforce the mortgage lien has elapsed, the mortgagee can do little to salvage its position. It has lost both the right to foreclose and the right to sue for collection of the debt. All it has in its favor is a recorded lien on the land, which cannot be removed from the title except by payment by the mortgagor. See *Chapman v Hicks* (1919) 41 CA 158, 182 P 336. However, even this recorded lien has limited value because the borrower may convey the property to another person after the statutory period expires, and the grantee may then terminate the cloud on the title created by the mortgage if the grantee paid consideration for the property and the lien has expired. *Faxon v All Persons, supra*. In rare cases in which the lender has been given possession, it is immune from ejectment until it has been paid, either by the borrower or from the profits of the land, even though its possession does not extend the time to foreclose. *Spect v Spect, supra*. See §§6.4-6.6.

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§7.33 b. Deeds of Trust

The situation is different for a beneficiary of a deed of trust than it is for a mortgagee. A trustee sale (see chap 2) under a deed of trust is not affected by expiration of the relevant statute of limitations. *Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090; *Sipe v McKenna* (1948) 88 CA2d 1001, 200 P2d 61. Consequently, the trustor (borrower) may not assert the statute of limitations as the basis for enjoining a trustee sale, but it may assert the passage of time under related theories. See §7.34.

A deed of trust gives the beneficiary (via the trustee) title to the collateral rather than merely a lien on it as in a mortgage. See *Koch v Briggs* (1859) 14 C 256. This trust title, together with the power of sale in the instrument, has often been said to endure for as long as the underlying trust purpose survives. *Hohn v Riverside County Flood Control & Water Conserv. Dist.* (1964) 228 CA2d 605, 39 CR 647. Thus, except for the bar under California's Marketable Record Title Act (CC §§880.020-887.090; see §7.34), the power of sale in the deed of trust may be exercised at any time following a default despite any statute of limitations bar on the underlying obligation (*Welch v Security-First Nat'l Bank* (1943) 61 CA2d 632, 143 P2d 770). See §§2.10, 3.10, 3.20.

Junior lienholders cannot complain of a late senior foreclosure, because they are presumed to have known that the senior had no obligation to hasten collection of its debt. *Summers v Hallam Cooley Enters.* (1942) 56 CA2d 112, 132 P2d 60. The only effect of the statute of limitations in this situation is that there can be no deficiency judgment, because the obligation itself is immune after 4 years (CCP §337), or possibly 6 years (see Com C §3118, discussed in §7.32), and also because the remedy of judicial foreclosure is lost at the same time (*Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090), leaving exercise of the power of sale (which precludes any deficiency judgment under CCP §580d; see §§3.4, 5.8) as the only method of foreclosure. For discussion of the effect of the Marketable Record Title Act, see §7.34; see also chaps 1-3.

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§7.34 c. Marketable Record Title Act

Although the trustor (borrower) under a deed of trust may not assert the statute of limitations as the basis for enjoining a trustee sale (see §7.33), it may assert the passage of time under California's Marketable Record Title Act (CC §§882.020-887.090), enacted in 1982. The duration of a debt secured by a deed of trust is limited to 10 years after the final maturity date of the debt, if that date can be established from the recorded evidence of indebtedness (*i.e.,* the mortgage or deed of trust), or, if no maturity date is evident, to 60 years after the date of recordation of the instrument. CC §882.020(a)(1)-(2).

When the provisions on maturity are stated in the unrecorded promissory note rather than in the recorded deed of trust, the 60-year period applies. CC §882.020; *Nicolopulos v Superior Court* (2003) 106 CA4th 304, 130 CR2d 626. In any event, any expiration date can be extended for 10 years by recording a "notice of intent to preserve interest" under CC §880.340. CC §882.020(a)(3). The recording of a lis pendens relating to litigation of the interests in the property will also extend the expiration date by 10 years. *Slintak v Buckeye Retirement Co.* (2006) 139 CA4th 575, 43 CR3d 131. Recording a notice of default that specifies the maturity date of the unrecorded note will not make the maturity date "ascertainable from the record" within the meaning of CC §882.020. See *Ung v Koehler* (2005) 135 CA4th 186, 37 CR3d 311, discussed in §3.20. For further discussion, see Soffer, *The Marketable Record Title Act—Is Private Foreclosure Barred 10 Years After Maturity, or Not?,* 25 Cal Real Prop J 16 (No. 2, 2007).

NOTE: The fact that the unrecorded note is referred to and may be found by a reasonable search does not change the time period from 60 years after creation to 10 years after maturity. See *Nicolopulos v Superior Court*, *supra; Miller v Provost* (1994) 26 CA4th 1703, 33 CR2d 288. But if the details of the secured obligation, including the maturity date, are included in the text of an overly detailed and recorded deed of trust, the details arguably may come at the cost of imposing the shorter limitations period.

Under CC §882.020(c), the time periods in the statute may also be extended "in the same manner and to the same extent" as a waiver under CCP §360.5. Many California deeds of trust contain a waiver of the statute of limitations to the fullest extent permitted by law. For such deeds of trust, even if the trustor executes no subsequent waiver of the statute of limitations or if the deed of trust beneficiary records no subsequent notice of intent to preserve interest, the applicable 10- or 60-year limit of CC §882.020 is probably extended to 14 years or 64 years.

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§7.35 7. Disputed Obligations

Misunderstandings between the parties are common in complex loan transactions, and a trustor's failure to make a payment demanded by the beneficiary is not necessarily a breach of the obligations. See, *e.g., Hauger v Gates* (1954) 42 C2d 752, 269 P2d 609 (default excused as offset against beneficiary); *Strike v Trans-West Discount Corp.* (1979) 92 CA3d 735, 155 CR 132 (notice of default, based on usurious claim, vacated); *Hunt v Smyth* (1972) 25 CA3d 807, 101 CR 4 (acceptance of previous partial payments may be waiver); *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 98 CR 735 (beneficiary should use funds in building loan account to satisfy payment due); *Ripley Improvement Co. v Hellman Commercial Trust & Sav. Bank* (1928) 90 CA 83, 265 P 835 (same). But see *Gaffney v Downey Sav. & Loan Ass'n* (1988) 200 CA3d 1154, 246 CR 421 (foreclosure proper despite receipt of separate, partial checks equaling amount due). For further discussion of payment disputes (including improper acceleration of debt, late charges, or prepayment penalties) and breach of lender obligations (including breach of one-action, security-first, and antideficiency rules) that may be grounds for defending debtor obligations and foreclosure, see chaps 3-5, 8 and California Real Estate Finance Practice: Strategies and Forms, chaps 1-4 (Cal CEB 2000). On usury law, see Real Estate Finance, chap 3 and Lind, *A Real Estate Attorney's Guide to California Usury Laws,* 18 CEB Real Prop L Rep 271 (Oct. 1995).

In such disputes, a court may enjoin the pending sale while it decides what amount is properly due. See *More v Calkins* (1890) 85 C 177, 24 P 729; *Baypoint Mortgage Corp. v Crest Premium Real Estate Inv. Retirement Trust* (1985) 168 CA3d 818, 214 CR 531. But see *Hazen v Nicholls* (1899) 126 C 327, 58 P 816; *Ravano v Sayre* (1933) 135 CA 60, 26 P2d 515. If the trustor admits liability and disputes only the amount, the court may limit the trustor to temporary injunctive relief (see *Producers Holding Co. v Hill* (1927) 201 C 204, 256 P 207), or it may enjoin the particular sale without prejudice to a later foreclosure based on a different default (see *Lockwood v Sheedy* (1958) 157 CA2d 741, 321 P2d 862).

It is common when the trustor-plaintiff disputes the obligation to allege causes of action for both injunctive and declaratory relief. Both are included in the form complaint in §7.44. A temporary restraining order or preliminary injunction is commonly sought in this situation. See §§7.25, 7.46-7.52. See also *Producers Holding Co. v Hill, supra; More v Calkins, supra; Strike v Trans-West Discount Corp., supra; Lenard v Edmonds* (1957) 151 CA2d 764, 312 P2d 308; *Stockton v Newman* (1957) 148 CA2d 558, 307 P2d 56. The trustor usually requests the injunction to preserve the status quo until the court can resolve the underlying disputed issues. The permanent relief sought will vary, depending on the grounds alleged. The trustor may seek an accounting to find the amount still owed or the amount necessary to reinstate the loan. Pending the result of the accounting, the trustor may seek to either reinstate the loan by paying only the delinquent amount found to be due or redeem the property from the lien by paying the full amount found to be due.

If the trustor contends that nothing is owed, either because full payment has already been made, because setoffs equal the balance due, or because the lien is otherwise invalid because of, *e.g.,* fraud or lack of capacity, then the prayer will request that the deed of trust be canceled and that title to the property be quieted free of the lien.

If the trustor contends that the proposed trustee sale is improper because the loan is not in default at all, the prayer should be that the court reinstate the loan by ordering the trustee to record a rescission of the notice of default and enjoining the trustee from proceeding with the sale. This relief should not bar the beneficiary from later foreclosing on the basis of new or different defaults. See *Lockwood v Sheedy, supra*.

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§7.36 8. Truth in Lending Act Violations

The federal Truth in Lending Act (TILA) (15 USC §§1601-1667f) requires a lender to make several advance disclosures to the borrower at the time of a consumer loan about the terms of the loan and mortgage. Counsel should remain alert to TILA's potential applicability in actions to enjoin foreclosure. See, *e.g., Phleger v Countrywide Home Loans, Inc.* (ND Cal, Mar. 3, 2009, No. C 07-01686) 2009 US Dist Lexis 17419. See more detailed discussions of TILA and its remedies in chap 12. See also chap 8. On applying TILA remedies in a debtor bankruptcy, see §7.115.

TILA is implemented in detail in Regulation Z (12 CFR pt 226), and the Official Staff Interpretations (updated annually) explain the Regulation in 12 CFR pt 226, Supp I. The lender's failure to disclose information required under TILA gives the borrower the right to do the following:

- Rescind the loan;
- Recover certain amounts already paid (including interest, finance charges, and closing costs);
- Offset amounts owing; and
- Collect statutory damages and attorney fees.

Arguably, the loan becomes unsecured if the borrower has a clear right of rescission and gives notice of it, and therefore the lender cannot proceed with a foreclosure. Also, TILA provides that a valid notice of rescission renders the security agreement void (see §12.69), and not merely voidable. Presumably, a trustee can be enjoined from conducting the sale or will be liable for damages for proceeding to the sale on a void security instrument. See authorities cited in §12.69B. When the borrower demonstrates serious TILA violations, some courts may grant a preliminary injunction restraining the foreclosure sale action even if the borrower does not demonstrate the ability to make full restitution in one lump sum on an award of rescission. *Avila v Stearns Lending, Inc.* (CD Cal, Apr. 7, 2008, No. 08-0419) 2008 US Dist Lexis 31813. For further discussion on tendering restitution, see §§12.69-12.69A.

The case law is in sharp conflict about whether the remedy of rescission remains available after a loan that violates TILA has been paid off. Compare *King v California* (9th Cir 1986) 784 F2d 910, 913 and *Plascencia v Lending 1st Mortgage* (ND Cal 2008) 583 F Supp 2d 1090 (rescission not available) with *Pacific Shore Funding v Lozo* (2006) 138 CA4th 1342, 1353, 42 CR3d 283 (rescission available). But if the borrower transfers ownership of the property, the borrower's rescission right is terminated. 15 USC §1635(f).

If rescission is unavailable to the borrower, an offset (such as damages incurred by the borrower because of a TILA violation) to the amount claimed to be in default may preclude foreclosure. See §§12.69-12.69C.

The statute of limitations on the right of rescission runs from the date of the loan and operates as a statute of repose. See *Beach v Ocwen Fed. Bank* (1998) 523 US 410, 411, 140 L Ed 2d 566, 118 S Ct 1408, discussed in §12.63A. (In contrast, claims for rescission under California contract law do not accrue until the plaintiff discovers the facts constituting the fraud or mistake. CCP §§337(3), 339(3).)

Several federal circuit courts and at least one California court have determined that class actions seeking loan rescissions are not allowed under TILA. See *Andrews v Chevy Chase Bank* (7th Cir 2008) 545 F3d 570; *McKenna v First Horizon Home Loan Corp.* (1st Cir 2007) 475 F3d 418; *LaLiberte v Pacific Mercantile Bank* (2007) 147 CA4th 1, 53 CR3d 745.

For detailed discussion of TILA and its subsection, the Home Ownership and Equity Protection Act of 1994 (HOEPA) (15 USC §§1647-1648; Pub L 103-325, 108 Stat 2160), see chap 12. For a demand letter that may be sent before filing a TILA action, see form in §7.30. On proposed legislation that may provide additional remedies for violations of TILA or other consumer statutes, see Note in §7.118. Attorneys interested in analyzing consumer loans on TILA issues may download a handbook from the Comptroller of the Currency at http://www.occ.treas.gov/handbook/til.pdf. See also Simmons, *The Federal Truth in Lending Act: What You Don't Know Can Hurt You,* 27 CEB Real Prop L Rep 149 (Nov. 2004), reprinted at http://www.abanet.org/rppt/publications/edirt/2005/1/Simmons.pdf.

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9. Improper Procedures

§7.37 a. Procedures Under CC §§2924-2924i

A trustee sale may be enjoined because the beneficiary or trustee is not following proper statutory procedures regarding such sales (see CC §§2924-2924i; see also chap 2). For example, the sale may be enjoined if the trustee fails to give proper notice of default. *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 98 CR 735; *Lockwood v Sheedy* (1958) 157 CA2d 741, 321 P2d 862. See §7.28.

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§7.38 b. Procedures Under SB 1137

Residential borrowers and tenants have additional rights granted to them under CC §§2923.5-2923.6 and 2924.8, as enacted by Stats 2008, ch 69, amended by Stats 2009, ch 43. See §§2.37-2.38, 2.49, 2.63, 2.65, 2.68. These laws, commonly referred to as SB 1137 and SB 306 (scheduled to sunset on January 1, 2013), were enacted by the California legislature in response to the "skyrocketing" residential foreclosure rates in the state.

Civil Code §2923.5, effective September 8, 2008, requires notice and, when possible, a dialogue between a secured lender and its homeowner borrower to explore alternatives to foreclosure before the lender commences a nonjudicial foreclosure process by sending a notice of default. Because §2923.5 was added to the statutory trustee sale procedures, a violation of this section potentially supports injunctive relief against a foreclosure sale or a right to challenge the validity of the sale. This section applies only to owner-occupied (noninvestment) residential property with no more than four dwelling units with loans made between January 1, 2003, and December 31, 2007. It precludes the filing of a notice of default until 30 days after the lender has contacted the borrower or 30 days after the lender has satisfied specified "due diligence" requirements in attempting to contact the borrower. This section further specifies a declaration concerning contact and due diligence in the notice of default or notice of sale. See §§2.37-2.38, 2.49, 2.63, 2.130, 2.133.

Under CC §2923.5(h), there are exceptions to the requirement to contact the borrower if any of the following has occurred:

(1) The borrower surrendered the property by either a letter confirming the surrender or delivery of the keys to the property to the trustee, the beneficiary, or an authorized agent.

(2) The borrower has entered into a contract "with an organization, person, or entity whose primary business is advising people who have decided to leave their homes on how to extend the foreclosure process and avoid their contractual obligations to mortgagees or beneficiaries."

(3) The borrower has filed a petition for relief in the bankruptcy court, "and the bankruptcy court has not entered an order closing or dismissing the bankruptcy case, or granting relief from a stay of foreclosure."

In February 2009, the California legislature enacted (for a relatively limited class of residential loans) the California Foreclosure Prevention Act (CFPA) (CC §§2924, 2923.52-2923.55). Enacted as an emergency measure at a second 2008-2009 legislative session as ABX2 7 (Stats 2008, 2d Extra Sess, ch 5), the CFPA sunsets on January 1, 2011, unless extended. CFPA §§2-7. (Note that SBX2 7, an identical bill, was also enacted as Stats 2008, 2d Extra Sess, ch 4.) The primary purpose of ABX2 7 was to impose an additional 90-day waiting period in the nonjudicial foreclosure process before issuing a notice of trustee sale. See §§2.62-2.62A.

Civil Code §2924.8, effective September 8, 2008, requires the trustee or beneficiary to prepare an additional notice to inform any nonborrower residential tenant in the property about the foreclosure sale. It must be posted and mailed first class when the trustee posts and mails the notice of sale for the property if the billing address for the note is different from the property address. The additional notice is intended to communicate the urgency and gravity of the foreclosure to residential tenants (*i.e.,* nonowners). See §§2.49, 2.63, 2.65, 2.68, 2.133. Because the legislature did not specifically provide a remedy for a violation of §2924.8, this issue will have to be resolved in the courts. If violated, it is unclear whether this section would support tenant injunctive relief against a foreclosure sale, although it may support a defense in a subsequent unlawful detainer action against a tenant. See *Cheney v Trauzettel* (1937) 9 C2d 158, 160, 69 P2d 832 (defense by trustor that required statutory foreclosure steps were not followed). See also *Evans v Superior Court* (1977) 67 CA3d 162, 171, 136 CR 596 (tenant having express agreement to purchase property from subsequent purchaser after foreclosure may litigate title defensively in unlawful detainer action); *Vella v Hudgins* (1977) 20 C3d 251, 255, 142 CR 414. See also authorities in §7.75; California Landlord-Tenant Practice §§8.68A-8.68E, 10.54 (2d ed Cal CEB 1997).

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B. Parties to Injunction Action

§7.39 1. Plaintiffs: Borrowers or Tenants

The trustor is the usual plaintiff in an action to enjoin a trustee sale, but the sale may also be enjoined at the behest of any party with the right to cure defaults (see CC §2924c), to redeem the property (CC §§2903-2904), or to automatically receive notice of default (CC §2924b(b)-(c)). See §§2.6, 2.43. These other parties may seek an injunction even if the trustor does not challenge the sale. See *Hall v Citizens Nat'l Trust & Sav. Bank* (1942) 53 CA2d 625, 128 P2d 545 (constructive trustee); *Vaughan v People's Mortgage Co.* (1933) 130 CA 632, 20 P2d 335 (trustor's brother). A junior creditor may sue to enjoin a sale that is improper and that will impair the junior's rights. See *Landsdown v Smith & Sons Reserve Corp.* (1934) 1 CA2d 618, 37 P2d 127. Guarantors probably have similar standing. See CC §§2810, 2819; *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64.

A senior lienholder lacks standing to enjoin a junior sale, because it cannot redeem or challenge the junior lien. CCP §527. Similarly, former owners of the property have no interest in the trustee sale, because its nonjudicial nature immunizes them from liability for a deficiency, which is their only possible concern. CCP §580d. A former owner who took back a second deed of trust or who has a vendor's lien would have standing to sue as a junior creditor, but following a proper foreclosure by the senior lienholder, the former owner would not have standing to pursue the buyer for a deficiency.

Tenants of the trustor whose leases may be terminated by a completed foreclosure sale should also have standing to enjoin the sale. See CC §2924b(c)(1), (c)(2)(D)-(E), and (c)(3), which require that notice of default and notice of sale be mailed to holders of leaseholds "acquired by an instrument sufficient to impart constructive notice" and to subsequent takers and encumbrancers. Tenants whose leases are superior to the deed of trust in foreclosure, or whose interests are exempt from the sale, probably lack standing to attack the sale, except on grounds special to their situations. On priorities of leasehold interests vis-à-vis liens of deeds of trust, see chap 6.

Residential tenants have additional rights granted to them (or at least potentially more time to find a place to move) under CCP §1161b and CC §§2923.5-2923.6, 2924.8, and 2929.3, as enacted by Stats 2008, ch 69 and amended by Stats 2009, ch 43. See §§2.37-2.38, 2.49, 2.63, 2.65, 2.68, 7.38. These laws, commonly referred to as SB 1137 and SB 306 (scheduled to sunset on January 1, 2013), were enacted by the California legislature in response to the "skyrocketing" residential foreclosure rates in the state. The most important rights are the following:

- Effective September 8, 2008, if the billing address for the promissory note is different from the property address, CC §2924.8 requires the posting and first-class mailing of an additional notice of sale for residential tenants (see §2.133) when the usual notice of foreclosure sale is posted and mailed to the borrower. The additional notice is designed to communicate the urgency and gravity of the foreclosure to tenants. If violated, this section potentially supports a defense to an unlawful detainer action following a foreclosure sale. See §7.38.
- Effective July 8, 2008, CCP §1161b requires owners to provide tenants and subtenants of foreclosed residential property 60 days' written notice to quit before commencing eviction proceedings. If violated, this section provides a potential defense to an unlawful detainer action but would not support injunctive relief against a foreclosure sale.
- Effective July 8, 2008, CC §2929.3 requires owners who acquired residential property at a foreclosure sale to maintain the physical exterior and remedy conditions that threaten public health and safety. If violated, this section would not support injunctive relief against a foreclosure, but it might provide a defense to an unlawful detainer action under applicable local eviction control law. See California Eviction Defense Manual, chaps 17, 20 (2d ed Cal CEB 1993).

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§7.40 2. Defendants

The defendant in an action to enjoin the sale is usually the trustee responsible under the deed of trust for giving the notices and conducting the sale (CC §2924), including any agent of the trustee authorized to conduct the sale (see *Orloff v Pece* (1933) 134 CA 434, 25 P2d 484). On trustee's duty to trustor, see *Block v Tobin* (1975) 45 CA3d 214, 119 CR 288; *Pierson v Fischer* (1955) 131 CA2d 208, 280 P2d 491. See also *Garfinkle v Superior Court* (1978) 21 C3d 268, 146 CR 208. See §§1.42, 3.36, 3.61 for discussion of a law permitting the trustee, under certain conditions, to decline to participate in an action in which it is named solely in its capacity as trustee.

PRACTICE TIP: Plaintiff's counsel should fully analyze the conduct of the trustee so as not to miss any facts sufficient to state a claim against it and overcome its election to decline participation in the action. If the trustee declines to participate, counsel might want to continue to provide the trustee with all pleadings and notices in the action to preserve all remedies in addition to injunctive relief. Limited discovery on the trustee may also be conducted.

The beneficiary under the deed of trust should also be named as a defendant because the foreclosure is based on its allegation of default. If not included as a party, the beneficiary may be able to substitute in a new trustee (see §§2.21-2.26) and continue the sale through the substitute. In addition, the trustor is likely to seek additional relief against the beneficiary, *e.g.,* damages for fraud or rescission of the loan transaction. Service of process on the trustee constitutes neither service on the beneficiary nor requires the trustee to notify the beneficiary of the action. CC §2937.7.

National banks were formerly regarded as immune from state court injunctions against foreclosure sales. See, *e.g., Kemple v Security-First Nat'l Bank* (1967) 249 CA2d 719, 57 CR 838; *First Nat'l Bank v Superior Court* (1966) 240 CA2d 109, 49 CR 358. However, in *Third Nat'l Bank v Impac, Ltd.* (1977) 432 US 312, 53 L Ed 2d 368, 97 S Ct 2307, the Supreme Court held that federal law (12 USC §91) does not bar an injunction to restrain the bank's foreclosure sale pending a hearing on the trustor's claim.

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§7.41 3. Tender Required for Provisional Relief

Courts usually require the trustor to pay or to tender payment of any amounts admittedly owed the beneficiary as a condition for issuing a temporary restraining order or preliminary injunction. *Bisno v Sax* (1959) 175 CA2d 714, 346 P2d 814; *Young v Burchill* (1929) 96 CA 341, 274 P 379. The injunction may later be dissolved if such continued payments are not made. *Meetz v Mohr* (1904) 141 C 667, 75 P 298. But this requirement may be excused if the beneficiary has lulled the trustor into not paying. *McCue v Bradbury* (1906) 149 C 108, 84 P 993. Tender may also be excused when payment could be construed as a waiver of the right to rescind. See *Stockton v Newman* (1957) 148 CA2d 558, 307 P2d 56.

A court may deny a permanent injunction that was sought solely to gain the trustor time to accumulate enough money to cure the default. *Gordon v McGaslin* (1943) 61 CA2d 540, 143 P2d 359. But a trial court may exercise its equitable powers to stay the effect of its decision to dissolve a temporary restraining order if it believes that the trustor should have more time to raise the necessary funds (*Lupertino v Carbahal* (1973) 35 CA3d 742, 746, 111 CR 112), or it may continue an order postponing the sale (*In re Reader* (1939) 32 CA2d 309, 89 P2d 654).

No tender is required if nothing is due, *e.g.,* if the trustor's setoff claims exceed the amount owed the beneficiary. *Hauger v Gates* (1954) 42 C2d 752, 269 P2d 609. A tender is also unnecessary when the hearing on a preliminary injunction is the debtor's only presale means of obtaining a judicial determination of the amount due or whether any amount is due. See *More v Calkins* (1890) 85 C 177, 24 P 729. See also *Stockton v Newman, supra*.

The requirement of a tender is based on the proposition that a party seeking the aid of equity must "do equity" by honoring all rightful obligations. A decision on this "do equity" requirement from the partnership area, *Dickson, Carlson & Campillo v Pole* (2000) 83 CA4th 436, 446, 99 CR2d 678, suggests that the "do equity" requirement is "not a complete defense to an action." *Dickson* suggests that the trial court has considerable discretion to impose conditions and "accommodate the equities" in lieu of a strict and literal tender of performance before commencement of litigation.

PRACTICE TIP: Civil Code §1500 is a powerful tool when a client is confronted with a dispute about payments but not liability. The statute requires the debtor to open a segregated account and deposit funds for the limited purpose of satisfying the debtor's liability. The debtor must give the lender notice that the account has been opened and each month notify the lender of the amount of funds deposited. See *Walker v Houston* (1932) 215 C 742, 12 P2d 952. No interest or attorney fees may be assessed, because under California law a proper tender has been made. See CC §1504; *Holland v Paddock* (1956) 142 CA2d 534, 298 P2d 587.

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§7.42 C. Jurisdiction and Venue

Jurisdiction to issue injunctive relief rests initially in the trial courts; appellate courts do not have original jurisdiction over actions seeking injunctive relief. See Cal Const art VI, §10; *Walsh v Railroad Comm'n* (1940) 16 C2d 691, 107 P2d 611.

An action to enjoin a trustee sale is usually filed in a superior court, which has original jurisdiction in all civil cases unless jurisdiction is conferred by statute on other courts. Cal Const art VI, §10. On designating action as limited versus unlimited civil case, see §7.72. Court commissioners have jurisdiction to issue injunctive relief subject to court supervision. CCP §259. See also 2 Witkin, California Procedure, *Courts* §351 (5th ed 2008).

The county in which the real property or some part of it is located is the proper county for trial of actions for the "determination in any form" of a right or interest in real property, subject to the court's power to transfer actions. CCP §392(a)(1). An action to enjoin a trustee sale and to reform the power of sale clause in the deed of trust is local rather than transitory, even when incidental relief (*e.g.,* damages) is also sought. Thus, the action is properly filed in the county where the real property is located and may not be transferred to the county in which the beneficiary resides. *Massae v Superior Court* (1981) 118 CA3d 527, 173 CR 527.

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D. Procedures for Obtaining Temporary Restraining Orders and Preliminary Injunctions

§7.43 1. Complaint to Enjoin Foreclosure

Injunctions may be sought as part of an action. CCP §525. An action requires a complaint, which commences the action. CCP §350. The allegations of the complaint must be tailored to fit the facts and legal contentions of the particular trustee sale. In an appropriate case, the plaintiff might add a cause of action for an accounting to establish the amounts actually owed by the plaintiff. See §7.44 for an illustrative complaint that includes causes of action for declaratory relief, injunction, and an accounting.

A trustor who successfully enjoins a sale may be entitled to recover attorney fees under CC §1717 if the promissory note or deed of trust provides for them. *Valley Bible Ctr. v Western Title Ins. Co.* (1983) 138 CA3d 931, 188 CR 335. See §§8.83-8.90. But see Warning in §7.23.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.44 2. Form: Complaint to Enjoin Foreclosure, and for Declaratory Relief and an Accounting

§7.44 2. Form: Complaint to Enjoin Foreclosure, and for Declaratory Relief and an Accounting

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_ _[*Name(s)*]_ _, Plaintiff(s) vs _ _[*Name(s)*]_ _, Defendant(s)	**No. _ _ _ _ _ _ COMPLAINT TO ENJOIN FORECLOSURE, AND FOR DECLARATORY RELIEF AND AN ACCOUNTING**

FIRST CAUSE OF ACTION
(Declaratory Relief by Plaintiff(s) _ _[*name(s)*]_ _
Against Defendant(s) _ _[*name(s)*]_ _)

1. Plaintiff _ _[*name*]_ _ is now, and at all times relevant to this complaint was, the _ _[*describe plaintiff's interest in property, e.g., owner*]_ _ of real property commonly known as _ _[*street address or other designation, including county*]_ _, California ("subject property"). The legal description of the subject property is attached as Exhibit A and incorporated here by reference. The assessor's parcel number is _ _[*number*]_ _.

2. Defendant _ _[*name of trustee*]_ _ is a _ _[*e.g., California corporation, national banking association*]_ _ authorized to engage in, and at all times mentioned in this complaint engaged in, _ _[*e.g., title insurance, banking and trust*]_ _ business as a _ _[*e.g., title insurance company, California state bank*]_ _. This defendant is the current trustee of the deed of trust described in paragraph 6.

3. Defendant _ _[*name*]_ _ is now, and at all times relevant to this complaint was, the beneficiary of the deed of trust described in paragraph 6.

4. Plaintiff does not know the true names, capacities, or basis for liability of defendants sued as Doe 1 through Doe 10. Each fictitiously named defendant is in some manner liable to plaintiff, or claims some right, title, or interest in the subject property, or both.

5. On _ _[*date*]_ _, for valuable consideration, _ _[*plaintiff/plaintiff's predecessor*]_ _, as borrower, made, executed and delivered to defendant, _ _[*name of beneficiary*]_ _, a written promissory note in the amount of _ _[*dollar amount*]_ _. A copy of the promissory note is attached as Exhibit B and incorporated here by reference.

6. To secure payment of the principal sum and interest as provided in the note and as part of the same transaction, _ _[*plaintiff/plaintiff's predecessor*]_ _, as trustor, executed and delivered to defendant, _ _[*name of beneficiary*]_ _, as beneficiary, a deed of trust dated _ _[*date*]_ _, by the terms of which plaintiff, as trustor, conveyed to defendant, _ _[*name*]_ _, as trustee, real property described in paragraph 1. On _ _[*date*]_ _, the deed of trust was recorded against the subject property in _ _[*state book and page or instrument number*]_ _ of the Official Records of _ _[*name*]_ _ County, California. A copy of the deed of trust is attached as Exhibit C and incorporated here by reference.

7. On _ _[*date*]_ _, defendant _ _[*name of beneficiary or trustee*]_ _ caused to be recorded a notice of default and of election to sell in _ _[*state book and page or instrument number*]_ _ of the Official Records of _ _[*name*]_ _ County, California, alleging (a) that a breach of the obligation secured by the deed of trust had occurred, consisting of plaintiff's alleged failure to _ _[*summarize default, e.g., pay certain monthly installments of principal and interest*]_ _, and (b) that defendant, as beneficiary, elects to sell, or to cause to be sold, the trust property to satisfy that obligation. A copy of the notice of default and election to sell is attached as Exhibit D and incorporated here by reference.

[*Option 1: If trustee lacks right to conduct sale*]

8. A breach of the obligation for which the deed of trust is security _ _[*has not occurred/is excusable because, e.g., the beneficiary improperly refused plaintiff's tender of arrearages*]**_ _. An actual controversy exists between plaintiff and defendant concerning their respective rights and duties pertaining to the subject property and the described transactions in that (a) plaintiff contends that _ _**[*state legal consequences resulting from facts alleged in preceding paragraphs*]**_ _, and (b) defendant disputes this contention and contends that _ _**[*state contentions*]**_ _.**

[*Option 2: If improper sale procedures alleged*]

8. Defendant _ _[*name*]**_ _ has improperly conducted the sale in that _ _**[*state improprieties, e.g., defendant failed to comply with the publishing and posting requirements of Civil Code §2924f by _ _*[*state specific facts constituting noncompliance or establishing fraudulent or collusive arrangements*]**_ _]_ _. An actual controversy exists between plaintiff and defendant concerning their respective rights and duties pertaining to the subject property and the described transactions in that (a) plaintiff contends that _ _**[*state legal consequences resulting from facts alleged in preceding paragraphs*]**_ _, and (b) defendant disputes this contention and contends that _ _**[*state contentions*]**_ _.**

[*Continue*]

9. Plaintiff desires a judicial determination and declaration of plaintiff's and defendant's respective rights and duties; specifically, _ _[*state declaration requested, e.g., that plaintiff did not breach his or her obligations or that trustee failed to meet statutory requirements for conducting the sale*]**_ _. Such a declaration is appropriate at this time so that plaintiff may determine _ _**[*his/her/its*]**_ _ rights and duties before the subject property is sold at a foreclosure sale.**

SECOND CAUSE OF ACTION
(Injunctive Relief by Plaintiff(s) _ _[*name(s)*]**_ _**
Against Defendant(s) _ _[*name(s)*]**_ _)**

10. Plaintiff realleges and incorporates by reference the allegations in paragraphs 1 through 8 of the First Cause of Action.

11. Defendants _ _[*beneficiary and trustee*]**_ _ intend to sell, and unless restrained will sell or cause to be sold, the subject property, all to plaintiff's great and irreparable injury in that _ _**[*specify, e.g., defendant has given notice that the trustee sale of the property will take place on a certain date and time, and at a certain address, and if the sale takes place as scheduled, plaintiff, having no right to redeem the subject property from the sale, will forfeit it*]**_ _.**

12. The scheduled sale is wrongful and should be enjoined by virtue of the facts alleged in the above paragraphs 7 and 8. Plaintiff has no other plain, speedy, or adequate remedy, and the injunctive relief prayed for below is necessary and appropriate at this time to prevent irreparable loss to plaintiff's interests.

THIRD CAUSE OF ACTION
(Accounting by Plaintiff(s) _ _[*name(s)*]**_ _**
Against Defendant(s) _ _[*name(s)*]**_ _)**

13. Plaintiff realleges and incorporates by reference the allegations in paragraphs 1 through 8 of the First Cause of Action.

14. The amount of money defendant _ _[*name of beneficiary*]**_ _ owes to plaintiff is unknown to plaintiff and cannot be determined without an accounting.**

WHEREFORE, plaintiff demands judgment as follows:

1. That the Court issue a declaration of the rights and duties of the parties; specifically, _ _[*specify declaration desired, e.g., (a) that trustee has no right to conduct the sale, because no breach occurred or because there is no valid lien, or (b) that trustee has not followed required sale procedures*]**_ _.**

2. That the Court issue a _ _[*e.g., temporary restraining order*]**_ _, a preliminary injunction, and a permanent**

injunction restraining defendants _ _[*names of beneficiary and trustee*]_ _ and their agents, attorneys, successors, and representatives, and all persons acting in concert or participating with them, from selling, attempting to sell, or causing to be sold the subject property either under the power of sale in the deed of trust or by foreclosure action.

3. That the Court render an accounting between plaintiff _ _[*name*]_ _ and defendant _ _[*name of beneficiary*]_ _ determining the amount, if any, that defendant actually owes plaintiff.

4. That plaintiff recover reasonable attorney fees and costs incurred in this action, and that the Court award all other appropriate relief.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Copies: Original (file with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: This complaint seeks declaratory and injunctive relief concerning a scheduled foreclosure sale. The form may also be revised for use as a cross-complaint in a judicial foreclosure action; in that event, no preliminary injunction is necessary.

A civil case cover sheet in the format prescribed by the Judicial Council must accompany the first paper filed in an action with the court, but it need not be served unless the cover sheet indicates that the case is complex under Cal Rules of Ct 3.400. See Cal Rules of Ct 3.250 regarding what papers may or may not be filed with the complaint. A footer showing the court paper's title is required on every page below the page number. See Cal Rules of Ct 2.110. On formal aspects of drafting and serving the complaint, see California Civil Procedure Before Trial, chaps 11, 14-18 (4th ed Cal CEB 2004); on pleading injunctive and declaratory relief, see Civ Proc Before Trial, chaps 32, 35.

See Cal Rules of Ct 2.100-2.119 concerning format of papers filed in court, including fax and e-mail addresses on pleadings, limited civil case identification standards, and requirement that pleading titles and footers stating the title of the document be in at least 10-point type.

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§7.45 3. Distinctions Among Types of Injunctive Relief

A temporary restraining order (TRO) is an interim order issued to prevent "great or irreparable injury" to the applicant pending the hearing on an application for a preliminary injunction. See CCP §527(c); *Biasca v Superior Court* (1924) 194 C 366, 228 P 861. Although a TRO is technically not an injunction (because it may be issued ex parte without a bond or an undertaking being required), it has the same force and effect. See CCP §§527(c), 529. A TRO automatically expires 15 days after issuance; on a showing of good cause, the order may provide that it will expire 22 days after issuance. See CCP §527(d); *Sharpe v Brotzman* (1956) 145 CA2d 354, 302 P2d 668 (interpreting earlier 10-day provision). The TRO terminates if a preliminary injunction is denied or if it is superseded by a preliminary injunction. See *Houser v Superior Court* (1932) 121 CA 31, 8 P2d 483.

A preliminary injunction is an order issued to preserve the status quo pending a final determination of an action on the merits. CCP §526(a). See *Continental Baking Co. v Katz* (1968) 68 C2d 512, 528, 67 CR 761; *State Bd. of Barber Examiners v Star* (1970) 8 CA3d 736, 87 CR 450. Its issuance must be conditioned on the posting of a bond to protect the enjoined party. CCP §529. See §§7.51-7.52. After the case has been heard on its merits, the preliminary injunction is either merged into a permanent injunction or dissolved if a permanent injunction is denied. See *Shahen v Superior Court* (1941) 46 CA2d 187, 115 P2d 516.

The decision to issue or deny a preliminary injunction is not an adjudication of the ultimate issues in the action (*People v Black's Food Store* (1940) 16 C2d 59, 105 P2d 361), although it may be indicative of the final judgment. A court will ordinarily issue a preliminary injunction only if there is a reasonable likelihood that the plaintiff will prevail at trial. See *Continental Baking Co. v Katz, supra*.

A permanent injunction is issued after a trial or other resolution of the case on its merits. Because a permanent injunction is not a provisional remedy, it may differ in scope or effect from any preliminary injunction previously issued. *San Diego Water Co. v Pacific Coast S.S. Co.* (1894) 101 C 216, 35 P 651. Because it represents a final resolution of the action, issuance of a permanent injunction is not ordinarily conditioned on a bond or an undertaking. *Shahen v Superior Court, supra*.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.46 4. TRO or Preliminary Injunction

§7.46 4. TRO or Preliminary Injunction

The attorney for the party seeking to enjoin the trustee sale must decide whether to first request a temporary restraining order (TRO) and order to show cause (OSC) or to merely seek a preliminary injunction on a noticed motion (see §§7.44-7.45). See Cal Rules of Ct 3.1150(a). Although the trustor has at least 110 days in which to seek to enjoin the sale (after the notice of default is recorded; see §2.62), much of this time may already have passed before an attorney is first contacted.

PRACTICE TIP: A TRO and an OSC should be sought immediately if the proposed trustee sale will take place in less than the 21 days required to file and serve a motion for a preliminary injunction. If a TRO is unnecessary but the complaint has not been served or the defendant has not answered, an OSC should be obtained as a vehicle for giving notice of the hearing on the preliminary injunction. Cal Rules of Ct 3.1150(a). Otherwise, the plaintiff will have to wait for an appearance by the defendant to serve an ordinary noticed motion. See CCP §§528, 1005. To avoid uncertainties created by the language of Rule 3.1150(a), the plaintiff should do the following:

- Always use an OSC if the responding party did not appear in the action even when a TRO was not requested; and
- Use the noticed motion procedure only if the responding party did appear and there is no need to shorten the notice time.

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a. Temporary Restraining Order

§7.47 (1) Checklist: Procedure for Obtaining TRO and OSC

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To obtain a temporary restraining order (TRO) and an order to show cause (OSC), the plaintiff's attorney must do the following:

Review

- Statutes governing OSC and TRO; see CCP §§525-534.
- Rules of Court governing OSC and TRO; see Cal Rules of Ct 3.1150, 3.1200-3.1207.

Prepare and file or submit to the court

- Complaint with appropriate summons or cross-complaint (see form in §7.44 and Practice Tip in §7.46).
- Application for OSC and TRO; see Cal Rules of Ct 3.1202.
- Affidavits or declarations in support of TRO (and preliminary injunction); see Cal Rules of Ct 3.1201.
- Supporting memorandum.
- Combined OSC and TRO for judge's signature (see §7.48); see Cal Rules of Ct 3.1150(a)-(c).
- Bond or undertaking, if required by court (counsel should be prepared in advance with adequate sureties; see §§7.51-7.52).

Record in the county recorder's office

- Lis pendens. See §7.53.

Notify

- Attorney for responding party or, if unknown, responding party of hearing on TRO. Under CCP §527(c), plaintiff's attorney must, with certain exceptions, certify under oath that he or she (1) informed opposing party or opposing party's attorney of time and place of hearing; (2) attempted to give such notice, specifying efforts made; or (3) not be required to give such notice, for the reasons specified. See Cal Rules of Ct 3.1203-3.1204. See also Comment to form in §7.48.

Serve on responding party (after obtaining OSC)

- Copies of summons and complaint or cross-complaint (if not previously served), TRO and OSC (stating date, time, and place of hearing), supporting affidavits or declarations, and supporting memorandum within 5 days after TRO is issued or 2 days before the hearing, whichever is earlier, or as ordered by the court on good cause. CCP §527(d)(2). If defendant did not appear, service must be made in the same manner as summons and complaint. See Cal Rules of Ct 3.1150(a), 3.1206.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.48 (2) Form: Order to Show Cause and Temporary Restraining Order

§7.48 (2) Form: Order to Show Cause and Temporary Restraining Order

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_ _[*Name(s)*]_ _,	)	**No.** _ _ _ _ _ _
Plaintiff(s)	)	
	)	**ORDER TO SHOW CAUSE**
vs	)	**AND TEMPORARY**
	)	**RESTRAINING ORDER**
_ _[*Name(s)*]_ _,	)	
Defendant(s)	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____)		**Trial date:** _ _[*if set*]_ _

Good cause appearing in the complaint, plaintiff's application, supporting declarations, and supporting memorandum; and it appearing that this is a proper case for issuance of an order to show cause and a temporary restraining order; and that, unless a temporary restraining order issues, plaintiff will suffer irreparable injury before the matter can be heard on notice;

IT IS HEREBY ORDERED that defendant _ _[*name*]_ _ appear on _ _[*date and time*]_ _, in Department _ _[*number*]_ _ of the above-titled Court, located at _ _[*address*]_ _, to show cause why a preliminary injunction should not be issued enjoining defendant from selling or attempting to sell, or causing to be sold, the trust property described in the complaint on file in this action either under the power of sale in the deed of trust or by foreclosure action.

IT IS FURTHER ORDERED that, pending the hearing on the order to show cause, defendant _ _[*name*]_ _; defendant's agents, officers, employees, partners, successors, and representatives; all persons acting in concert or participating with them; and each of them are hereby restrained and enjoined from selling, attempting to sell, or causing to be sold the trust property described in the complaint on file in this action either under the power of sale in the deed of trust or by foreclosure action.

IT IS FURTHER ORDERED that a copy of the complaint, supporting declarations, and supporting memorandum, together with a copy of this order to show cause and temporary restraining order, be served on defendant no later than _ _[*date set by court (at least 2 days before hearing); see CCP §527(d)(2)*]_ _.

[*Add if appropriate; see §7.51*]

IT IS FURTHER ORDERED that a bond _ _[*or undertaking*]_ _ on this temporary restraining order is hereby fixed at _ _[*Court to insert amount*]_ _.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

Copies: Original (present to judge for signature and file with court clerk); copies for service and notice; office copies.

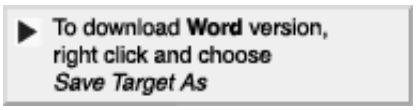
Comment: The first page of a pretrial notice of motion must show the date, time, and location (if known) of the hearing, the name of the hearing judge (if known), the nature or title of any attached document other than an exhibit, the filing date of the action, and the trial date (if set). Cal Rules of Ct 3.1110(b). A footer showing the court paper's title is required on every page below the page number. See Cal Rules of Ct 2.110. For rules on the format of court papers and on law and motion generally, see Cal Rules of Ct 3.1100-3.1362. See discussion and checklist of OSC and TRO procedures in §§7.46-7.47 and in California Civil Procedure Before Trial, chaps 13, 32 (4th ed Cal CEB 2004).

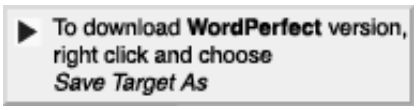
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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/ b. When Preliminary Injunction Alone Is Sought by Noticed Motion or OSC/§7.49 (1) Checklist: Obtaining Hearing on Preliminary Injunction

b. When Preliminary Injunction Alone Is Sought by Noticed Motion or OSC

§7.49 (1) Checklist: Obtaining Hearing on Preliminary Injunction





To obtain a hearing on the application for a preliminary injunction when no temporary restraining order is sought, the plaintiff's attorney must do the following:

Prepare and file or submit to the court

- Complaint or cross-complaint with appropriate summons (see form in §7.44 and Practice Tip in §7.46).
- Affidavits or declarations in support of preliminary injunction.
- Supporting memorandum.
- Notice of motion with proof of service of moving papers, or application for OSC and OSC (have order issued with hearing date set by court) (see §7.48). See Cal Rules of Ct 3.1150(a).
- Bond or undertaking, if required by court (counsel should be prepared in advance with adequate sureties; see §§7.51-7.52).

Record in the county recorder's office

- Lis pendens, if real property is involved. See §7.53.

Serve on responding party (after court issues OSC, if applicable)

- Notice of motion or OSC (stating the date, time, and place of the hearing), supporting memorandum, affidavits or declarations, summons, and complaint or cross-complaint. For notice of motion, service of moving, opposing, and reply papers must comply with time requirements of CCP §1005. Plaintiff's attorney may obtain from trial court an OSC why preliminary injunction should not issue, in which event service must be made within time ordered by court, but no later than 2 days before hearing. CCP §527. See Practice Tip in §7.46.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.50 (2) Form: Notice of Motion for Preliminary Injunction

§7.50 (2) Form: Notice of Motion for Preliminary Injunction

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	)	**No.** _ _ _ _ _ _
	)	**NOTICE OF MOTION**
vs	)	**FOR PRELIMINARY**
	)	**INJUNCTION; SUPPORTING**
_ _[*Name(s)*]_ _, **Defendant(s)**	)	**MEMORANDUM;** **SUPPORTING**
	)	**DECLARATIONS**
	)	
	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
	)	**Hearing judge:** _ _[*if known*]_ _
	)	**Action filed:** _ _[*date*]_ _
_____	)	**Trial date:** _ _[*if set*]_ _

To defendant and defendant's attorney:

PLEASE TAKE NOTICE that on _ _[*date and time*]_ _, or as soon thereafter as counsel can be heard, in Department _ _[*number*]_ _ of the above-titled Court, located at _ _[*address*]_ _, plaintiff will move for a preliminary injunction as prayed for in the complaint on file in this action, enjoining defendant and defendant's agents, officers, employees, and representatives, from selling, attempting to sell, or causing to be sold the trust property described in the complaint on file in this action, either under the power of sale in the deed of trust or by foreclosure action. This motion will be made on the following grounds: _ _[*Summarize factual grounds; see §§7.26-7.38*]_ _, which are detailed in the complaint on file in this action, plaintiff's supporting declarations, and the supporting memorandum, which are attached to this notice.

The motion is based on this notice; all pleadings, papers, and records on file in this action; matters of which the court takes judicial notice; the accompanying supporting memorandum; and declaration(s) of _ _[*name(s)*]_ _**;** _ _[*and on such evidence as may be presented at the hearing*]_ _**.**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Copies: Original (file with court clerk with proof of service); copies for service (one for each attorney of record and unrepresented party); office copies. For filings at times when the clerk's office is closed, note the "drop box" provisions of Cal Rules of Ct 2.210.

Comment: The primary difference between a preliminary injunction hearing that is noticed by motion and one that is noticed by an OSC is that in a noticed motion the attorney for the moving party sets the hearing date and serves a notice of motion (instead of obtaining an OSC from the court and serving the OSC) on the party to be enjoined. In either event, the moving papers must include a supporting memorandum (see Cal Rules of Ct 3.1113) and supporting declarations (see CCP §527). In courts with more than one department, the proper department in which to move for a preliminary injunction is established by local court rules. The time requirements in CCP §1005 for serving moving, opposing, and reply papers on the hearing on the preliminary injunction must be observed.

The first page of each court paper must show the date, time, and location (if known) of the hearing, the name of the hearing judge (if known), the nature or title of any attached document other than an exhibit, the filing date of the action, and the trial date (if set). Cal Rules of Ct 3.1110(b). A footer showing the court paper's title is required on every page

below the page number. See Cal Rules of Ct 2.110. For rules on format of court papers and on law and motion generally, see Cal Rules of Ct 3.1100-3.1370. On procedure for preliminary injunction motions, see California Civil Procedure Before Trial, chaps 11-13, 32 (4th ed Cal CEB 2004). On captions for court papers, see Civ Proc Before Trial, chap 11. See Cal Rules of Ct 3.1113(h) concerning pagination of supporting memorandum.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.51 c. Bond or Undertaking

§7.51 c. Bond or Undertaking

The trial court has discretion to require a bond or an undertaking when issuing a temporary restraining order (TRO), and courts usually exercise this discretion by imposing a bonding requirement. See *Biasca v Superior Court* (1924) 194 C 366, 228 P 861. If an undertaking is required, the TRO does not become effective until the undertaking is deposited with the court. *Armstrong v Superior Court* (1916) 173 C 341, 159 P 1176; *Heyman & Co. v Landers* (1859) 12 C 107. An "undertaking" means a surety, indemnity, fiduciary, or the like executed by sureties alone. CCP §995.190. A bond may be executed by sureties alone or the principal may join. CCP §995.140.

When a court issues a preliminary injunction, it must require the moving party to give a written undertaking with sufficient sureties (CCP §529), unless the enjoined party waives the requirement (see *City of Los Angeles v Superior Court* (1940) 15 C2d 16, 98 P2d 207) or the court, in its discretion, waives the requirement for an indigent party (*Conover v Hall* (1974) 11 C3d 842, 114 CR 642). The undertaking provides security for damages that may be sustained by the responding party as a result of the preliminary injunction if the court later decides that it was wrongly granted. CCP §529(a). The successful party (on the issue of granting the preliminary injunction) must submit a proposed order to the judge, with an undertaking in the amount ordered within 1 court day after the motion is granted or within the time ordered. Cal Rules of Ct 3.1150(f).

The undertaking requirement on preliminary injunctions, when applicable, is jurisdictional; if a court fails to require an undertaking, or if the undertaking is not given, the injunction is inoperative (*Federal Automotive Servs. v Lane Buick Co.* (1962) 204 CA2d 689, 22 CR 603) and may be dissolved on motion of the enjoined party (*Neumann v Moretti* (1905) 146 C 31, 79 P 512). An undertaking given on a TRO expires with the order, and a new one must be posted for a preliminary injunction. *Maier v Luce* (1923) 61 CA 552, 215 P 399.

NOTE: The requirements for bonds are different if the claim is brought under federal law in federal court. In particular, although a bond is required, the court has discretionary power under Fed R Civ P 56(c) to determine the amount that it "considers proper to pay the costs and damages sustained by any party found to have been wrongfully enjoined," or the court can waive the bond requirement if the enjoined party is unlikely to suffer harm. See *International Controls Corp. v Vesco* (2nd Cir 1974) 490 F2d 1334, 1356.

The sureties on an undertaking in state court may be either individual or corporate. CCP §995.310. All sureties who issue bonds or undertakings on preliminary injunctions must meet the standards in Cal Rules of Ct 3.1130. See Cal Rules of Ct 3.1150(g). Challenges to the sufficiency of the sureties or the amount of the undertaking or to any other cause are made by noticed motion under CCP §§995.910-995.960 and must be filed within 5 days after the undertaking is filed. CCP §529. The quality, not the mere number, of sureties establishes their sufficiency under CCP §529. *River Trails Ranch Co. v Superior Court* (1980) 111 CA3d 562, 168 CR 747.

Because it is not a provisional remedy, a permanent injunction issued after trial is not conditioned on a bond or undertaking. *Shahen v Superior Court* (1941) 46 CA2d 187, 115 P2d 516.

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§7.52 d. Amount

The undertaking or bond is intended to provide security to the beneficiary for any damages it suffers from a preliminary injunction if a court subsequently decides that it was wrongly granted. The deed of trust itself is not impaired, and once the injunction is vacated the beneficiary may continue under it to realize on the security. Requiring an undertaking equal to the principal obligation is therefore probably improper because it duplicates the security of the deed of trust. The undertaking need only protect the beneficiary against otherwise uncompensated losses resulting from delay in enforcement of the deed of trust. See §§7.51-7.52.

If the security is declining in value, an undertaking represented by monthly deposits of the interest owed on the remaining indebtedness is one alternative. Setting a bond that is excessively large or unrelated to any damage that an injunctive delay may cause constitutes a denial of due process to the trustor. *Lindsey v Normet* (1972) 405 US 56, 31 L Ed 2d 36, 92 S Ct 862.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.53 5. Lis Pendens

§7.53 5. Lis Pendens

A notice of action pending (lis pendens) should be recorded immediately after the complaint seeking to enjoin the sale has been filed. The purpose of the lis pendens is to put all subsequent purchasers of the property on notice of the plaintiff's claim. *Putnam Sand & Gravel Co. v Albers* (1971) 14 CA3d 722, 92 CR 636. Consequently, even if a preliminary injunction is denied and the trustee sale proceeds, the fact that a lis pendens has been recorded will cause the purchaser to take subject to the plaintiff's ultimate claims. The foreclosure purchaser will not qualify as a bona fide purchaser (BFP) able to take advantage of the conclusive presumptions of regularity in the recitals of the trustee's deed. See CC §2924.

WARNING: The service requirements for creating a lis pendens are rigorous, and failure to comply with those requirements will result in a void lis pendens that imparts no actual or constructive notice of the action. CCP §§405.22-405.23.

Counsel may consider sending a demand letter (see form in §7.30) before filing suit to obtain loan documents from which counsel may learn of additional parties or additional notice requirements. Counsel may wish to obtain a preliminary report on title (or research the California Secretary of State's website to determine agents for service of process) and use Internet search engines to find additional addresses for which service of process may be effectuated.

For comprehensive discussion of lis pendens procedures and practice forms, see California Real Property Remedies and Damages, chap 13 (2d ed Cal CEB 2002).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.54 E. Appealing Temporary Restraining Orders

§7.54 E. Appealing Temporary Restraining Orders

A direct appeal may be taken from an order issuing or dissolving, or refusing to issue or dissolve, a temporary restraining order (TRO) or preliminary injunction. CCP §§904.1(a)(6) (unlimited civil cases), 904.2(g) (limited civil cases). However, direct appeals of interim injunctive orders are not particularly effective, because the case may proceed to trial and judgment before the appeal can be heard. Instead, interim orders are often challenged by way of extraordinary writs. See California Civil Procedure Before Trial, chap 32 (4th ed Cal CEB 2004); California Civil Writ Practice §§16.150-16.151 (4th ed Cal CEB 2008).

A final judgment either issuing or denying a permanent injunction is also appealable. CCP §§904.1(a)(1), 904.2(a); *U.S. Hertz, Inc. v Niobrara Farms* (1974) 41 CA3d 68, 116 CR 44.

When an injunction is denied, the trial court, to preserve the status quo pending appeal, has authority either to issue a TRO or to continue a preliminary injunction previously issued. *City of Pasadena v Superior Court* (1910) 157 C 781, 109 P 620. The trial court has this power even after a notice of appeal has been filed. *General Elec. Co. v Federal Employees' Distrib. Co.* (1955) 132 CA2d 649, 282 P2d 941. If the trial court has dissolved a previously issued injunction or has otherwise refused to enjoin a trustee sale pending appeal, the claimant may petition the appellate court for a stay or a writ of supersedeas to preserve the status quo pending appeal. CCP §923; Cal Rules of Ct 8.112. See *People ex rel San Francisco Bay Conserv. & Dev. Comm'n v Town of Emeryville* (1968) 69 C2d 533, 72 CR 790. See generally California Civil Appellate Practice (3d ed Cal CEB 1996). In *Hunt v Smyth* (1972) 25 CA3d 807, 101 CR 4, a trustor who obtained a preliminary injunction before the reinstatement period expired but ultimately lost on the merits was given the remaining unused portion of the previous reinstatement period by the appellate court. It is likely that this result is an aberration rather than a conscious decision by the courts to permit every defaulting trustor to extend the time of reinstatement by the delays the trustor can cause by manipulating the judicial system. Amendments to CC §2924c enacted since *Smyth* may provide the debtor with additional opportunities to reinstate. See in particular CC §2924g(d).

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§7.55 F. Improper Attempts to Enjoin

If a temporary restraining order or preliminary injunction is granted but the court subsequently rules that such relief was improper, the plaintiff is liable for any loss from a decline in the value of the security that occurred during the postponement period. *Surety Sav. & Loan Ass'n v National Auto. & Cas. Ins. Co.* (1970) 8 CA3d 752, 87 CR 572. Thus, if property originally worth $100,000 declined in value to $95,000 during the pendency of an interim injunctive order, a beneficiary owed $100,000 or more may recover $5000 in damages for the delay. But if the beneficiary was owed only $95,000 or less, it has no recoverable damages, because even a sale at this reduced value produces funds sufficient to satisfy the debt.

On other damages, a successful beneficiary may recover attorney fees, interest, loss of rental income, and costs of protecting the property, as appropriate. *Surety Sav. & Loan Ass'n v National Auto. & Cas. Ins. Co., supra*. Also, the claimant's attorney may be liable for using dilatory tactics in enjoining a foreclosure. *Kapelus v Newport Equity Funds, Inc.* (1983) 147 CA3d 1, 194 CR 893 (sanctions of $5000 imposed against debtor and debtor's attorney). Of course, if the debtor is successful in enjoining a sale and the loan documents provide for attorney fees to the prevailing party, the debtor may recover attorney fees under CC §1717. *Valley Bible Ctr. v Western Title Ins. Co.* (1983) 138 CA3d 931, 188 CR 335.

Recovery against the unsuccessful trustor is generally satisfied by the bond the trustor was required to furnish. Language in CCP §529 appears to limit damages to the amount specified in the bond. See *Surety Sav. & Loan Ass'n v National Auto. & Cas. Ins. Co., supra*. If so, further damages are recoverable only by a separate action for abuse of process or for malicious prosecution. See *Dickey v Rosso* (1972) 23 CA3d 493, 100 CR 358.

The antideficiency rules may not protect a trustor from damage liability for improperly delaying a sale, although no appellate court has ruled directly on this issue. See *Passanisi v Merit-McBride Realtors, Inc.* (1987) 190 CA3d 1496, 1509, 236 CR 59 (CCP §580d did not bar attorney fee award to beneficiary who successfully resisted trustor's action to enjoin foreclosure sale). See also *Jones v Union Bank* (2005) 127 CA4th 542, 25 CR3d 783 (neither antideficiency rules nor CC §§2924c-2924d barred award of attorney fees to beneficiary who successfully defended action to set aside sale), cited in §7.60. Although antideficiency rules generally shift the risk of loss because of decline in value of the security over time from the owner of the security to the creditor, the bargain is that the creditor may promptly commence foreclosure when a default occurs and does not contemplate additional delays caused by improper injunctive relief obtained by the owner. An unsuccessful action for an injunction may be treated as analogous to waste, justifying monetary recovery against even a deficiency-protected trustor if it was sought in bad faith. See §4.40. See also *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557.

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VI. SETTING ASIDE TRUSTEE SALE

A. Parties to Set-Aside Action

§7.56 1. Plaintiffs

Any party having the right to reinstate a loan after a default under the deed of trust (see CC §2924c; see also §§2.5, 2.52, 6.63, 9.57), to redeem the property from the lien of the deed of trust (CC §§2903-2904; see §2.73), or to receive automatic notice of default (CC §2924b(c)(2); see §2.43) should have standing to set aside an improper trustee sale. *Munger v Moore* (1970) 11 CA3d 1, 89 CR 323. But see *Bertschman v Covell* (1928) 205 C 707, 272 P 571. On grounds for setting aside sale, see §§7.67-7.68.

The trustor (or other party plaintiff, *e.g.,* a junior lienholder) may sue either to have the sale set aside or to quiet title against the purchaser at the sale. See *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826; *Taliaferro v Crola* (1957) 152 CA2d 448, 313 P2d 136; *Brown v Busch* (1957) 152 CA2d 200, 313 P2d 19; *Standley v Knapp* (1931) 113 CA 91, 298 P 109; *Henderson v Fisher* (1918) 38 CA 270, 176 P 63.

The plaintiff is not required to have previously sought to enjoin the sale and is not estopped from raising issues that could have been argued before the sale. See *Hauger v Gates* (1954) 42 C2d 752, 269 P2d 609. A trustor is not required to seek damages for wrongful sale of the property if the trustor seeks to have the title restored. See *Marlenee v Brown* (1943) 21 C2d 668, 134 P2d 770; *Strutt v Ontario Sav. & Loan Ass'n* (1970) 11 CA3d 547, 90 CR 69; *Standley v Knapp, supra*.

If the trustee files a bankruptcy petition either before or after the sale, any unresolved claims against the beneficiary or trustee must be listed as an asset in Schedule B to preserve the claim. See §§7.84, 12.150. When the trustor is in bankruptcy, the right to sue to set aside the sale is vested in the bankruptcy trustee, unless the trustee has abandoned the claim or the debtor has obtained bankruptcy court approval to proceed with the claim. *Bostanian v Liberty Sav. Bank* (1997) 52 CA4th 1075, 61 CR2d 68. A debtor in a Chapter 13 case or a debtor in possession in a Chapter 11 case has the same rights as a bankruptcy trustee. The claim must be scheduled as personal property of the estate to preserve its value in the event a bankruptcy trustee decides not to administer the estate because it is a "no asset case."

NOTE: A "no asset" case is one in which the scheduled or recoverable assets, less encumbrances and exemptions, are insufficient to generate any funds for creditors. Failure to schedule trustor's claims as even a contingent unliquidated asset in Schedule B can result in the dismissal of a subsequent state court action. See *Cloud v Northrop Grumman Corp.* (1998) 67 CA4th 995, 1012, 79 CR2d 544; *Robinson v National Auto. & Cas. Ins. Co.* (1955) 132 CA2d 709, 713, 282 P2d 930. The bankruptcy trustee in a "no asset" case does not formally "close" the case but instead files a "no asset" report, which results in the bankruptcy court clerk's filing a closing order as a ministerial act.

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§7.57 2. Junior Creditors

A trustor must ordinarily demonstrate injury resulting from the alleged impropriety in the sale. See *Sargent v Shumaker* (1924) 193 C 122, 133, 223 P 464; *Dawes v Tucker* (1918) 178 C 46, 171 P 1068; *California Trust Co. v Smead Inv. Co.* (1935) 6 CA2d 432, 44 P2d 624; *American Trust Co. v deAlbergaria* (1932) 123 CA 76, 10 P2d 1016. Similarly, a junior creditor who attacks the sale must show actual harm from the faulty sale, *i.e.,* that the presale value of the security was sufficient to protect the junior. See *Hill v Gibraltar Sav. & Loan Ass'n* (1967) 254 CA2d 241, 62 CR 188. Because a senior creditor is unaffected by a junior sale, there is no reason to permit it to sue to have a junior sale set aside. After the sale, the senior may be able to accelerate under its due-on-sale clause (see §§8.8, 8.19-8.23).

It is more difficult for a junior lienholder than for a trustor to set aside a sale, because damages are usually an adequate remedy for an unpaid creditor. See *United States Cold Storage v Great W. Sav. & Loan Ass'n* (1985) 165 CA3d 1214, 212 CR 232. See also *FPCI RE-HAB 01 v E&G Invs., Ltd.* (1989) 207 CA3d 1018, 255 CR 157 (sold-out junior lienholder failed to show that it was damaged when notice of sale given by prior creditor claimed entire amount stated in its wraparound deed of trust).

The court in *Arnolds Mgmt. Corp. v Eischen* (1984) 158 CA3d 575, 205 CR 15, held that a junior lienholder who had not received notice of a trustee sale was nevertheless required to tender the entire balance due as a condition to setting aside the sale, but that requirement was disapproved in *United States Cold Storage v Great W. Sav. & Loan Ass'n, supra*. See *Abdallah v United Sav. Bank* (1996) 43 CA4th 1101, 1109, 51 CR2d 286. (For discussion of some of these cases, see 12 CEB Real Prop L Rep 135 (May 1989).) The extension of reinstatement rights until 5 business days before a sale (CC §2924c(e)) will also support a junior's claim that it should not be required to satisfy the entire debt as a condition for challenging a defective senior sale, because reinstating rather than redeeming is all it would have had to do to stop the senior sale had it received proper notice.

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§7.58 3. Guarantors

Guarantors, "indemnitors," and other parties potentially liable for deficiency judgments after the trustee sale usually have no need to set aside the sale, because the sale's invalidity should constitute a direct defense in any action brought against them. See CC §2845. See also *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 98 CR 735; *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64; *Mortgage Fin. Corp. v Howard* (1962) 210 CA2d 569, 26 CR 917. But see *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 37 CR3d 83.

Such defenses, however, may be of no avail against a transferee of the note who is a holder in due course (see *Szczotka v Idelson* (1964) 228 CA2d 399, 39 CR 466) or if the guaranty or indemnity agreement waives the requirements of CC §2845 (as most do). To the extent that the invalidity of the sale is not available to the guarantor as a defense, the guarantor should have standing to challenge the sale. On guarantors' rights in foreclosure, see chap 9.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.59 4. Defendants

§7.59 4. Defendants

The foreclosure purchaser is an essential party when the action is to set aside a completed trustee sale (rather than to enjoin a pending one). The trustee and beneficiary should also be named as defendants; they are indispensable parties. *Washington Mut. Bank v Blechman* (2007) 157 CA4th 662, 69 CR3d 87 (holding that default judgment declaring sale null and void only against successful third party bidder at trustee sale did not preclude collateral attack on judgment by seller (former secured creditor) and trustee). The trustee may sometimes decline to participate in an action in which it is named solely in its capacity as trustee. See §§1.42, 3.36, 3.61.

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§7.60 B. Factors That Limit Postsale Attacks

It may be to the trustor's advantage to obtain an injunction against the sale as early as possible. See §§7.23-7.24. The following are some of the disadvantages of trying to overturn a completed sale:

- If the sale is upheld (*i.e.,* the purchaser prevails on the merits), the trustor has no further opportunity to reinstate the loan. (In contrast, if the trustor loses an action to enjoin the sale, the court may grant additional time to reinstate. See *Hunt v Smyth* (1972) 25 CA3d 807, 101 CR 4. See also §7.54.)
- The trustor risks dealing with the special defenses of bona fide purchasers (BFPs) who either purchased at the foreclosure sale or who purchased subsequently from a credit-bidding beneficiary at the sale. See *Weingard v Atlantic Sav. & Loan Ass'n* (1970) 1 C3d 806, 819, 83 CR 650; *Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413; *Strutt v Ontario Sav. & Loan Ass'n* (1970) 11 CA3d 547, 90 CR 69. See also §7.65.
- The law provides presumptions about the validity of the sale arising from recitals in the trustee's deed. See §§7.61-7.63.
- Both pre- and postsale attacks expose the borrower to attorney fee liability when the attack fails and the loan documents contain attorney fee provisions. See *Jones v Union Bank* (2005) 127 CA4th 542, 25 CR3d 783; *Passanisi v Merit-McBride Realtors, Inc.* (1987) 190 CA3d 1496, 236 CR 59.

When an unsuccessful challenge occurs prior to sale, the creditor may elect to include the attorney fees in the debt as a "protective advance" or may make a bid at foreclosure that, whether by design or by inadvertence, includes the fees and has the effect of relieving the borrower of the personal exposure. But as a practical matter, the borrower is more clearly exposed to fees in a failed postsale challenge, when there is little such "cover," and the fee award will almost always be a salient and stand-alone personal liability of the borrower. See, *e.g*., *Jones v Union Bank, supra*. On attorney fees, see §§8.83-8.90.

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§7.61 1. Presumption of Validity

A trustor's rights are best preserved by attempting to enjoin the foreclosure sale beforehand rather than waiting until the sale is held and then filing an action to set it aside or defending against the attempt of the foreclosure sale purchaser to evict the trustor. The principal reason is the presumption of the validity of the sale that arises from recitals in the trustee's deed. See §§7.62-7.63. Tactical advantages are also involved even though the trustor is generally permitted to assert the same grounds in a postsale attack that could have been raised in a presale attack. *Mersfelder v Spring* (1903) 139 C 593, 73 P 452; *Py v Pleitner* (1945) 70 CA2d 576, 161 P2d 393; *Holland v Pendleton Mortgage Co.* (1943) 61 CA2d 570, 143 P2d 493.

Whether the facts in a case justify setting aside a trustee sale is largely a matter for the trial court's discretion. *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826; *Brown v Busch* (1957) 152 CA2d 200, 313 P2d 19. In the absence of contrary evidence, the sale is presumed to have been conducted fairly and with regularity. *Hohn v Riverside County Flood Control & Water Conserv. Dist.* (1964) 228 CA2d 605, 39 CR 647; *Brown v Busch, supra*.

The pattern of both published and unpublished appellate decisions suggests some impatience on the part of the courts with hyper-technical attacks on trustee sales. Trial and appellate courts will entertain attacks on sales in the face of "irregularities" only if they can be shown to be "more than minor" and to have caused prejudice. See, *e.g., Knapp v Doherty* (2004) 123 CA4th 76, 20 CR3d 1 (premature delivery of notice of sale was "trivial" defect); *Woodward v Washington Mut. Bank* (May 6, 2004, G031422; not certified for publication) 2004 Cal App Unpub Lexis 4471, 2004 WL 966212; *Aulisio v Summit Homeowner's Ass'n* (Sept. 29, 2003, C042830; not certified for publication) 2003 CA Unpub Lexis 9349, 2003 WL 22229550.

As a result of amendments made to California's foreclosure laws in 2008 and 2009 under SB 1137 (2008) and SB 306 (2009) (see §§2.37-2.38, 2.49, 2.63, 2.65, 2.68, 7.38-7.39), both sides to a foreclosure sale may experience greater uncertainty. This is because the courts have not yet ruled on whether the additional prerequisites to a trustee sale are crucial enough to justify enjoining or setting aside the sale when they are not met. For example, CC §2923.5 precludes the recordation of a notice of default until 30 days after the lender contacts the borrower or 30 days after the lender satisfies specified "due diligence" requirements for contacting the borrower. The statute further requires specific recitals concerning contact and due diligence in the notice of default or sale. Civil Code §2924.8 requires the posting and mailing of an additional notice for the benefit of residential tenants when posting and mailing the notice of sale if the billing address for the note is different from the property address.

In February 2009, the legislature enacted (for a relatively small class of residential loans) the California Foreclosure Prevention Act (CFPA) as an emergency measure at a second 2008-2009 legislative session as ABX2 7 (Stats 2008, 2d Extra Sess, ch 5). The CFPA sunsets on January 1, 2011, unless extended. CFPA §§2-7. The primary purpose was to impose an additional 90-day waiting period in the nonjudicial foreclosure process before issuing a notice of trustee sale. See §§2.62-2.62A.

The presumption that a trustee sale is valid does not always cut in favor of the foreclosing creditor. For example, in *6 Angels, Inc. v Stuart-Wright Mortgage, Inc.* (2001) 85 CA4th 1279, 102 CR2d 711, the court of appeal relied on the presumption of validity to affirm the summary adjudication in favor of a bidder who purchased property at a trustee sale for one cent over a credit bid of $10,000, which the foreclosing lender claimed should have been for $100,000.

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§7.62 a. Trustee's Recitals

Most deeds of trust provide that the trustee's deed (issued after a foreclosure sale) may contain the trustee's recitals regarding the regularity of the sale proceeding and that these recitals constitute conclusive proof of their truthfulness. Consistent with such a provision, a typical trustee's deed will recite the following:

- There was a default, and a notice of default was recorded and has not been cured;
- Three months elapsed between recording the notice of default and posting the notice of sale;
- There was a proper demand to sell;
- There was proper notice of time and place of sale;
- There was compliance with the requirements for mailing and posting notices; and
- There was a proper public auction and sale to the high bidder.

Under the authorizing stipulation in the deed of trust, these six "facts" are intended to be incontrovertible when a trustor is challenging the validity of a trustee sale of the property. See *Mersfelder v Spring* (1903) 139 C 593, 73 P 452; *Pierson v Fischer* (1955) 131 CA2d 208, 280 P2d 491. But see *Seccombe v Roe* (1913) 22 CA 139, 133 P 507. See also *Little v CFS Serv. Corp.* (1987) 188 CA3d 1354, 1359, 233 CR 923 (dictum). However, CC §2953 outlaws waivers of trustors' rights on foreclosure and may be read to invalidate the authorizing provisions in the deed of trust if the trustor can show that the facts did not occur as recited. See 4 Witkin, Summary of California Law, *Security Transactions in Real Property* §164 (10th ed 2005).

Older cases are split on the conclusiveness of these recitals. Some cases gave protection to all purchasers (*Cobb v California Bank* (1936) 6 C2d 389, 57 P2d 924; *Sorensen v Hall* (1934) 219 C 680, 683, 28 P2d 667; *Bank of America v McLaughlin Land & Livestock Co.* (1940) 40 CA2d 620, 105 P2d 607), while others limited protection to bona fide purchasers (BFPs) (*Harker v Rickershauser* (1928) 94 CA 755, 271 P 912; *Seccombe v Roe, supra*). Some cases suggested an exception for "fraud of which the purchaser at the trustee's sale was aware." *Jose Realty v Pavlicevich* (1913) 164 C 613, 617, 130 P 15. Still other cases suggested that the conclusive presumption would not apply in an equitable proceeding; this would then exclude application of the presumption to an ejectment action, which is at law instead. *Mersfelder v Spring* (1903) 139 C 593, 595, 73 P 452. See California Real Property Remedies and Damages, chap 10 (2d ed Cal CEB 2002).

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§7.63 b. Statutory Recitals

The present effect of the trustee's deed recitals (described in §7.62) is modified by CC §2924, which provides a statutory basis for the validity of certain recitals. This section limits the scope of the recitals in two respects. First, only the recitals on giving notice (mailing, publication, delivery, and posting) are included in §2924, leaving out the other recitals (of default, proper delay, demand to sell, and proper sale). See, *e.g., Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413. The effect of these omissions is discussed below. Second, the recitals are conclusive only when a bona fide purchaser (BFP) or encumbrancer is involved. See *Garfinkle v Superior Court* (1978) 21 C3d 268, 279 n16, 146 CR 208; *Estate of Yates v West End Fin. Corp.* (1994) 25 CA4th 511, 32 CR2d 53. In other cases, the recitals are merely prima facie and rebuttable evidence of compliance. *Wolfe v Lipsy* (1985) 163 CA3d 633, 209 CR 801; *Beck v Reinholtz* (1956) 138 CA2d 719, 292 P2d 906; *Seidell v Tuxedo Land Co.* (1934) 1 CA2d 406, 36 P2d 1102.

Civil Code §2924 also appears to protect recitals in the trustee's deed even if they were not earlier authorized in the deed of trust itself. But because all deeds of trust inevitably authorize these recitals, it is unlikely that the occasion will ever arise for a court to determine the status of recitals falling within the scope of the statute but not authorized by the deed of trust.

The statute itself creates no presumption of regularity; it merely gives special effect to documentary recitals of regularity. Thus, a beneficiary or trustee commencing a trustee sale should first look to the deed of trust to ascertain what recitals are permitted (or—if the loan itself has not yet been made—to determine whether the authorization of recitals is sufficiently broad) and then make sure that the recitals in the intended trustee's deed conform to them as well as, perhaps, to §2924.

The conclusive presumption created by §2924 is constitutionally valid, even against a junior lienholder who never signed the authorizing deed of trust and did not receive notice of the senior sale. Because the trustee sale statutes restrict private action (foreclosure) rather than enable it, they do not constitute a state action that would compel the protection of a junior's due process rights. *Garfinkle v Superior Court, supra; Homestead Sav. v Darmiento* (1991) 230 CA3d 424, 281 CR 367.

The judiciary has made no significant distinctions between the validity or effect of the recitals in terms of their foundation in the deed of trust versus their endorsement in the legislation. The recitals could perhaps be held effective on contract grounds even if they do not come under the protection of CC §2924. Thus a recital of the regularity of the sale itself might be held to be conclusive even if the claimed irregularity had nothing to do with lack of notice and the sale was made to the beneficiary itself (concededly not a BFP). The preclusive effect of the recitals is likely to be held to depend entirely on §2924 rather than on the authorizing language of the deed of trust. The scope of the recitals will be given the breadth of what the deed of trust authorizes rather than restricted to the recitals in the statute. *Cobb v California Bank* (1936) 6 C2d 389, 57 P2d 924; *Sorensen v Hall* (1934) 219 C 680, 683, 28 P2d 667; *Bank of America v McLaughlin Land & Livestock Co.* (1940) 40 CA2d 620, 105 P2d 607.

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§7.64 c. If No Trustee's Deed Issued or If Issued Late

The special protection afforded by the recitals in the trustee's deed arises only if the deed is actually executed and delivered to the foreclosure purchaser. Although CC §2924h provides that a trustee sale is "deemed final upon the acceptance of the last and highest bid," the courts also require that a trustee's deed be delivered before the recitals in it have any special effect. *Angell v Superior Court* (1999) 73 CA4th 691, 86 CR2d 657 (wrong amounts stated); *Little v CFS Serv. Corp.* (1987) 188 CA3d 1354, 1359, 233 CR 923 (lack of notice). But see *Moeller v Lien* (1994) 25 CA4th 822, 30 CR2d 777. Thus, a trustee who discovers an irregularity after the hammer has fallen but before its deed is delivered may thereafter refuse to deliver the deed. *Whitman v Transtate Title Co.* (1985) 165 CA3d 312, 211 CR 582. Also, a trustee may abort a foreclosure sale if the trustee learns after concluding the auction but before delivering the deed that the trustor and the beneficiary had previously agreed to postpone the sale. See *Residential Capital, LLC v Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 134 CR2d 162, cited in §§2.79, 2.96, 2.101.

NOTE: If a trustee's deed is duly recorded and thereafter an irregularity is discovered, there is no statutory basis on which the deed may be rescinded and the foreclosure process renewed. Civil Code §1058.5(b) provides for the rescission of a trustee's deed only when the deed is "invalidated by a pending bankruptcy or otherwise." See *Bank of America v La Jolla Group II* (2005) 129 CA4th 706, 717, 28 CR3d 825. Nevertheless, trustees will and do attempt to rescind trustees' deeds on the grounds that "this is how it has always been done" or "the title company said so." In addition, the trustor may have damage claims that are not mitigated by the trustee's (successful or unsuccessful) rescission of the deed.

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§7.65 2. Bona Fide Purchaser (BFP)

To gain statutory protection against attacks by the trustor or other aggrieved parties over sale improprieties, the foreclosure sale purchaser must qualify as a BFP or encumbrancer "for value and without notice."

A beneficiary who purchases at its own sale by a credit bid does not qualify as a BFP. *20th Century Plumbing Co. v Sfregola* (1981) 126 CA3d 851, 179 CR 144; *Tomczak v Ortega* (1966) 240 CA2d 902, 50 CR 20. It is unclear whether the beneficiary can elevate itself to BFP status by adding cash to its credit bid.

A third party who purchases at the trustee sale without notice of any claim of invalidity qualifies as a BFP. *Sorensen v Hall* (1934) 219 C 680, 28 P2d 667. A third party who later purchases for value, and without notice, from a beneficiary who purchased at its own sale may be similarly protected. But see *Di Nola v Allison* (1904) 143 C 106, 76 P 976. The plaintiff in an action to set aside the sale should therefore record a lis pendens as soon as the complaint is filed to prevent a subsequent taker from qualifying as a BFP. See *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 98 CR 735. See also §7.74. If the property is acquired by a BFP, the plaintiff's recovery for a wrongful foreclosure sale may be limited to damages against the beneficiary or the trustee.

Real property lawyers have long debated whether professional distressed property buyers who acquire property at a foreclosure sale for prices substantially less than market value qualify as BFPs. Those arguing that they should not so qualify tend to emphasize the less-than-heroic conduct of these buyers. Others argue that distressed property buyers play a valuable recycling role by creating a market for foreclosure properties. At least one court of appeal decision, *Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413, rejected the argument that speculative bidders who buy low at foreclosure sales cannot qualify as BFPs.

PRACTICE TIP: The court in *Melendrez* noted that foreclosure law is designed to encourage the activities of such bidders and a more vigorous auction process. Following *Melendrez*, those seeking to attack sales to professional bidders should focus more on identifying facts that may defeat BFP status and that demonstrate the lack of truly competitive bidding.

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§7.66 3. Value Versus Sale Price

The traditional recordation law's requirement of value has meant that the purchaser must pay more than merely nominal value (*U.S. v Certain Parcels of Land Situated in San Bernardino County* (SD Cal 1949) 85 F Supp 986), but many courts have protected foreclosure purchasers even when their bids were significantly below market. See, *e.g., Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413 (sale for $197,100 of property valued at up to $380,000); *Moeller v Lien* (1994) 25 CA4th 822, 30 CR2d 777 (sale for 25 percent of market value); *Baldwin v Brown* (1924) 193 C 345, 224 P 462 (sale for 10 percent); *Crofoot v Tarman* (1957) 147 CA2d 443, 305 P2d 56 (sale for 40 percent); *Eigenhuis v Morris* (1934) 136 CA 333, 28 P2d 928 (sale for 20 percent). See also the judicial foreclosure case *Amalgamated Bank v Superior Court* (2007) 149 CA4th 1003, 57 CR3d 686 (sale for $2000 of property valued at $6.5 million).

In general, the fact that the amount bid is below the property's market value is not by itself a sufficient ground to set aside a trustee sale. *Central Nat'l Bank v Bell* (1936) 5 C2d 324, 54 P2d 1107; *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826. See *BFP v Resolution Trust Corp.* (1994) 511 US 531, 545, 128 L Ed 2d 556, 457, 114 S Ct 1757, holding that the price bid at the foreclosure sale is fair and reasonable as long as all the requirements of the state's foreclosure law have been met. "Any irregularity in the conduct of the sale that would permit judicial invalidation of the sale under applicable state law deprives the sale price of its conclusive force." Only a slight irregularity will invalidate a sale if the bid is grossly inadequate. *Whitman v Transtate Title Co.* (1985) 165 CA3d 312, 211 CR 582. Compare *Estate of Yates v West End Fin. Corp.* (1994) 25 CA4th 511, 32 CR2d 53 (professional foreclosure purchaser who had notice of irregularity in trustee sale and bought property for $12,000 (from buyer who had paid only $5000 at trustee sale for property worth $120,000) not a BFP), with *Melendrez v D & I Inv., Inc., supra,* discussed in §7.65.

The Restatement of Mortgages proposes that sales at "grossly inadequate" prices be set aside and puts that standard generally at less than 20 percent of fair market value. Restatement (Third) of Property: Mortgages §8.3, Comment b (1997).

PRACTICE TIP: The vigor of the bidding at the foreclosure auction is another factor that may color a court's perception of whether a bid is "grossly inadequate." See, *e.g., Melendrez v D & I Inv., Inc., supra* (successful bid in *Melendrez* was probably high enough in absolute terms to avoid claim of "gross inadequacy").

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C. Grounds for Setting Aside Sale

§7.67 1. Compared With Grounds for Enjoining Sale

A completed sale may be set aside on the same grounds that would support an action to enjoin the sale (see §§7.25-7.38), unless the property has been purchased by a BFP (see §7.65), in which case the plaintiff may be limited to money damages. See *Weingard v Atlantic Sav. & Loan Ass'n* (1970) 1 C3d 806, 819, 83 CR 650. See also §7.70. Justifications in reported cases for setting aside the trustee sale include the following:

- Assertions that no breach occurred or that the trustee did not have the power to foreclose. *Hauger v Gates* (1954) 42 C2d 752, 269 P2d 609 (setoff equaled amount owed); *Bank of America v La Jolla Group II* (2005) 129 CA4th 706, 28 CR3d 825 (reinstatement of loan); *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 98 CR 735 (waiver of breach); *Saterstrom v Glick Bros. Sash, Door & Mill Co.* (1931) 118 CA 379, 5 P2d 21 (void deed of trust); *Van Noy v Goldberg* (1929) 98 CA 604, 277 P 538 (debt not matured).
- Attacks on the presale foreclosure process. *Estate of Yates v West End Fin. Corp.* (1994) 25 CA4th 511, 32 CR2d 53; *Strutt v Ontario Sav. & Loan Ass'n* (1972) 28 CA3d 866, 105 CR 395; *Standley v Knapp* (1931) 113 CA 91, 298 P 109; *Seccombe v Roe* (1913) 22 CA 139, 133 P 507.
- Improper conduct by the trustee or beneficiary at the sale itself. *Pierson v Fischer* (1955) 131 CA2d 208, 280 P2d 491.
- Gross disparity between sale price and property value, combined with evidence of even slight unfairness or irregularity in the sale process. See *Stevens v Plumas Eureka Annex Mining Co.* (1935) 2 C2d 493, 41 P2d 927; *Sargent v Shumaker* (1924) 193 C 122, 223 P 464; *Estate of Yates v West End Fin. Corp., supra; Lopez v Bell* (1962) 207 CA2d 394, 24 CR 626; *Foge v Schmidt* (1951) 101 CA2d 681, 226 P2d 73. (Miscommunication related to an agreement for postponement of the foreclosure sale is not the type of irregularity that justifies setting the sale aside. See *Nguyen v Calhoun* (2003) 105 CA4th 428, 129 CR2d 436.)
- Purported sale conducted by a former trustee who was substituted out before the sale was completed and a trustee's deed delivered. *Pro Value Props., Inc. v Quality Loan Serv. Corp.* (2009) 170 CA4th 579, 88 CR3d 381; *Dimock v Emerald Props., LLC* (2000) 81 CA4th 868, 97 CR2d 255. But see *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859, cited in §§2.22, 2.25-2.26, 2.74, 2.98.

In most of these situations, the trustor-borrower must overcome the presumptions of regularity that apply to a completed sale. See §§7.60-7.66.

PRACTICE TIP: Borrower's counsel relying on minor procedural irregularities should develop evidence, insofar as the facts permit, that the irregularities caused prejudice to the client. See *Knapp v Doherty* (2004) 123 CA4th 76, 20 CR3d 1, for a case in which a failure to demonstrate prejudice to the borrower was fatal to the borrower's challenge, despite an admitted irregularity in the service of the notice of sale.

When there has been suspicious conduct by a beneficiary or trustee, counsel should advise clients to attend the foreclosure sale. The failure to actually and duly "cry" the foreclosure sale may constitute an irregularity sufficient to overcome the presumption that the price was fair and reasonable under *BFP v Resolution Trust Corp.* (1994) 511 US 531, 128 L Ed 2d 556, 457, 114 S Ct 1757. See §§7.28, 7.61, 11.86. Counsel should also advise clients purchasing at the foreclosure sale to list the property for a subsequent sale to establish, if a valid purchase offer is made, the amount of damages measured by the difference between the amount bid at foreclosure and the bona fide offer to purchase.

For further discussion of payment disputes and breach of lender obligations that may be grounds for setting aside foreclosure, see chaps 8-9, 12; California Real Estate Finance Practice: Strategies and Forms, chaps 1-5 (Cal CEB 2000). On usury law, see Real Estate Finance, chap 3; Lind, *A Real Estate Attorney's Guide to California Usury Laws,* 18 CEB Real Prop L Rep 271 (Oct. 1995).

On setting aside prebankruptcy foreclosures using avoidable preference doctrine in debtor's bankruptcy proceeding, see §7.112.

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§7.68 2. Commercial Reasonableness

The general requirement of commercial reasonableness regulating dispositions on default under Division 9 of the Commercial Code for personal property generally do not apply to real estate. *C.F. Brookside, Ltd. v Skyview Mem. Lawn Cemetery (In re Affordable Hous. Dev. Corp.)* (BAP 9th Cir 1994) 175 BR 324 (sale of parcels in single block and with allegedly insufficient advertising upheld). The detailed statutory regulation of real estate sales is deemed to supplant the less precise commercial reasonableness requirement of the Commercial Code. However, in *Aspen Enters. v Bodge* (1995) 37 CA4th 1811, 44 CR2d 763, the court imposed a requirement of commercial reasonableness on the election of a creditor holding mixed real and personal property to conduct a unified foreclosure sale, even though such a sale would be expected to be subject solely to the rules of real estate law and not to the Commercial Code. See *Ford & Vlahos v ITT Commercial Fin. Corp.* (1994) 8 C4th 1220, 1233, 36 CR2d 464 (compliance with Commercial Code's notice requirements does not guarantee that sale will be deemed commercially reasonable).

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§7.69 D. Ancillary Relief

An action to set aside a trustee sale is often accompanied by additional causes of action, such as the following:

- To quiet title (CCP §§760.010-765.060; see California Real Property Remedies and Damages, chap 7 (2d ed Cal CEB 2002));
- To cancel one or more instruments of title, including the trustee's deed and possibly the deed of trust (CC §3412; see Real Property Remedies, chap 6);
- For an accounting; and
- For recovery of possession through ejectment (see Real Property Remedies, chap 10) or for recovery of damages for withholding possession (CCP §740).

When attacking a completed trustee sale, the trustor-plaintiff usually seeks to have the sale set aside and the trustee's deed canceled. Additional relief depends on the grounds advanced in seeking to set aside the sale.

- If the grounds are that no lien exists, the complaint should seek cancellation of both the deed of trust and the trustee's deed and should include a cause of action to quiet title.
- If the trustor acknowledges a valid lien but contends that there was no default, the complaint should seek to reinstate the loan in addition to having the sale set aside. An accounting should also be sought if the purported default was monetary.
- If the trustor admits the default but disputes the amount owed, the action may seek either reinstatement or redemption after the sale has been vacated. A cause of action for an accounting will also be necessary.
- If defective sale procedures are alleged (either noncompliance with notice requirements or misconduct at the sale), the trustor will seek either to have the loan reinstated or to obtain the right to redeem the property from the lien after the sale is set aside.

If the sale is set aside and the trustee's deed canceled, the trial court will set a price and time for reinstatement or redemption. On reinstatement and redemption generally, see §§2.51, 2.73. The redemption price should include the correct balance of the debt together with any proper costs the beneficiary (or purchaser) incurred after the sale, but the trustor may be given credit for reasonable postsale rental income. On amount to reinstate, see §§2.57-2.61. Trustee fees for conducting the sale will probably not be allowed to the beneficiary if the sale is declared improper. *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 98 CR 735. On attorney fees, see §§8.83-8.90. Interest and incidental expenses may be awarded at the trial court's discretion. See *Lupertino v Carbahal* (1973) 35 CA3d 742, 111 CR 112; *System Inv. Corp. v Union Bank, supra*.

If the complaint alleges wrongdoing by a third party purchaser and not by either the trustee or the beneficiary, the appropriate relief may be judicial imposition of a constructive trust. See *Roberts v Salot* (1958) 166 CA2d 294, 333 P2d 232; *Lantz v Stribling* (1955) 130 CA2d 476, 279 P2d 112. Further relief may be a mandatory injunction, ordering either that the defendant purchaser convey the property back to the trustor or that the trustee's deed be delivered to the court and canceled. CC §3412. See *Rablin v Greiner* (1935) 4 C2d 255, 48 P2d 696; *Vaughan v Roberts* (1941) 45 CA2d 246, 113 P2d 884. On damages relief, see §7.70.

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§7.70 E. Alternative Relief; Damages

When a foreclosure sale is declared voidable, the plaintiff is entitled to have it set aside or to recover damages. *Standley v Knapp* (1931) 113 CA 91, 298 P 109. When an improper sale cannot be set aside (*e.g.,* because title has passed to a BFP), damages comparable to those for conversion of personal property are the usual and appropriate remedy. See *Munger v Moore* (1970) 11 CA3d 1, 89 CR 323. See also CC §§1708, 3333; *Murphy v Wilson* (1957) 153 CA2d 132, 314 P2d 507. Because an action for damages is legal rather than equitable, the parties are entitled to a jury trial. *Raedeke v Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 111 CR 693; *Bank of Seoul & Trust Co. v Marcione* (1988) 198 CA3d 113, 244 CR 1.

Grounds for relief in damage actions should be the same as those warranting cancellation of the sale, but allegations and proof of monetary loss must also be included. The measure of general damages due the trustor is the value of the lost equity in the property, *i.e.,* the value of the property at the time of sale in excess of all existing liens. *Strutt v Ontario Sav. & Loan Ass'n* (1972) 28 CA3d 866, 875, 105 CR 395; *Munger v Moore, supra*. The measure of damages in favor of an aggrieved junior lienholder is similar, except that the junior's claim cannot exceed the amount due on the junior lien. *Munger v Moore, supra*. For example, if there is a first lien of $100,000 and a second lien of $20,000 on property with a market value of $150,000, the senior lienholder who wrongfully sells the property is liable to the trustor for $30,000 (market value less all liens) and liable to the junior for $20,000 (market value less senior liens, but restricted to the amount of the junior lien).

A sale conducted notwithstanding an automatic stay arising upon the filing of a voluntary bankruptcy petition is void, not voidable. 11 USC §362. See §11.17. In that situation, relief is sought in the bankruptcy court. See §§11.20-11.55.

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§7.71 F. Burden of Proof; Nonjury Trial

A plaintiff challenging the sale has the burden of proof on all issues and must show injury by the alleged irregularity. See *California Trust Co. v Smead Inv. Co.* (1935) 6 CA2d 432, 44 P2d 624; *American Trust Co. v deAlbergaria* (1932) 123 CA 76, 10 P2d 1016.

An action brought solely to set aside the sale is equitable and therefore does not entitle the parties to a jury trial. When a claim for damages is joined with the action, the court may hear the equitable cause of action first. *Raedeke v Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 111 CR 693; *Rablin v Greiner* (1935) 4 C2d 255, 48 P2d 696. When such an order of trial is followed, any findings made by the court in the equity phase will be binding on the jury in the jury phase of the trial. However, because the underlying right to set aside the sale may be contractual, the right to a jury trial may be doubtful if the case turns on legal, as distinct from factual, issues. *Grimes v Elite Ins. Co.* (1978) 82 CA3d 130, 142, 146 CR 808; *Straube v Security First Nat'l Bank* (1962) 205 CA2d 352, 363, 23 CR 213.

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§7.72 G. Jurisdiction and Venue

The superior court has original jurisdiction in all civil cases unless a statute specifically confers jurisdiction on another court. Cal Const art VI, §10. All California counties have consolidated their municipal and superior courts. In response to this ability to merge municipal courts with superior courts, the legislature created a class of actions called "limited civil cases." Limited civil cases correspond to the jurisdiction formerly reserved for municipal courts, *i.e.,* the amount in controversy does not exceed $25,000. If a plaintiff elects to seek only money damages and the amount in controversy or value of the property does not exceed $25,000, jurisdiction will be in the superior court and the action must be designated a limited civil case. If either the amount in controversy or the value of the property exceeds $25,000, or if the action is equitable, the limitations on monetary recovery and other restrictions in limited civil cases will not apply. See CCP §§85-89. A complaint to set aside a trustee sale invariably involves requests for equitable relief (*e.g.,* quiet title, declaratory relief, accounting), which require that the action be filed in the superior court and designated as an unlimited civil case.

If the plaintiff seeks to have the trustee sale set aside, the proper venue is the county in which the real property or some part of it is located. CCP §392(a)(1). The venue rules that govern an action to enjoin a trustee sale also apply to an action to set aside the sale. See §7.42.

If the plaintiff seeks only damages, the general rules for transitory actions apply (see California Civil Procedure Before Trial, chap 8 (4th ed Cal CEB 2004)), and venue is proper in the county of residence of any one of the defendants (CCP §395(a)). In contract actions, venue is proper in the county in which the contract was entered into or was to be performed. CCP §395(a). If the plaintiff seeks both damages and to have the sale set aside, the court may treat the complaint as stating primarily a transitory cause of action (the damages claim) and will therefore treat the action as transitory for venue purposes. *Vaughan v Roberts* (1941) 45 CA2d 246, 113 P2d 884.

A plaintiff may also seek relief in a bankruptcy court, with the redemption amount being paid over a period of time through a Chapter 13 or a Chapter 11 plan, possibly utilizing other remedies found only in the Bankruptcy Code (Title 11 of the United States Code). See §§11.96-11.132.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.73 H. Form: Complaint to Set Aside Trustee Sale

§7.73 H. Form: Complaint to Set Aside Trustee Sale

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_ _[*Name(s)*]_ _, **Plaintiff(s)**	**No.** _ _ _ _ _ _
vs	**COMPLAINT TO SET ASIDE TRUSTEE SALE**
_ _[*Name(s)*]_ _, **Defendant(s)**	

Plaintiff alleges:

FIRST CAUSE OF ACTION
(To Set Aside Sale)

1. Plaintiff _ _[*name*]_ _ **is now, and at all times relevant to this complaint was, the** _ _[*describe plaintiff's interest in property, e.g., owner*]_ _ **of real property commonly known as** _ _[*street address or other designation, including county*]_ _**, California ("subject property"). The legal description for the subject property is attached as Exhibit A and incorporated here by reference. The assessor's parcel number is** _ _[*number*]_ _**.**

2. Defendant _ _[*name*]_ _ **claims to be the owner, by virtue of a trustee's deed from** _ _[*name of trustee*]_ _ **to the real property described in paragraph 1.**

3. Defendant _ _[*name of trustee*]_ _ **is a** _ _[*e.g., California corporation, national banking association*]_ _ **authorized to engage in, and at all times mentioned in this complaint was engaged in, the** _ _[*e.g., title insurance, banking and trust*]_ _ **business as a** _ _[*e.g., title insurance company, California state bank*]_ _**.**

4. Defendant _ _[*name*]_ _ **is now, and at all times relevant to this complaint was,** _ _[*the beneficiary under the deed of trust alleged in paragraph 7 and is a resident of* _ _[*name*]_ _ *County, California/allege other capacity and residence*]_ _**.**

5. Plaintiff does not know the true names, capacities, or basis for liability of defendants sued as Doe 1 through Doe 10. Each fictitiously named defendant is in some manner liable to plaintiff, or claims some right, title, or interest in the subject property, or both.

6. On _ _[*date*]_ _**, for valuable consideration,** _ _[*plaintiff/plaintiff's predecessor*]_ _**, as borrower, made, executed, and delivered to defendant** _ _[*name of beneficiary*]_ _ **a written promissory note in the amount of** _ _[*dollar amount*]_ _**. A copy of that note is attached as Exhibit B and incorporated here by reference.**

7. To secure payment of the principal sum and interest as provided in the note and as part of the same transaction, _ _[*plaintiff/plaintiff's predecessor*]_ _**, as trustor, executed and delivered to defendant** _ _[*name of beneficiary*]_ _**, as beneficiary, a deed of trust dated** _ _[*date*]_ _**, by the terms of which plaintiff, as trustor, conveyed to defendant** _ _[*name*]_ _**, as trustee, real property described in paragraph 1. On** _ _[*date*]_ _**, the deed of trust was recorded against the subject property in** _ _[*state book and page or instrument number*]_ _ **of the Official Records of** _ _[*name*]_ _ **County, California. A copy of the deed of trust is attached as Exhibit C and incorporated here by reference.**

8. On _ _[*date*]_ _**, defendant** _ _[*name of beneficiary or trustee*]_ _ **caused to be recorded a notice of default and an election to sell in** _ _[*state book and page or instrument number*]_ _ **of the Official Records of** _ _[*name*]_ _ **County, California, alleging that (a) a breach of the obligation secured by the deed of trust had occurred, consisting of plaintiff's alleged failure to** _ _[*summarize default, e.g., pay certain monthly installments of*

principal and interest]_ _, **and (b) defendant beneficiary elected to sell, or cause to be sold, the trust property to satisfy that obligation. A copy of the notice of default and election to sell is attached as Exhibit D and incorporated here by reference.**

9. Plaintiff alleges on information and belief that on _ _[*date*]_ _, defendant beneficiary and defendant trustee published and posted, or caused to be published and posted, at various times and in various places certain notices of their intent to sell the trust property at public auction at _ _[*time*]_ _ on _ _[*date*]_ _, at _ _[*state address*]_ _ in the City of _ _[*name*]_ _, _ _[*name*]_ _ County, California, purportedly to satisfy the obligation secured by the deed of trust, on grounds of the alleged breach of the obligation and under the power of sale in the deed of trust. Defendant trustee attempted and purported to sell the trust property as noticed, accepted valuable consideration from defendant _ _[*name of purchaser*]_ _, and then executed and delivered or caused to be executed and delivered a trustee's deed to defendant _ _[*name of purchaser*]_ _. The deed was recorded in _ _[*state book and page or instrument number*]_ _ of the Official Records of _ _[*name*]_ _ County, California. A copy of the trustee's deed is attached as Exhibit E and incorporated here by reference.

10. The sale was improperly held and the trustee's deed was wrongfully executed, delivered, and recorded in that _ _[*state plaintiff's contentions, e.g., no breach of the obligation, absence of a valid lien, invalid presale procedures, improper sale procedures*]_ _ in violation of the terms and conditions of the promissory note and deed of trust and in violation of the duties and obligations of defendant beneficiary and defendant trustee to plaintiff, all to plaintiff's loss and damage in that plaintiff has been wrongfully deprived of the beneficial use and enjoyment of the real property and has been deprived of legal title by forfeiture.

[*Add if plaintiff disputes amount owed but not fact of breach*]

11. Plaintiff _ _[*has tendered/offers to tender*]_ _ to defendant beneficiary or defendant trustee all amounts due and owing so that the claimed default may be cured and plaintiff may be reinstated to all former rights and privileges under the promissory note and deed of trust. Plaintiff is ready, willing, and able to tender those sums, if any, that the Court finds due and owing on rendering the accounting requested in the Fourth Cause of Action of this complaint.

[*Continue*]

SECOND CAUSE OF ACTION
(To Cancel Trustee's Deed)

[12.] Plaintiff realleges and incorporates by reference the allegations in paragraphs 1 through 10.

[13.] Defendant _ _[*name of purchaser*]_ _ claims an estate or interest in the real property described in paragraph 1 adverse to that of plaintiff, but defendant's claims are without any right; defendant has no estate, right, title, or interest in the real property.

[14.] The claims of defendant _ _[*name of purchaser*]_ _ are based on the trustee's deed (Exhibit E), described in paragraph 9, purporting to have been executed by defendant _ _[*name of trustee*]_ _ and delivered to defendant _ _[*name of purchaser*]_ _ on _ _[*date*]_ _ and purporting to convey the property to defendant _ _[*name of purchaser*]_ _.

[15.] Although the trustee's deed (Exhibit E) appears valid on its face, it is invalid, _ _[*void/voidable*]_ _, and of no force or effect regarding plaintiff's interests in the real property described in paragraph 1, for the reasons set forth in paragraph 10.

[16.] The _ _[*estate/interest*]_ _ in the described real property claimed by defendant _ _[*name of purchaser*]_ _ based on the trustee's deed, is a cloud on plaintiff's title in and to the real property, tends to depreciate its market value, restricts plaintiff's full use and enjoyment of the real property, and hinders plaintiff's right to unrestricted alienation of it. If the trustee's deed is not delivered and canceled, there is a reasonable fear that plaintiff will suffer serious injury.

THIRD CAUSE OF ACTION
(To Quiet Title)

[17.] Plaintiff realleges and incorporates by reference the allegations in paragraphs 1 through 10.

[18.] Plaintiff seeks to quiet title against the following claims of defendants: _ _[*Describe claims held by each defendant, identifying, e.g., any supporting document, the nature of the interest the claim purports to create, recording any information*]**_ _. Defendants' claims are without any right, and defendants have no right, title, estate, lien, or interest in the property described in paragraph 1.**

[19.] Plaintiff names as defendants in this action all persons unknown claiming (a) any legal or equitable right, title, estate, lien, or interest in the property described in the complaint adverse to plaintiff's title, or (b) any cloud on plaintiff's title to the property. The claims of each unknown defendant are without any right, and these defendants have no right, title, estate, lien, or interest in the property described in paragraph 1.

[20.] Plaintiff desires and is entitled to a judicial declaration quieting title in plaintiff as of _ _[*date*]**_ _, _ _**[*and restoring possession to plaintiff*]**_ _.**

FOURTH CAUSE OF ACTION
(Accounting)

[21.] Plaintiff realleges and incorporates by reference the allegations in paragraphs 1 through 10.

[22.] The amount of money still owed to defendant _ _[*name of beneficiary*]**_ _ is unknown to plaintiff and cannot be determined without an accounting.**

WHEREFORE, plaintiff demands judgment as follows:

1. That the Court issue (a) a declaration that the sale of the trust property is null and void and of no force or effect, and (b) an order setting aside the trustee sale of the real property.

2. That the Court (a) issue an order that defendant _ _[*name of purchaser*]**_ _ deliver the trustee's deed to the Court, and (b) cancel the trustee's deed.**

3. That the Court order judgment quieting title in plaintiff _ _[*name*]**_ _ as owner of the real property described in paragraph 1, declaring that defendant _ _**[*name of purchaser*]**_ _ has no right, title, estate, lien, or interest in the property adverse to plaintiff _ _**[*and ordering that plaintiff be restored to possession of the real property*]**_ _.**

4. That the Court render between plaintiff, _ _[*name*]**_ _, and defendant _ _**[*name of beneficiary*]**_ _ an accounting determining the amount, if any, actually owed to defendant by plaintiff.**

5. That the Court award damages for the unlawful detention of the premises at the rate of _ _[*dollar amount*]**_ _ per month from _ _**[*date*]**_ _, until delivery of possession to plaintiff.**

6. That plaintiff recover all attorney fees and costs in this action, and that the Court award any other appropriate relief.

Date: _ _ _ _ _ _

__[*Signature of attorney*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]**_ _**

Copies: Original (file with court clerk); copies for service (one for each defendant to be served); office copies.

Comment: When the plaintiff seeks to set aside the sale, the complaint will always contain the first two causes of action, to set aside the trustee sale and to cancel the trustee's deed. The other causes of action will depend on the basis for the claim. See §7.69 on nonmonetary relief. A plaintiff who concedes that a sum is owed but disputes the existence of a default or contends that the default is excused should ask the court to restore the estate or interest, subject to the lien of the deed of trust, or to set a time and place for redemption. The plaintiff can probably recover possession of the property under the quiet-title cause of action. See California Real Property Remedies and Damages, chap 7 (2d ed Cal CEB 2002). An additional cause of action for ejectment may also be included to cover the possession issue. See Real Property Remedies §7.15, chap 10.

This complaint may be revised for use as a cross-complaint in such cases. Because of the posture of the proceedings, no preliminary injunction need be sought.

See §§7.43-7.44 on formatting of pleadings.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.74 I. Lis Pendens

§7.74 I. Lis Pendens

If relief involving title is sought, a notice of a pending action (lis pendens) should be recorded on the same day the complaint is filed to ensure that any subsequent purchaser or encumbrancer takes subject to the plaintiff's claims. See §7.53. For complete discussion of lis pendens, see California Real Property Remedies and Damages, chap 13 (2d ed Cal CEB 2002).

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VII. UNLAWFUL DETAINER AND OTHER POSTSALE ACTIONS

§7.75 A. Defending Unlawful Detainer and Related Actions

A trustor who remains in possession of the property after a trustee sale may be removed by an unlawful detainer action brought by the purchaser. CCP §1161a(b)(2); *MCA, Inc. v Universal Diversified Enters. Corp.* (1972) 27 CA3d 170, 103 CR 522. If the sale was improper, however, the unlawful detainer action may fail. *Crummer v Whitehead* (1964) 230 CA2d 264, 40 CR 826. An ejectment action may also be appropriate if the situation does not qualify for an unlawful detainer action. On ejectment and defenses to it, see California Real Property Remedies and Damages, chap 10 (2d ed Cal CEB 2002).

Arguably, a nonborrower tenant on the property may raise impropriety in the sale as a defense to an unlawful detainer action on the theory that the lease would otherwise still be in effect. See CC §1708; *Schubert v Lowe* (1924) 193 C 291, 223 P 550. See also *Pike v Hayden* (1950) 97 CA2d 606, 218 P2d 578; *Rishwain v Smith* (1947) 77 CA2d 524, 175 P2d 555. See also authorities cited in §7.38.

For further discussion of defenses to unlawful detainer action brought under CCP §1161a or §1161b, see California Eviction Defense Manual, chap 20 (2d ed Cal CEB 1993); California Landlord-Tenant Practice §§8.7, 8.68A-8.68E, 8.109-8.153, 10.54 (2d ed Cal CEB 1997).

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§7.75A B. Effect of Federal Law on Evictions

Effective May 21, 2009, the federal government enacted preemptive legislation that temporarily protects bona fide residential tenants holding possession under a month-to-month agreement or a lease from immediate eviction after a foreclosure sale by the purchaser or the foreclosing lender. See Protecting Tenants at Foreclosure Act of 2009 (Pub L 111-22, §§701-704, 123 Stat 1660). Under §704, the Act automatically terminates on December 31, 2012. The Act applies to interests in property after foreclosure "on a federally-related mortgage or on any dwelling or residential real property." 12 USC §5220(a). To qualify for protection under the Act, the lease or tenancy must be bona fide by meeting the following criteria (12 USC §5220(b)):

- The tenant must not be the borrower or related to the borrower as a child, spouse, or parent;
- The lease or tenancy must be the result of an arm's length transaction; and
- The rent must not be substantially less than the fair market rent for the property.

Under state law, most California residential tenants holding possession under a lease subordinate to the foreclosed loan are entitled to 60 days' notice of eviction after foreclosure under CCP §1161b. The new federal law increases this to 90 days for month-to-month tenants. 12 USC §5220(a)(1). Tenants holding possession under a residential lease have the right to possession until the end of the lease term, unless the purchaser will occupy the unit as a primary residence, in which case the 90-day notice applies. 12 USC §5220(a)(2).

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§7.76 C. Effect of Eviction Action on Suit to Set Aside Sale

Because of the summary nature of unlawful detainer proceedings, a judgment for the purchaser in such an action is not necessarily res judicata and will probably not bar a subsequent suit by the trustor to set aside the sale or to recover damages. *Cheney v Trauzettel* (1937) 9 C2d 158, 69 P2d 832; *Byrne v Baker* (1963) 221 CA2d 1, 34 CR 178; *Patapoff v Reliable Escrow Serv. Corp.* (1962) 201 CA2d 484, 19 CR 886. See *Gonzalez v Toews* (2003) 111 CA4th 977, 4 CR3d 434. An unlawful detainer judgment will have collateral estoppel or res judicata effect only on an issue that was actually raised, or could clearly have been raised, in the unlawful detainer proceeding. *Vella v Hudgins* (1977) 20 C3d 251, 142 CR 414 (unlawful detainer judgment following trustee sale was not res judicata, because no transcript of unlawful detainer trial existed and trial court record had no findings of fact or conclusions of law on defense of lender fraud); *Gonzales v Gem Props.* (1974) 37 CA3d 1029, 112 CR 884 (no res judicata effect because plaintiff did not have opportunity to fully litigate contentions regarding title). For further discussion, see Banke, *Staying Postforeclosure Eviction Actions Pending Borrower Actions Against Lenders,* 32 CEB Real Prop L Rep 92 (July 2009).

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§7.77 D. Drawbacks of Challenging Sale During Eviction

Waiting to defend against an unlawful detainer action generally gives the trustor less leverage than can be acquired by initiating an action to vacate the sale.

- An unlawful detainer action nearly always proceeds at a much faster pace than an ordinary civil action. The trial may occur within the month following the filing of defendant's answer. See California Landlord-Tenant Practice, chap 11 (2d ed Cal CEB 1997).
- The purchaser's title in an unlawful detainer action can be challenged by the trustor's claiming noncompliance with statutory foreclosure requirements (see §7.26); other grounds are not permitted. *Cheney v Trauzettel* (1937) 9 C2d 158, 69 P2d 832; *Abrahamer v Parks* (1956) 141 CA2d 82, 296 P2d 341. See *Vella v Hudgins* (1977) 20 C3d 251, 142 CR 414; *Evans v Superior Court* (1977) 67 CA3d 162, 136 CR 596 (tenant having express agreement to purchase property from subsequent purchaser after foreclosure may litigate title defensively in unlawful detainer action). See also Landlord-Tenant §§10.54, 10.73, 11.62-11.64.
- Later court of appeal cases applying *Cheney* and *Vella* are not consistent and have disagreed on procedures for litigating title and financing issues pending an eviction action. Compare *Asuncion v Superior Court* (1980) 108 CA3d 141, 166 CR 306, with *Mobil Oil Corp. v Superior Court* (1978) 79 CA3d 486, 145 CR 17. However, if the trustor files an independent related civil action before the unlawful detainer trial commences, there is greater opportunity for successfully defending the eviction following a foreclosure. See Banke, *Staying Postforeclosure Eviction Actions Pending Borrower Actions Against Lenders,* 32 CEB Real Prop L Rep 92 (July 2009).

On defending unlawful detainer actions, see California Eviction Defense Manual (2d ed Cal CEB 1993).

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§7.78 VIII. LENDER LIABILITY

Aggrieved borrowers sometimes sue their lenders for behavior they believe was harmful to their interests, even when that behavior was permitted by the loan documents. The success of some of these actions makes lender liability a standard topic at meetings of lenders' counsel. Remedies for predatory lending, *e.g.,* can be based on either the common law or statutory and regulatory protections. See chap 12. Although lenders have always faced the risk that noncompliance with the loan agreement may subject them to liability that their borrowers may offset against the loan balance, some cases have raised the possibility of much more substantial liability. See *K.M.C. Co. v Irving Trust Co.* (6th Cir 1985) 757 F2d 752 ($7.5 million judgment against lender); *State Nat'l Bank v Farah Mfg. Co.* (Tex App 1984) 678 SW2d 661 ($18.6 million judgment against lender). There is also judicial recognition of other duties (*e.g.,* duty of good faith and fair dealing, duty of commercial reasonableness, and quasi-fiduciary duty). The cases have a common thread: The lender's legal duties are held to depend on the entire relationship between lender and borrower and not just on the written documents. See, *e.g., Barrett v Bank of America* (1986) 183 CA3d 1362, 229 CR 16; *Sahadi v Continental Ill. Nat'l Bank & Trust Co.* (7th Cir 1983) 706 F2d 193; *State Nat'l Bank v Farah Mfg. Co., supra*. For comprehensive discussion of lender liability theories and defenses, see chap 12. See also chap 10.

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§7.79 A. Agreements to Lend

Any aspect of a loan or prospective loan transaction contains the potential for lender liability. For example, delay in processing a loan application may be actionable when the final interest rate is higher than that originally offered, especially if the delay was intentional. See *Morosani v First Nat'l Bank* (11th Cir 1983) 703 F2d 1220 (lender liable under Racketeer Influenced and Corrupt Organizations Act (RICO) (18 USC §§1961-1968) for collecting loan fees based on fraudulent statements). A lender that commits to fund a loan and then improperly creates a situation that would discharge its commitment may be liable for any harm it causes the borrower. See *Penthouse Int'l v Dominion Fed. Sav. & Loan Ass'n* (2d Cir 1988) 855 F2d 963 ($128.7 million judgment for lost profits for breach of loan commitment); *Landes Constr. Co. v Royal Bank of Canada* (9th Cir 1987) 833 F2d 1365 ($18.5 million judgment plus forfeiture of $3 million already advanced for breach of oral loan commitment). See also Flick & Replansky, *Liability of Banks to Their Borrowers: Pitfalls & Protections,* 103 Banking LJ 220 (1986); Malloy, *Lender Liability for Negligent Real Estate Appraisals,* U Ill L Rev 53 (1984). For further discussion, see §§12.7, 12.46.

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§7.80 B. Ongoing Duties

Under ordinary commercial circumstances, a secured lender is not in a fiduciary or quasi-fiduciary relationship with the borrower. *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735. Particular facts, however, such as excessive control over the borrower's decision-making process, may characterize the lender as a fiduciary to the borrower, with attendant heightened obligations. In *K.M.C. Co. v Irving Trust Co.* (6th Cir 1985) 757 F2d 752, the court upheld a $7.5 million judgment against a lender who refused to advance $800,000 under a discretionary $3.5 million line of credit. In *Barrett v Bank of America* (1986) 183 CA3d 1362, 229 CR 16, the lender was held liable for failing to disclose that it did not intend to release guaranties it held as security.

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§7.81 C. Calling Loans

Lenders have been held liable in some cases for calling their loans due in bad faith, despite the existence of "at will" or "due-on-demand" provisions in the loan documents. See *Sahadi v Continental Ill. Nat'l Bank & Trust Co.* (7th Cir 1983) 706 F2d 193; *Brown v Avemco Inv. Corp.* (9th Cir 1979) 603 F2d 1367 (applying Texas law). Other courts have held that good faith is not required when a demand note is called. See *Flagship Nat'l Bank v Gray Distrib. Sys.* (Fla App 1986) 485 So2d 1336; *Centerre Bank v Distributors, Inc.* (Mo App 1985) 705 SW2d 42. No reported California case has yet considered this issue directly, but see *Gaffney v Downey Sav. & Loan Ass'n* (1988) 200 CA3d 1154, 246 CR 421 (judgment awarding punitive damages and damages for emotional distress for wrongful foreclosure reversed on ground that foreclosure was proper). See also *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467, suggesting that the implied covenant of good faith cannot be used to alter or disregard the express provisions of a contract.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.82 D. California Decisions; Risk Analysis

§7.82 D. California Decisions; Risk Analysis

Most recent California decisions on liability have been favorable to lenders:

- *Kruse v Bank of America* (1988) 202 CA3d 38, 248 CR 217: Judgment of $20 million in compensatory damages and $27 million in punitive damages against bank that had induced its customer to believe that financing would be made available was overturned because there is no tort liability for bad faith denial of contract when there is no loan contract.
- *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735: Lender may successfully invoke the parol evidence rule to bar evidence of an alleged oral agreement that the term of the existing loan would be extended.
- *Mitsui Mfrs. Bank v Superior Court* (1989) 212 CA3d 726, 260 CR 793: Ordinary commercial contract between borrower and lender does not create a "special relationship" and therefore does not support tort action for breach of implied covenant of good faith and fair dealing.
- *Kim v Sumitomo Bank* (1993) 17 CA4th 974, 21 CR2d 834: Construction lender's phased disbursement of loan proceeds does not create a "special relationship" between parties that would impose liability for failure to (1) require a performance bond, (2) exercise the right to take over construction, (3) inspect before disbursements made, or (4) require use of a builder's control service.
- *Peterson Dev. Co. v Torrey Pines Bank* (1991) 233 CA3d 103, 284 CR 367: Failure of construction lender and its subsidiary to provide permanent financing is not constructive fraud or breach of fiduciary duty in absence of fiduciary or special relationship.
- *Storek & Storek v Citicorp Real Estate* (2002) 100 CA4th 44, 122 CR2d 267: A construction project lender's "out of balance" determination need only be objectively reasonable and, if it was, the lender has the right to withhold additional advances and has no duty to make such advances on the basis of notions of moderation (under *Price v Wells Fargo Bank, supra*) or subjective good faith.

These decisions, while clearly favorable to lenders, do not rule out successful arguments by borrowers based on the following categories of lender misconduct or theories of liability (in addition to those set forth in §§7.79-7.81 and chap 12):

- Breach of contract (*Lowe v Massachusetts Mut. Life Ins. Co.* (1976) 54 CA3d 718, 127 CR 23);
- Traditional tort theories (*e.g.,* fraud, negligence);
- Violations of statutory rules;
- Impermissible borrower waivers (*DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292);
- Lulling by the lender's words or acts (*Lopez v Bell* (1962) 207 CA2d 394, 24 CR 626);
- Estoppel by the lender's words or acts (*Lupertino v Carbahal* (1973) 35 CA3d 742, 111 CR 112); and
- Security transactions between parties with preexisting fiduciary relationships, such as husband and wife (*Marriage of Lange* (2002) 102 CA4th 360, 125 CR2d 379).

PRACTICE TIP: Accurate lender liability analysis requires avoiding facile generalizations and paying particular attention to the uniqueness of each case. It is crucial that the practitioner not jump to a lender liability approach before carefully analyzing borrower rights and lender exposures under the one-action and antideficiency rules. Also, the expense of a lender liability action may undermine the borrower's ability to successfully reorganize in a bankruptcy. See *In re DCNC N.C. I, LLC* (Bankr ED Pa 2009) 407 BR 651.

For comprehensive discussion of lender liability, see chap 12.

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§7.83 E. Loan or Joint Venture

An important issue is whether creative financing arrangements result in joint ventures or mortgage loan financing between the parties. Reported cases are factually driven and depend on the degree of lender control in the borrower's business. See, *e.g., Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135 CR 802. Lenders who are recharacterized as joint venturers may have fiduciary obligations to their coventurers-borrowers and may be restrained from calling their loans or refusing to extend additional credit if that action is harmful to the other side. For discussion of lender liability during foreclosure process, see chap 12.

Third parties may also recover from lenders despite the lack of a lender-borrower relationship. See *Connor v Great W. Sav. & Loan Ass'n* (1968) 69 C2d 850, 73 CR 369, in which the supreme court permitted buyers to sue the developer's construction lender for defective construction. The legislature promptly rejected the result in *Connor* by enacting CC §3434, but the broader questions of what obligations lenders owe and to whom remain open.

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§7.84 F. Reporting Lender Liability Claims in Bankruptcy

Lender liability claims by a debtor in bankruptcy must be reported as an asset of the debtor's estate in the debtor's Schedule B—Personal Property and resolved during the bankruptcy case either as an adversary proceeding filed in the bankruptcy court, by removal of a prepetition action to the bankruptcy court, or through separate litigation in state or federal court. Absent adequate disclosure and reservation of such claims, confirmation of a reorganization plan will bar or estop the debtor from later asserting lender liability claims. See, *e.g., National Envt'l Waste Corp. v Stephens, Berg & Lasaster (In re Nat'l Envt'l Waste Corp.)* (9th Cir 2000) 200 F3d 1266; *Hay v First Interstate Bank* (9th Cir 1992) 978 F2d 555. See Note in §7.56 and Practice Tips in §§7.82, 12.113, 12.150. On bankruptcy strategies for insolvent debtors, see §§7.85-7.125. See comprehensive discussion of bankruptcy and lender liability in chaps 11-12.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.85 IX. PROTECTION IN BANKRUPTCY

§7.85 IX. PROTECTION IN BANKRUPTCY

One of the most effective ways for a debtor to halt a foreclosure, at least temporarily, is to file a petition in bankruptcy under the federal Bankruptcy Code (Title 11 of the United States Code). But see §§7.86-7.87, 11.46. Filing a bankruptcy petition automatically stays most collection activities by the debtor's creditors (see §§7.90-7.95, 11.5-11.19), including secured creditors who are in the process of foreclosing. The automatic stay commences on the debtor's filing a petition to initiate any of the most frequently used types of bankruptcy: Chapter 7 (liquidation), Chapter 11 (reorganization), Chapter 12 (adjustment of debts of family farmers and family fishermen), or Chapter 13 (adjustment of debts of an individual with regular income). A trustee is appointed to take possession of the debtor's nonexempt property in Chapter 7 cases. 11 USC §701. In Chapter 11 cases, unless a Chapter 11 trustee is appointed, the debtor acts as a debtor in possession to administer the property of the estate, having most of the powers of a bankruptcy trustee. See 11 USC §1107. Similarly, in a Chapter 13 case, the individual debtor remains in possession of the estate, administering the estate through a plan and payments made through a Chapter 13 trustee. 11 USC §§1303-1304. On debtor's rights and powers in Chapter 12 cases (family farmers or fishermen with regular annual income), see 11 USC §1203.

NOTE: Each of California's four federal bankruptcy court districts has promulgated local rules, some of which are extensive. Local rules generally tend to fill gaps in the Federal Rules of Bankruptcy Procedure. They impose calendaring and notice requirements. Counsel proposing to file a bankruptcy case or make an appearance in any bankruptcy court in California must first consult the court's website and become familiar with its local bankruptcy rules and applicable local forms. In all districts, attorneys are subject to sanctions for noncompliance with local rules. See, *e.g.,* CD Cal Local Bankr R 1001-1(f); ED Cal Local Bankr R 1001-1(g); ND Cal Local Bankr R 9011-1; SD Cal Local Bankr R 1001-5. Copies of local bankruptcy rules are readily obtainable from the clerk of the applicable bankruptcy court or the court's website. See the following websites:

http://www.cacb.uscourts.gov	Central District
http://www.caeb.uscourts.gov	Eastern District
http://www.canb.uscourts.gov	Northern District
http://www.casb.uscourts.gov	Southern District

Local bankruptcy rules vary significantly from district to district. Of all the federal judicial districts in California, the Central District has the most comprehensive set of local rules and has also promulgated its own forms, including customized versions of certain of the Official Forms, as well as other forms, some of which are mandatory and others optional. District-specific forms include, among others, forms of a Chapter 11 plan, Chapter 11 disclosure statement, Chapter 13 plan, and motion for relief from the automatic stay.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23) made significant revisions to both consumer and business provisions of the Bankruptcy Code. Sections 7.85-7.125 provide an overview of the impact of bankruptcy law on foreclosure of real property security. For more extensive discussion of the Bankruptcy Code, including the changes made by the BAPCPA, see chap 11.

Because a bankruptcy petition automatically stays existing state court litigation against the debtor, the debtor's attorney should promptly inform any parties and their counsel involved in state court litigation about the filing of the petition. California Rules of Court 3.650 requires the party that caused the stay to file a notice of the stay and attach a copy of the order or other document evidencing the stay. For Notice of Stay of Proceedings, Judicial Council Form CM-180, which must be used in state court, see California Landlord-Tenant Practice §14.57 (2d ed Cal CEB 1997).

WARNING: Under the BAPCPA, the automatic stay may be terminated as to the debtor automatically after a short period or may not apply at all if a bankruptcy petition is filed after the dismissal of a prior bankruptcy. See §7.90, 11.6, 11.11. Counsel for all parties should ascertain whether the stay actually applies. See 11 USC §362(b)(20)-(21), (c)(3)-(4). If the stay applies, debtor's counsel must explain that a creditor's motion for relief from the stay (see §§7.90, 7.99) is likely and must prepare to defend the motion from the inception of the bankruptcy (see §§7.105-7.106, 11.46). On strategies for early discovery, see §7.105.

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§7.86 A. Deciding Whether to File Bankruptcy Petition

Debtors and their counsel, especially those not well versed in bankruptcy matters, might believe that commencing a bankruptcy case is an easier way to postpone a pending foreclosure sale than a state court injunction proceeding, which would require analyzing foreclosure procedures as well as statutory and case review. Congress intended, through the BAPCPA, to discourage precipitous filings and to encourage use of Chapter 13 over Chapter 7 for individuals. The BAPCPA requires, among other things, that

- individuals participate in mandatory credit counseling within 180 days before filing (see 11 USC §109(h));
- for Chapter 7 filings, individual debtors satisfy a "means test" for income, in which annualized monthly income is compared with the median income for the Metropolitan Statistical Area in which the debtor(s) reside(s) (see 11 USC §707(b)); and
- the time periods between certain types of bankruptcy filings be increased as follows:

- period between Chapter 7 filings must be 8 years rather than 6 (see 11 USC §727);
- period between a prior Chapter 7 and subsequent Chapter 13 in which a discharge is requested must be a period of 4 years (see 11 USC §1328(f)(1)); and
- period between a Chapter 7 filing and a Chapter 11 individual filing must be a period of 8 years (see 11 USC §1141(d)(3)).

Chapter 7 cases that do not meet the BAPCPA requirements are subject to prompt dismissal, with attendant loss of the benefits of bankruptcy protection. See 11 USC §§109(h), 349, 707(a)-(b). See also BAPCPA limitations on automatic stay, discussed in §§7.90, 11.6, 11.11.

On the other hand, bankruptcy should be considered if the borrower is marginally solvent, because the expense of a state-court lender liability action may undermine the borrower's ability to successfully reorganize in a bankruptcy. See *In re DCNC N.C. I, LLC* (Bankr ED Pa 2009) 407 BR 651.

PRACTICE TIP: A marital dissolution agreement under which there is a division of community property and liabilities does not bind creditors, because the creditors of the community are not parties to the marital dissolution agreement. This consequence is not often articulated by counsel or understood by either spouse and may lead to a subsequent bankruptcy filing. Bankruptcy counsel may need to rely on state contract law to determine whether the spouse sought to be liable is a party to the disputed contract. This analysis may be necessary, *e.g.,* when only one spouse has executed a promissory note and deed of trust as obligor-trustor; when one spouse has pledged marital property as collateral to secure the debt of another (*e.g.,* a corporate debt) as a surety; or a judgment was entered against only one spouse and not the other. A codebtor stay inures to the benefit of the nonfiling spouse for so long as there is an automatic stay or the case remains open. 11 USC §1301.

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§7.87 1. Disadvantages of Bankruptcy Filing

Although the automatic stay has some obvious advantages for the debtor, filing a bankruptcy petition involves substantial risks and disadvantages to the debtor that should be considered:

- **Expense.** Bankruptcies, particularly debtor in possession Chapter 11 cases, can be costly in attorney fees and administration expenses (*e.g.,* trustee, appraiser, and property management fees), particularly when the case involves a contested reorganization plan or other contested matters such as property valuation, lien validity or priority, or relief from stay. Chapter 7 and Chapter 13 cases, as a matter of pure economics, require less expensive costs of administration. Counsel should review the local bankruptcy rules of the federal judicial district in California where the case will be filed to ensure that they understand (1) when court approval of their employment is required and (2) any applicable restrictions concerning the attorney fees they may charge.
- **Dismissal difficult.** Bankruptcy cases can be difficult to terminate, because they involve the administration of an estate for the benefit of many interests rather than being a two-sided civil dispute. Only Chapter 13 cases may be dismissed on a simple motion of the debtor. 11 USC §1307(b). Note, however, that the Ninth Circuit has held that the right to dismiss is tempered by the conversion of a Chapter 13 case for cause. *Rosson v Fitzgerald (In re Rosson)* (9th Cir 2008) 545 F3d 764, relying on *Marrama v Citizens Bank of Mass. (In re Marrama)* (2007) 549 US 365, 166 L Ed 2d 956, 127 S Ct 1105. Dismissal of an individual's case potentially jeopardizes the availability of the protection of the automatic stay if a successor case is filed. See §7.90.
- **Disclosure requirements.** Bankruptcy requires detailed disclosure of the debtor's income, assets, liabilities, and individual expenses. Under the BAPCPA, requirements for greater accountability for the accuracy of disclosures were added, including submission of the debtor's tax returns to the Chapter 7 or Chapter 13 trustee and random audits by the Office of the United States Trustee. 11 USC §521(e)(2)(A). Serious penalties, including denial of a discharge, can result from incomplete or inaccurate disclosures. Accurate disclosures may give creditors knowledge of claims (*e.g.,* for fraud or waste) that might have escaped discovery in conventional state court foreclosure proceedings. Counsel and client must beware of making inconsistent disclosures between the bankruptcy filing and other filings, such as, *e.g.,* family court proceedings, federal and state tax returns, or credit applications.
- **Impact on credit rating.** A bankruptcy filing generally remains on an individual's credit history for 10 years. Other negative credit issues—*e.g.,* a history of late payments, too much debt, lawsuits, or judgment liens—may drop off an individual's credit report sooner than a bankruptcy filing. However, a bankruptcy followed by a later "clean" credit history may result in an individual's credit report being rehabilitated in a shorter period of time, *e.g.,* 2 or 3 years. Counsel may want to advise the client to give each of the three credit bureaus and each of the two check-reporting bureaus notice of the bankruptcy filing so that demand may be made after the bankruptcy discharge is entered for those agencies to accurately reflect the bankruptcy filing and credit history.
- **Potential inability to obtain rental housing.** Many rental applications require a prospective tenant to disclose any bankruptcy filings; landlords routinely obtain credit reports on prospective tenants. Thus, a bankruptcy might prevent an individual from obtaining an apartment in the future.
- **Potential inability to obtain future credit.** A bankruptcy filing generally will make it more difficult for an individual debtor to obtain credit in the future. The debtor may not be able to obtain a home loan or car loan right after the bankruptcy filing and may be charged higher interest rates for several years afterward.
- **In Chapter 11, loss of debtor in possession status.** Bankruptcy judges have broad powers to remove the debtor as a debtor in possession in Chapter 11 cases and to put a Chapter 11 trustee in its place. 11 USC §1104. Once this occurs, the debtor loses many of the advantages of a Chapter 11 case. The Chapter 11 trustee's agenda and duties to creditors may not be consistent with the debtor's original goals in filing the bankruptcy.
- **Possible loss of antideficiency protection.** Secured lenders may be able to obtain results that would not be possible under state law. For example, some lenders have obtained confirmation of "grab dirt" plans, which may

give them quick resort to the security, possibly evading the various debtor protections required by state antideficiency laws. Other creditors have arranged for sales of the security "free and clear of liens" under 11 USC §363, successfully contending that such sales are not foreclosures and do not carry with them the debtor protections of state court foreclosures (*e.g.,* post-trustee-sale antideficiency bar, exhaustion of security requirement, fair value protections). See *Vista Del Mar Assocs. v West Coast Land Fund (In re Vista Del Mar Assocs.)* (BAP 9th Cir 1995) 181 BR 422. See also §§5.72, 11.73.

- **Impact on guarantors and sureties.** The debtor filing a petition can lead the creditor to focus collection efforts on guarantors or sureties. This approach may or may not be advantageous, depending on the relationship between the guarantor and the principal debtor. (In Chapter 13 cases, a codebtor is provided a codebtor stay, which prevents creditors from pursuing it under 11 USC §1301.) However, to the extent that a deed of trust evidences a pledge by the debtor (as surety) of the debtor's principal residence as security for a commercial loan granted to a corporate entity, the debtor retains all rights to challenge the enforcement of the deed of trust. In such cases, the debtor as surety is distinguishable from a debtor who gives a personal guaranty of a commercial loan.
- **Impact on debtor's employment.** The debtor is protected under 11 USC §525(b) against discrimination by governmental agencies and private employers who refuse or deny, among other things, permits, licenses, student loans, or employment to bankruptcy debtors. It has yet to be seen whether or to what extent litigation may arise when a private employer denies employment on the basis of a credit report. See, *e.g., Wakefield v SWS Sec., Inc. (In re Wakefield)* (Bankr ND Tex 2003) 293 BR 372 (upheld award of damages to Chapter 7 debtor discharged from employment).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.88 2. Status of Lien-Stripping After BAPCPA

§7.88 2. Status of Lien-Stripping After BAPCPA

Historically, one of the most useful and powerful debtor tools in individual Chapter 11 or Chapter 13 cases (although not in Chapter 7 cases) was the ability of a debtor to reduce (or "strip down") the amount of a secured claim to the fair market value of the collateral as of the date of the bankruptcy filing. See 11 USC §506(a), (d). This strategy is known as "lien-stripping." For discussion of the procedures for allowance of secured claims in bankruptcy, including lien-stripping to the extent still permitted, see §§11.90-11.92, 11.101-11.102, 11.121-11.126, 11.137. As discussed in §11.92, despite the language of §506(a), lien-stripping has been significantly restricted by the BAPCPA as a strategy for bankruptcy debtors.

- Lien-stripping is not allowed at all in a Chapter 7 case. It is also not allowed in a Chapter 11 or Chapter 13 case if the creditor's claim is secured only by the debtor's principal residence. See §§11.92, 11.102, 11.123. It is still allowed in Chapter 12 for claims secured by the debtor's principal residence. See §11.137.
- Lien-stripping was significantly restricted for creditor's claims secured by personal property collateral. Property acquired for "personal, family or household purposes" must be valued at its "replacement value." 11 USC §506(a)(2). See §§11.92, 11.121, 11.125.
- Lien-stripping is still allowed in Chapter 13 cases for junior deeds of trust on a debtor's principal residence *provided* that the debtor can prove that there is no equity at all to support the junior lienholder's position. *Zimmer v PSB Lending Corp. (In re Zimmer)* (9th Cir 2002) 313 F3d 1220; *Lam v Investors Thrift (In re Lam)* (BAP 9th Cir 1997) 211 BR 36. See §11.126.
- A Chapter 13 filing after a discharge in a Chapter 7 case (informally called "Chapter 20") is allowed. *Johnson v Home State Bank* (1991) 501 US 78, 115 L Ed 2d 66, 111 S Ct 2150. See §11.25. However, the use of "Chapter 20" to strip away a wholly undersecured second, the personal liability for which was discharged in the prior Chapter 7, is carefully scrutinized case by case.

For example, in an unpublished decision, the bankruptcy court in *In re Winitzky* (CD Cal, May 7, 2009, No. 1:08-bk-19337) 2009 Bankr Lexis 2430 denied the debtors' efforts to follow a Chapter 7 discharge with a Chapter 13 case and a motion to remove the wholly undersecured creditor's lien from the property. The court reasoned under *In re Lam, supra, In re Zimmer, supra,* and *Nobelman v American Sav. Bank* (1993) 508 US 324, 124 L Ed 2d 228, 113 S Ct 2106, as well as under BAPCPA that the filing of the Chapter 13 case could not result in a discharge, and therefore the lien could not be "stripped." The court expressed its concern that the "Chapter 20" filing was orchestrated with declining values and the resultant distancing of the wholly undersecured second from any equity in the real property.

It is unknown whether the *Winitzky* decision spells the end of Chapter 20s that call for the determination of the value of property for the purpose of removing a wholly undersecured second (or third) or whether the courts will limit the *Winitzky* decision to its facts and the specific issue that it decided. In a successful "Chapter 20," a wholly undersecured deed of trust may be avoided from title, but only under very limited facts, and only on completion of a Chapter 13 plan. Such limited facts may include, but are not limited to, otherwise nondischargeable debt that is paid in full; the curing of default payments on a first deed of trust that were not in default at the time of the original Chapter 7 filing; real property tax default payments that are cured; and income taxes or student loans that are paid in full by the end of the Chapter 13 term. Because Congress has not expressly prohibited the use of "Chapter 20" to strip a wholly undersecured creditor's lien, no such prohibition can be applied. See *U.S. v Ron Pair Enters., Inc.* (1989) 489 US 235, 241, 103 L Ed 2d 290, 109 S Ct 1026 (when statute's language is plain, sole function of court is to enforce it according to its terms). This result seems consistent with current state and federal efforts to preserve homeownership, reduce foreclosures, and encourage lenders and servicers to grant relief to at-risk homeowners.

NOTE: Determination of the amount of debt, secured or unsecured, may have a negative impact on whether the debtor is eligible for a Chapter 13 under 11 USC §109(e), as eligibility is based on the debtor's schedules as of the filing date of the bankruptcy case. See *Scovis v Henrichsen (In re Scovis)* (9th Cir 2001) 249 F3d 975 (because judgment lien was avoidable under 11 USC §522(f) as of date petition and schedules are filed, judgment lien that

impaired homestead exemption increased amount of unsecured debt that exceeded Chapter 13 jurisdiction). See discussion in §§7.101, 11.126.

It is unknown whether the *Scovis* ruling will negatively impact Chapter 13 jurisdiction under 11 USC §109(e) when a note secured by a deed of trust (rather than a judgment debt) is determined wholly undersecured.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.89 B. Bankruptcy Estate

§7.89 B. Bankruptcy Estate

Filing a bankruptcy petition creates a bankruptcy estate, comprised of all the debtor's legal and equitable interests in property wherever located, as well as the proceeds, rents, and profits from that property. 11 USC §541(a). See §11.3. When the debtor holds bare legal title to real property, *e.g.,* as a trustee, only that nominal interest passes to the bankruptcy estate. See *Torrez v Torrez (In re Torrez)* (9th Cir 1987) 827 F2d 1299. Real property owned by a partnership debtor is part of the bankruptcy estate even when nominal legal title is held by a nondebtor partner (*Jones v Wingo (In re Wingo)* (BAP 9th Cir 1988) 89 BR 54), and, if title has not yet transferred to the creditor, property already seized under a prebankruptcy judgment levy remains part of the bankruptcy estate and subject to the automatic stay (*Ramirez v Fuselier (In re Ramirez)* (BAP 9th Cir 1995) 183 BR 583). The debtor is divested of ownership rights to the property that passes into the estate, and only the trustee (or debtor in possession exercising the rights and powers of a trustee) may use, sell, lease, or create a security interest in it thereafter. 11 USC §§363-364. See *Crevier v Welfare & Pension Fund (In re Crevier)* (9th Cir 1987) 820 F2d 1553. The Chapter 11 or Chapter 7 trustee has a duty to administer the bankruptcy estate and has the power to begin actions and assert defenses on its behalf. 11 USC §323; Fed R Bankr P 6009. A Chapter 13 trustee is not similarly empowered (11 USC §1302), but the Chapter 13 debtor is (11 USC §§1303-1304).

Sections 7.90-7.125 provide an overview of the impact of bankruptcy law on foreclosure of real property security from the debtor's perspective. For further discussion of bankruptcy practice as it relates to real property security issues from the creditor's perspective, see chap 11. See also Moving for Relief From an Automatic Stay in Bankruptcy (Cal CEB Action Guide September 2006), which has numerous sample forms and strategies for stay relief motions; Debt Collection Practice in California, chap 12 (2d ed Cal CEB 1999).

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§7.90 C. Filing Triggers Automatic Stay

Filing a petition in bankruptcy under any chapter of the Bankruptcy Code invokes the automatic stay of 11 USC §362(a), bringing most creditor collection efforts to a complete halt, even when a secured creditor is involved. See §§11.5-11.19. A creditor's continued collection efforts may result in imposition of sanctions and injunctive relief. See 11 USC §362(k). See also §7.93. The debtor's property is considered to have been transferred to a newly created bankruptcy estate (11 USC §541) controlled either by a trustee in bankruptcy (under Chapter 7) or by the debtor as debtor in possession (under Chapter 11 or 13).

The automatic stay—in substance, a statutory injunction—protects the bankruptcy estate by prohibiting virtually all attempts by creditors to collect debts or recover property of the bankruptcy estate until relief from the stay is obtained (see 11 USC §362(d); see also §7.99) or the stay terminates. 11 USC §362(c)-(e), (h), (n). See generally *Far Out Prods., Inc. v Oskar* (9th Cir 2001) 247 F3d 986; *Contractors' State License Bd. v Dunbar (In re Dunbar)* (9th Cir 2001) 245 F3d 1058. For extensive discussion of the automatic stay, see Moving for Relief From an Automatic Stay in Bankruptcy (Cal CEB Action Guide September 2006). Filing the petition stays the commencement or continuation of any proceeding to enforce a lien against estate property or to recover any money claim against the debtor. 11 USC §362(a). The stay "stops all collection efforts, all harassment, and all foreclosure actions." *Barnett v Lewis* (1985) 170 CA3d 1079, 1088, 217 CR 80. See *Schwartz v U.S. (In re Schwartz)* (9th Cir 1992) 954 F2d 569. A state court can determine the effect of the automatic stay, but it cannot modify or terminate the stay. *Gruntz v County of Los Angeles (In re Gruntz)* (9th Cir 2000) 202 F3d 1074.

To discourage serial filings, the BAPCPA provides that the filing of a petition does not automatically stay the enforcement of a security interest in real property (1) for up to 2 years following entry of a stay relief order in a prior bankruptcy action or (2) if the filing violates a prior court order prohibiting the debtor from filing again. 11 USC §362(b)(20)-(21). See §11.11. Among bankruptcy lawyers and judges, this feature has become known as the "semi-automatic stay." The debtor may file a motion, usually, an ex parte application, to extend the automatic stay, which, unless opposed or cause is not shown, is granted without further notice or hearing. Local bankruptcy rules as well as special court rules and orders of individual judges should be consulted for proper procedures; special court rules and orders of individual judges are available from their personal clerks. On additional lender protections provided by the BAPCPA, see §11.6.

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1. Scope and Effect of Automatic Stay

§7.91 a. Effect on Creditors

Unless a statutory exception applies (see 11 USC §362(b)), the stay prohibits any act by a creditor to create, perfect, or enforce a lien against the debtor's property, including the use of any judicial or administrative proceeding. 11 USC §362(a). Because the language of §362(a) precludes even the execution of a notice of default (see §2.37), it brings all judicial and nonjudicial foreclosure proceedings to a halt, and all actions in violation of the stay—including trustee sales (*i.e.,* nonjudicial foreclosures)—are void ab initio. *Far Out Prods., Inc. v Oskar* (9th Cir 2001) 247 F3d 986; *Schwartz v U.S. (In re Schwartz)* (9th Cir 1992) 954 F2d 569, 571. This is the rule whether or not the violation was willful. *In re Schwartz, supra.*

If the debtor maintains a deposit account with a financial institution that is also a creditor, the mutuality of obligation doctrine allows for a setoff without violation of the automatic stay, as long as "three steps have been taken: (i) a decision to effectuate a setoff, (ii) some action accomplishing the setoff, and (iii) a recording of the setoff." *Citizens Bank of Md. v Strumpf* (1995) 516 US 16, 19, 133 L Ed 2d 258, 116 S Ct 286. But the creditor may relinquish other rights under state law if it exercises such a setoff. See *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, discussed in chap 4.

The stay is operative immediately whether or not the creditor knows of it (although punitive damages may not be imposed against a creditor for violating the stay if it had no actual notice of the stay; see §7.93). Thus, a bankruptcy petition filed at 11:59 a.m. categorically prohibits a trustee sale previously noticed for 12 noon on the same day. A few earlier court decisions applied 11 USC §549(c) to uphold a good faith purchase when the buyer had no knowledge of the bankruptcy and the trustee's deed was recorded before the recordation of the notice of the bankruptcy petition. See *Tsafaroff v Taylor (In re Taylor)* (9th Cir 1989) 884 F2d 478; *In re Stork* (Bankr ND Cal 1997) 212 BR 970. But the Ninth Circuit limited §549(c) to a debtor-initiated sale and held it inapplicable to foreclosures that violate the automatic stay. See *40235 Washington St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076. See also *Value T Sales, Inc. v Mitchell (In re Mitchell)* (BAP 9th Cir 2002) 279 BR 839. The BAPCPA does not seem to change this result. Failure to give a creditor actual notice of the filing may be a defense to a finding of willful and intentional violation of the stay and may, therefore, preclude an award of punitive damages. See *Ozenne v Bendon (In re Ozenne)* (BAP 9th Cir 2006) 337 BR 214 (willful violation requires proof that creditor knew of automatic stay and intentionally took actions that violated stay).

The automatic stay does not prohibit the transfer of claims between creditors and assignees or the substitution of trustees. Fed R Bankr P 3001(e). See *Reusser v Wachovia Bank (In re Reusser)* (9th Cir 2008) 525 F3d 855, 861, in which the Ninth Circuit held that there was no violation of the automatic stay when Wachovia Bank foreclosed following assignment of a deed of trust from Washington Mutual Bank, which had been granted relief from stay before the assignment.

The stay does not prohibit a creditor from protecting its setoff rights by "temporarily" withholding payment of a debt (*e.g.,* the return of impounds)—known as an "administrative freeze" on the debtor's bank account—as long as no final setoff occurs. See *Citizens Bank v Strumpf* (1995) 516 US 16, 133 L Ed 2d 258, 116 S Ct 286 (bank account frozen). But such action may be subject to attack as a violation of the one-action rule in CCP §726. See §11.10. See also chap 4.

PRACTICE TIP: After initiating a bankruptcy filing, debtor's counsel must expect a creditor's motion for relief from the automatic stay and must prepare to defend it from the inception of the bankruptcy. See §7.99, 11.46.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.92 b. Statutory Exceptions to Stay

§7.92 b. Statutory Exceptions to Stay

As amended by the BAPCPA, 11 USC §362(b) lists 28 statutory exceptions to the automatic stay. The following are key exceptions potentially related to real estate secured lending:

- Certain actions to perfect a lien or security interest taken within 30 days after the bankruptcy petition was filed (11 USC §362(b)(3));
- Creation or perfection of liens for ad valorem property taxes, or special taxes or assessments on real property (whether or not ad valorem) coming due postpetition (11 USC §362(b)(18));
- Any act to enforce a lien or security interest in real property if relief from stay was granted in a prior case under 11 USC §362(d)(4) within the past 2 years, although the debtor may move to have the stay reinstated on the basis of changed circumstances or for other good cause shown (11 USC §362(b)(20));
- Any act to enforce a lien or security interest in real property if the debtor is not eligible to be a debtor under 11 USC §109(g), or if the case was filed in violation of a bankruptcy court order in a prior case prohibiting the debtor from refiling (11 USC §362(b)(21)); and
- Any transfer that is not avoidable under 11 USC §544 (the strong-arm powers) or 11 USC §549 (postpetition transfers) (11 USC §362(b)(24)).

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§7.93 c. Remedies for Violation of Stay

"Innocent" violations. Neither a creditor's subjective good faith belief in the propriety of its conduct nor its reliance on the advice of counsel is a defense to a stay violation. *Havelock v Taxel (In re Pace)* (9th Cir 1995) 67 F3d 187; *Tsafaroff v Taylor (In re Taylor)* (9th Cir 1989) 884 F2d 478; *Goichman v Bloom (In re Bloom)* (9th Cir 1989) 875 F2d 224. If the creditor's postpetition actions were innocent, the bankruptcy court may annul the stay retroactively and thereby validate those events. See, *e.g*., *Jewett v Shabahangi (In re Jewett)* (BAP 9th Cir 1992) 146 BR 250 (when debtor filed Chapter 13 petition 5 days after trustee sale but before recordation of trustee's deed, court annulled stay retroactively on finding that creditor would have been entitled to stay relief order for cause at time of sale). A California statutory amendment enacted after *Jewett* provides that if the bankruptcy petition is filed after the foreclosure sale but before the trustee's deed is recorded, and if the trustee's deed is recorded within 15 days of the sale, the deed effectively relates back and the sale is deemed final as of the prebankruptcy sale date. CC §2924h(c). Such a transfer does not violate the automatic stay and therefore is not void. 11 USC §§362(b)(3), 546(b); *Bebensee-Wong v FNMA (In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820. See chap 11.

Willful violations. A creditor's willful violation of the stay may be punished by contempt proceedings, and individual debtors may recover actual damages, punitive damages, and attorney fees under 11 USC §362(k). See *Computer Communications, Inc. v Codex Corp. (In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725. Actual damages may include emotional distress damages. *Dawson v Washington Mut. Bank* (9th Cir 2004) 390 F3d 1139.

Bankruptcy trustees and corporate debtors may recover attorney fees and actual damages under 11 USC §105 for violations of the automatic stay even though they do not qualify for recovery of attorney fees, actual damages, and punitive damages under 11 USC §362(k). See *Havelock v Taxel (In re Pace)* (9th Cir 1995) 67 F3d 187; *Johnston Envt'l Corp. v Knight (In re Goodman)* (9th Cir 1993) 991 F2d 613.

Punitive damages may not be awarded under §362(k) if the offending creditor did not have actual notice of the case. The debtor and debtor's counsel should provide all parties to a pending foreclosure with actual notice of the bankruptcy filing. All federal bankruptcy courts in California have implemented electronic case-filing systems, under which is issued a "Notice of Electronic Filing" that sets forth the date, time, place, and docket number of the case. Good practice is to list on the mailing matrix not only the current lienholder listed on the last billing statement but also the substitute trustee, if any, and even the agent for service of process for each.

PRACTICE TIP: When it comes to giving adequate notice of the bankruptcy filing or significant motions in the action, counsel cannot be too careful. Courts are trending toward requiring compliance with Fed R Bankr P 7004, giving notice to the last address given by the creditor to which correspondence or inquiries should be sent or to the agent for service for process; if a federal bank (national association), notice should be given to a corporate office. See authorities cited in §11.122.

If the creditor did not have actual notice of the bankruptcy case, the creditor must transfer or return the security and may be liable for damages if it willfully refuses to do so. *Abrams v Southwest Leasing & Rental, Inc. (In re Abrams)* (BAP 9th Cir 1991) 127 BR 239. See *U.S. v Arkison (In re Cascade Roads)* (9th Cir 1994) 34 F3d 756; *Stainton v Lee (In re Stainton)* (BAP 9th Cir 1992) 139 BR 232.

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§7.94 d. Transfers by Debtor

A voluntary transfer of a grant deed or deed of trust by the *debtor* during a bankruptcy case without court approval is not void but merely voidable under 11 USC §549(a). *Phoenix Bond & Indem. Co. v Shamblin (In re Shamblin)* (9th Cir 1989) 890 F2d 123. The automatic stay of 11 USC §362 does not apply to, or cause to be deemed void, sales or transfers of property initiated by the debtor, even when the transaction was without bankruptcy court approval. *Burkart v Coleman* (*In re Tippett)* (9th Cir 2008) 542 F3d 684 (although such sales may be subject to avoidance under 11 USC §549, trustee did not obtain avoidance because court applied defense in favor of bona fide purchaser).

CAUTION: Procedurally, the dispositive issue in *Tippett* turned on the validity of the transaction under 11 USC §362 rather than its voidability under 11 USC §549. Sales by the debtor without bankruptcy court approval may, when procedurally appropriate, still be challenged and set aside under the avoidance provisions of §549. *Tippett* can be added to the long list of California real property cases that turn on the subtle but important distinction between transactions that are *void* and those that are merely *voidable*. In the latter cases, outcomes will turn in large part on the legitimacy and equities of the third party who participated in the unauthorized transaction. See *Dimock v Emerald Props., LLC* (2000) 81 CA4th 868, 97 CR2d 255, and *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859, for discussions of the void-versus-voidable distinction.

Counsel representing buyers should consider that sales of real property under an order of the bankruptcy court may be advantageous for several reasons, among them, that a court will require a thorough review of title and possible determination of the extent, validity, or priority of liens against title; that the price is the best price at the time; and that title transferred pursuant to such an order is not subject to invalidation on reversal or modification of the order after appeal. 11 USC §363(m).

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§7.95 e. Who Else Is Protected by Stay?

The automatic stay in a partnership bankruptcy case does not operate as a stay of actions against nondebtor partners (*Patton v Bearden* (6th Cir 1993) 8 F3d 343) or the debtor's nondebtor spouse (*James v Washington Mut. Sav. Bank (In re Brooks)* (9th Cir 1989) 871 F2d 89; *In re Int'l Forex, Inc.* (Bankr SD Cal 2000) 247 BR 284). However, a Chapter 13 bankruptcy filing by one spouse but not the other provides the nonfiling spouse with a codebtor stay. 11 USC §1301. The automatic stay prevents foreclosure by the holder of a senior deed of trust on real property when a junior lien secured by the same real property is part of the bankruptcy estate, *i.e.,* the beneficiary under the junior deed of trust is in bankruptcy. See §11.12. This is so even though the senior lender is not a creditor of the junior lender and the senior lender's claim cannot be dealt with under the junior lender's Chapter 11 plan. *First Fed. Bank v Cogar (In re Cogar)* (BAP 9th Cir 1997) 210 BR 803.

When the stay arises from a bankruptcy filing by a trustor, junior lienholders and other creditors lack standing to complain of violations of the stay by senior lienholders. See *James v Washington Mut. Sav. Bank (In re Brooks)* (9th Cir 1989) 871 F2d 89; *Magnoni v Globe Inv. & Loan Co. (In re Globe Inv. & Loan Co.)* (9th Cir 1989) 867 F2d 556.

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§7.96 f. Income Tax Issues for Debtor

Income tax issues concerning capital gains or losses or forgiveness of indebtedness arising from the transfer of an interest in property should not be overlooked. The debtor-client should consult with a tax professional who can provide an analysis of the effect a transfer would have on the client's tax liability. Despite a foreclosure in violation of the automatic stay, in some instances it may be in the client's best interest to allow the foreclosure sale to lie and the resulting trustee's deed to record. For further discussion, see §§2.110-2.112, 7.4, 10.24, 10.30.

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§7.97 g. Effect on Redemption and Reinstatement Rights

Many decisions have held that the automatic stay does not toll state statutory reinstatement periods (under CC §2924c) or postsale redemption periods (under CCP §729.030). *Heikkila v Carver (In re Carver)* (8th Cir 1987) 828 F2d 463; *Steele v Pridham (In re Pridham)* (Bankr ED Cal 1983) 31 BR 497; *Triangle Mgmt. Servs. v Allstate Sav. & Loan Ass'n* (ND Cal 1982) 21 BR 699. See *Napue v Gor-Mey W., Inc.* (1985) 175 CA3d 608, 220 CR 799. But see *Hamblen v Federal Sav. & Loan Ins. Corp. (In re Thomas J. Grosso Inv.)* (9th Cir 1972) 457 F2d 168 (under prior bankruptcy law, automatic stay tolled postsale redemption period after judicial foreclosure); *In re Capital Mortgage & Loan, Inc.* (Bankr ED Cal 1983) 35 BR 967 (automatic stay protects debtor's preforeclosure equity of redemption). See also authorities cited in §§2.94, 11.12-11.13.

WARNING: Many of these cases were decided under California statutes or bankruptcy provisions that were superseded or amended after the decisions or under laws of states other than California. The facts as well as the law and the reasoning of the cases should be carefully analyzed before citing them.

PRACTICE TIP: Debtor's counsel, if possible, should consider filing the bankruptcy petition more than 5 days before the foreclosure sale date, so as to preserve the reinstatement period. Failure to do so risks that during a contested relief from stay hearing, the creditor will argue that the debtor is unable to pay the entirety of the indebtedness.

NOTE: Tax consequences of transfer or foreclosure may also influence the debtor's decision to redeem or reinstate. See §7.96.

Postsale redemption periods are extended in the debtor's favor to 60 days after commencement of the bankruptcy case if expiration would otherwise have occurred within that 60-day period. See 11 USC §108(b); *Johnson v First Nat'l Bank* (8th Cir 1983) 719 F2d 270; *Westergaard v Cucumber Creek Dev. (In re Cucumber Creek Dev.)* (Bankr D Colo 1983) 33 BR 820. For further discussion, see §§11.12-11.13. See also §§2.88-2.96 on postponement effects on debtor's notice and reinstatement rights.

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§7.98 2. Duration of Stay

Unless the automatic stay is modified by order of the bankruptcy court or terminates as provided below, the stay prevents any action against the debtor and continues in effect until the case is closed or dismissed or a discharge is granted or denied to the debtor. 11 USC §362(c)(2). To the extent that the stay prohibits actions against estate property, it terminates when the property is sold or abandoned. 11 USC §362(c)(1).

The automatic stay terminates automatically as a matter of law in the following circumstances after a specified period of time following the filing of a bankruptcy case:

- Under 11 USC §362(e)(1), the automatic stay terminates with respect to a creditor who files a motion for relief from the stay as it affects actions against property of the estate 30 days after the motion is filed, unless the court, after notice and a hearing, orders the stay continued in effect pending a final hearing and final determination of the matter. The court is required to continue the stay in effect if there is a "reasonable likelihood" that the party opposing relief will prevail at the final hearing. 11 USC §362(e)(1). The court is required to conclude the final hearing no later than 30 days after the preliminary hearing, unless the 30-day period is extended with consent of the parties or for a specific time that the court finds is required by "compelling circumstances." 11 USC §362(e)(1).

PRACTICE TIP: It is essential for debtor's counsel to become familiar with local bankruptcy court rules governing relief from stay proceedings, along with any special procedures observed by the bankruptcy judge in the case concerning preliminary and final hearings under 11 USC §362(e)(1).

- Under 11 USC §362(e)(2), in any Chapter 7, 11, or 13 case with an individual debtor, the stay terminates altogether—not merely with respect to particular property or particular creditors—60 days after a motion for relief from stay is filed, unless (1) the court renders a final decision during the 60-day period or (2) the 60-day period is extended by agreement of all parties in interest or by the court for a specific period of time that the court finds is required for good cause as described in findings made by the court.
- Under 11 USC §362(c)(3), the automatic stay is terminated 30 days after the petition date in any single or joint case filed by an individual debtor under Chapter 7, 11, or 13 (except a case refiled under Chapter 11 or Chapter 13 after a dismissal under 11 USC §707(b)) if another single or joint case involving the same debtor was pending during the preceding year but was dismissed. 11 USC §362(c)(3)(A).
- Under 11 USC §362(h)(1), with respect to personal property (or an unexpired personal property lease), the stay is terminated (and the property is no longer property of the estate) if the debtor fails within the time specified (1) to timely file the statement of intention required by 11 USC §521(a)(2) with respect to the property or to indicate in the statement that the debtor will, as applicable, either surrender or retain the property, and if retaining it, either redeem it under 11 USC §722, enter into a reaffirmation agreement as provided in 11 USC §524(c), or assume the lease under 11 USC §365(p) if the trustee does not do so, and (2) to timely carry out the action specified in such statement (unless the debtor intends to reaffirm the debt but the creditor refuses to agree to the reaffirmation).

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§7.99 3. Relief From Stay

Before filing a bankruptcy case on behalf of a debtor client, ostensibly to obtain the benefit of the automatic stay, it is important for counsel to understand that the Bankruptcy Code provides a mechanism by which a secured creditor may obtain relief from the automatic stay to foreclose under its deed of trust on real property. The secured creditor initiates relief from stay proceedings by filing a motion consistent with 11 USC §362, Fed R Bankr P 4001(a) and 9014, and local bankruptcy court rules. Notice and a hearing are required on such a motion (11 USC §102) unless the beneficiary can show that an ex parte application is necessary to prevent irreparable damage to its security interest. 11 USC §362(f). On detailed procedures for stay relief motions, see §§7.100, 7.105-7.106, 11.33-11.50.

Once a motion for relief is filed, the stay automatically terminates in 30 days unless a preliminary hearing is held within 30 days and a final hearing within 30 days after that. 11 USC §362(e). See §7.98. The BAPCPA further provides that the stay automatically terminate in Chapter 7, 11, and 13 cases of individual debtors 60 days after the motion is filed unless the court issues a final decision continuing the stay before the 60 days run or unless that period is extended by consent of the parties or by the court for good cause. 11 USC §362(e)(2). See §7.99. See also Moving for Relief From an Automatic Stay in Bankruptcy (Cal CEB Action Guide September 2006), which has numerous sample forms and strategies for stay relief motions.

A common problem in stay relief motions is that the motion might be filed by a party that is not the real party in interest. The failure of the loan servicer to join the "real party in interest" note owner or prove compliance with agency requirements of applicable commercial law in a relief from stay proceeding will result in denial of the motion. See *In re Kwan Jin Hwang* (Bankr CD Cal 2008) 393 BR 701, rehearing granted and opinion modified at (Bankr CD Cal 2008) 396 BR 757. *Hwang* has been followed in subsequent published and unpublished opinions of the bankruptcy courts. See, *e.g., In re Jacobson* (Bankr WD Wash 2009) 402 BR 359. See also *In re Vargas* (Bankr CD Cal 2008) 396 BR 511. For discussion of *Hwang,* see §§7.15, 7.109. See also §7.105.

Some local bankruptcy court rules in California allow for "scream or die" motions, in which the opportunity to be heard is couched in terms of shifting the burden to the debtor to oppose a relief from stay motion and request a hearing. Counsel must review the local rules before proceeding. Also, with the bankruptcy courts' use of an electronic case-filing system, standard relief from stay forms and orders are often required, not optional. On bankruptcy court hearings, see §§11.33-11.41.

The enforceability of a covenant in a workout agreement or a confirmed plan in bankruptcy, in which the debtor agrees not to oppose relief from stay motions, is usually determined by the equities of the case. See §11.21. Although it may not always be enforceable against the debtor personally (see *Southwest Ga. Bank v Desai (In re Desai)* (Bankr MD Ga 2002) 282 BR 527), it should not bind other creditors (*In re Atrium High Point Ltd. Partnership* (Bankr MD NC 1995) 189 BR 599).

The hearing on the stay may also be an appropriate forum to resolve other questions requiring reference to state law. See, *e.g., Carnation Co. v Lampi (In re Kristal)* (9th Cir 1985) 758 F2d 454 (automatic stay not lifted, because creditor had lost its security by violating one-action rule (CCP §726)). Note that the findings made in a stay relief hearing may not estop the trustee or debtor in possession from later challenging the validity or perfection of a lender's security interest. See §11.54.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.100 a. Grounds for Relief; Burden of Proof

§7.100 a. Grounds for Relief; Burden of Proof

To obtain relief from the stay, the secured creditor must do one of the following:

- Show cause for granting relief, including the lack of adequate protection of the creditor's security interest (11 USC §362(d)(1)). This may include a showing that the creditor lacks an adequate equity cushion in light of the failure of the debtor to make regular monthly payments or the property's decline in value.
- Show that the debtor has no equity in the property and that the property is not necessary to an effective reorganization (11 USC §362(d)(2)). This is not an issue in a Chapter 7 case because there is no possibility to reorganize in such cases. However, if there is equity to provide adequate protection to the creditor, even in a Chapter 7 case, the court may deny relief from stay and the creditor will need to wait until the automatic stay terminates as a matter of law.
- In the case of a single asset real estate bankruptcy filing (see §7.104), simply request relief if the debtor has not performed specified actions within 90 days of the petition date (11 USC §362(d)(3)).
- Show that the filing was part of a scheme to hinder, delay, or defraud creditors involving either transfer of the real estate without consent or multiple bankruptcy filings involving the property (11 USC §362(d)(4)).

The creditor has the burden of proof on the issues that the debtor has no equity in the property and that the filing was part of a scheme to hinder, delay, or defraud creditors. The burden of proof is on the debtor for "all other issues." 11 USC §362(g). Although those are the ultimate burdens, the creditor has the initial burden of establishing a prima facie case for relief under §362(d) (see checklist in §7.106), after which the burden of persuasion shifts to the trustee or debtor, consistent with the proof allocation in §362(g). See, *e.g., Delaney-Morin v Day (In re Delaney-Morin)* (BAP 9th Cir 2003) 304 BR 365 (reversing order granting stay relief because no competent evidence submitted).

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§7.101 b. Bad Faith

Cause for granting relief from the stay under 11 USC §362(d)(1), (d)(4) may include the debtor's bad faith. For detailed discussion of debtor bad faith, see chap 11. Bad faith is usually found when the original trustor conveys the property to a new entity that immediately files bankruptcy (the "new debtor syndrome") or when there are repeated filings intended to gain the benefit of successive automatic stays. 11 USC §362(d)(4); *Duvar Apartments, Inc. v FDIC (In re Duvar Apartments, Inc.)* (BAP 9th Cir 1996) 205 BR 196. In such circumstances, the bankruptcy court need not also determine whether the debtor's proposed plan of reorganization is feasible. 205 BR at 201. See *Sun Valley Newspapers v Sun World Corp. (In re Sun Valley Newspapers)* (BAP 9th Cir 1994) 171 BR 71.

Bad faith may also be found when a debtor ignores a pending state court judgment of liability that would cause the debtor's case to exceed the jurisdictional limits under 11 USC §109(e) for a Chapter 13 filing (currently $336,900 of matured, liquidated, noncontingent, unsecured debt). *Guastella v Hampton (In re Guastella)* (BAP 9th Cir 2006) 341 BR 908. Similarly, a Chapter 13 case may not be sustained if the amount of secured debt exceeds the jurisdictional limit of 11 USC §109(e) (currently $1,010,650). Determination of the amount of debt, secured or unsecured, is based on the debtor's schedules as of the filing date of the bankruptcy case. See *Scovis v Henrichsen (In re Scovis)* (9th Cir 2001) 249 F3d 975 (judicial lien that impairs homestead exemption is avoided, resulting in amount of unsecured debt exceeding Chapter 13 jurisdiction under 11 USC §109(e) because lien is avoidable as of date that petition and schedules are filed). See further discussion in §7.88.

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§7.102 c. Lack of Adequate Protection

Cause for granting relief from the stay under 11 USC §362(d)(1) may also include a lack of "adequate protection" for a secured creditor. See 11 USC §361. What constitutes a lack of adequate protection is not defined, but the Bankruptcy Code lists three ways by which adequate protection may be given to a creditor whose security is subject to the automatic stay: periodic cash payments (11 USC §361(1)), an additional or replacement lien (11 USC §361(2)), or other relief that will give the creditor the "indubitable equivalent" of its original interest (11 USC §361(3)). See §§11.109-11.112.

Adequate protection is usually provided by payments to protect the creditor from depreciation of its collateral and proof that the collateral is insured. The debtor's equity in real property may provide a "cushion" for the creditor against property depreciation. See generally *Pistole v Mellor (In re Mellor)* (9th Cir 1984) 734 F2d 1396. An "equity cushion" is generally defined as the difference between the value of the real property less the total amount of all liens senior to the beneficiary, including, *e.g.,* perfected homeowners association and mechanics' liens. See *Pistole v Mellor, supra*.

Many creditors will stipulate to an adequate protection order, typically requiring the debtor to cure defaults and make postpetition principal and interest payments in specified amounts. If the debtor fails to make the payments, the adequate protection order may also permit the creditor to obtain relief from stay within a short period of time. The bankruptcy court may impose an adequate protection order over a creditor's objection. If the creditor is undersecured and the value of the security is declining, protection in the form of cash payments or additional security may be required. See §11.23. An undersecured creditor, however, is not entitled to postpetition interest. *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626.

PRACTICE TIP: In a Chapter 13 case (in which postpetition adequate protection payments are governed by 11 USC §1326(a)) or in a Chapter 11 case (in which payments for adequate protection are based on the "fair and equitable" requirement of 11 USC §1129(b)), early determination of the extent of the security interest is critical to an effective reorganization. The trustee or debtor in possession seeking to continue the stay based on the argument that the creditor is adequately protected by an equity cushion has the burden of proof on that issue. *Gauvin v Wagner (In re Gauvin)* (BAP 9th Cir 1982) 24 BR 578.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.103 d. When Debtor Has No Equity

§7.103 d. When Debtor Has No Equity

The automatic stay against foreclosure may be lifted if the property is unnecessary to the debtor's effective reorganization and the debtor lacks equity in the property. The debtor's equity, as contrasted to the beneficiary's equity cushion (see §7.102), is the difference between the value of the real property and the total of all liens against the real property. See *Pistole v Mellor (In re Mellor)* (9th Cir 1984) 734 F2d 1396, 1400 n2. Regarding the real property, "no equity" would mean there is nothing in the debtor's estate to protect. See 11 USC §362(d)(2). The burden is on the creditor to prove that the debtor lacks equity. 11 USC §362(g); *Harsh Inv. Corp. v Bialac (In re Bialac)* (9th Cir 1983) 712 F2d 426. See *Stewart v Gurley* (9th Cir 1984) 745 F2d 1194 (defining "equity"). The creditor must also show that the property is not necessary to an effective reorganization, lest lifting the stay impair the rights of the debtor's other creditors. (For example, a debtor may no longer have any equity in its business premises, but the premises are nevertheless essential for the business to continue if the other creditors are to receive anything from a reorganization.) Concerning the possibility of reorganization, a debtor may be able to defeat the undersecured creditor's motion for relief from the stay by showing that there are prospects for an infusion of new capital. However, the debtor must establish a reasonable possibility that its plan can be confirmed in a reasonable time. *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626; *Sun Valley Newspapers v Sun World Corp. (In re Sun Valley Newspapers)* (BAP 9th Cir 1994) 171 BR 71. The debtor must do more than manifest unsubstantiated hopes for a successful reorganization. *Canal Place Ltd. Partnership v Aetna Life Ins. Co. (In re Canal Place Ltd. Partnership)* (5th Cir 1991) 921 F2d 569, 577.

See *Imperial Bank v Tri-Growth Centre City, Ltd. (In re Tri-Growth Centre City, Ltd.)* (Bankr SD Cal 1992) 136 BR 848 for discussion of factors to consider in ruling on relief from stay when the debtor has equity in the property but reorganization is not feasible.

PRACTICE TIP: In the course of a Chapter 11 or Chapter 13 case, a debtor may file a motion for an order to declare the value of the real property for the purpose of establishing (1) that a creditor is wholly undersecured and therefore not entitled to further payments and (2) that relief from stay should be denied because the real property is the debtor's principal residence. These facts are almost by definition necessary to an effective reorganization, even when the debtor has no equity remaining in the property. See, *e.g.*, *Zimmer v PSB Lending Corp. (In re Zimmer)* (9th Cir 2002) 313 F3d 1220; *Lam v Investors Thrift* (*In re Lam)* (BAP 9th Cir 1997) 211 BR 36.

For further discussion of grounds for relief from stay, see §11.22-11.32.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.104 e. Single Asset Real Estate Case

§7.104 e. Single Asset Real Estate Case

Because of perceived abuses of the bankruptcy process by real estate investors and speculators who used bankruptcy filings in an effort to wait out market downturns rather than to genuinely reorganize a complex business enterprise, the Bankruptcy Code was amended in 1994 to impose stricter time and procedural limits in so-called "single asset real estate" cases.

"Single asset real estate" is defined in 11 USC §101(51B) as

> real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

Because real estate developers commonly isolate ownership of separate pieces of commercial real property in separate legal entities for liability and tax reasons, many commercial real estate projects will fall within this definition.

NOTE: Before the BAPCPA, the definition of "single asset real estate" was limited to property with secured debt in the aggregate not exceeding $4 million. The BAPCPA removed the $4 million cap, with the result that the single asset real estate rules now apply in large real estate cases filed on or after October 17, 2005. The amended definition, however, continues to exclude real estate on which significant business operations are conducted, such as hotels or hospitals.

In single asset real estate cases, relief from stay must be granted unless, within 90 days after the filing date or 30 days after the court determines that the case involves a single asset real estate debtor, the debtor either files a reorganization plan that has a reasonable possibility of being confirmed within a reasonable time or begins monthly payments to each creditor whose claim is secured by the single asset real estate in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the property. 11 USC §362(d)(3). For further discussion of single asset real estate cases, see §11.32.

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4. Defending Stay Relief Motions on Securitized Loans

§7.105 a. Recurring Issues; Preserving Claims

Procedures and statutory grounds for generally opposing motions for relief from the automatic stay imposed by federal bankruptcy law are discussed in §§11.21, 11.34, 11.46-11.48. Recurring issues in stay relief motions involving securitized loans filed by loan servicers (such as MERS (Mortgage Electronic Registration Systems); see §7.15) that became significant in the current mortgage crisis are the following:

- Motions for stay relief filed by entities that do not demonstrate through supporting documents that they have standing to file the motions or that have not joined the real party in interest as a moving party. See Com C §§3104, 3301-3302, 3305, 3412-3413; *In re Lee* (Bankr CD Cal 2009) 408 BR 893; *In re Jacobson* (Bankr WD Wash 2009) 402 BR 359; *In re Kwan Jin Hwang* (Bankr CD Cal 2008) 393 BR 701, rehearing granted and opinion modified at (Bankr CD Cal 2008) 396 BR 757 (see §§7.15, 7.109); *In re Parrish* (Bankr ND Ohio 2005) 326 BR 708. See also Fed R Bankr P 7017, 9014. When the court finds that a motion lacks evidentiary support, the court may impose sanctions against the moving party under Fed R Bankr P 9011.
- Creditors adding prepetition or postpetition attorney fees or both to the amounts due from the debtors when those fees are not recoverable under California or bankruptcy law. See CC §§2924c(c)-(d), 2924d(b) and discussion in §§2.58-2.59, 2.102. On recoverable attorney fees under California law in secured loans, see §§8.83-8.90. On attorney fee awards in bankruptcy proceedings, see §11.94. See also *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199.
- Creditors adding to the amount in default under the loan significant sums as "costs," "late charges," or "advances" that are not itemized. In many instances, the added amounts do not fall within the language of the note and deed of trust or are not allowed by statute. See, *e.g.,* CC §§2924c(c)-(d), 2924d(b). See also §§2.58-2.59, 2.102, 8.25-8.35, 8.74-8.90. Other examples are charges incurred for the benefit of third party investors, such as a filing fee for filing an assignment of the mortgage to a trust, charges for broker's price opinions, or charges for a loan servicer's activities. See also examples in §11.94.
- Affidavits that contain conflicting statements about the entity that has possession of the note, with no explanation for the conflict.
- Affidavits or testimony that fails to properly authenticate exhibits, such as payment records, promissory notes, and deeds of trust, under Fed R Evid 901. See also *In re Lee, supra*.
- Testimony by moving party's employees who are not competent to testify regarding evidentiary facts for the motion. See *In re Vargas* (Bankr CD Cal 2008) 396 BR 511.
- Affidavits seeking stay relief that are deficient because, *e.g.,* (1) they appear to be signed by the affiant in one state and notarized in another state, (2) they do not state the date and amount of each payment that has not been made, (3) they claim unpaid payments that were not required by the note, or (4) the affiant has no demonstrated connection to the parties who entered into the note.
- Motions alleging that the underlying note is lost but failing to attach "lost note" affidavits or attaching affidavits that do not comply with Fed R Evid 1004. See also §§1.13, 2.34.
- Local counsel for creditor appearing at hearings on motions for relief from stay who have not been in direct contact with their out-of-town clients and who do not have access to the information needed to advance the motion to a hearing.
- Motions attaching copies of deeds of trust, the authenticity of which is not properly certified under Fed R Evid 902(4) by the county recorder's office.
- Motions alleging that the movant is entitled to enforce a note secured by a deed of trust, but the attached deed of trust and assignments do not demonstrate that they were recorded with the county recorder's office, raising questions of priority vis-à-vis other secured creditors. See also §7.109.
- Motions filed without notice being given to other parties with an interest in the property, such as other

lienholders. See §11.33.

- Motions alleging that the movant is entitled to enforce a note but not factually establishing the right to enforce under Com C §§3301, 3501(a), 3412. See *In re Kwan Jin Hwang, supra*. See also Com C §3302; Eggert, *Held Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law,* 35 Creighton L Rev 363 (Feb. 2002). See also §§3.45, 3.65.
- Motions seeking relief in a case in which the debtor has no interest in the property, or the debtor is not obligated on the note, and no other legal basis is stated for seeking relief from stay.

Debtor's counsel should consider sending a form of demand letter (see §7.30) before filing a bankruptcy to obtain as many loan and security documents as possible. During the case, after service of a motion for relief from stay, counsel may want to propound simple discovery to obtain further documents or documentation from the moving party, the trustee, beneficiary, predecessors in interest, or other parties in interest. Counsel must review applicable local bankruptcy court rules as well as the Federal Rules of Bankruptcy Procedure. See §7.85.

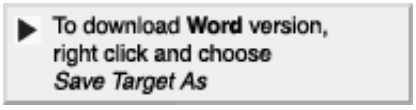
If the debtor may have causes of action for lender liability or claims for relief against the moving party or other parties in interest, counsel should consider amending Schedule B to disclose the possible claim as an asset to preserve it in the event the bankruptcy trustee files a "no asset" report. See Note in §7.56. Following a "no asset" report, a debtor who has disclosed the claim and preserved its rights may proceed with an action in the superior court in the county where the real property is located, on the basis of the documentary evidence obtained in the bankruptcy case, to seek injunctive relief to stay the foreclosure or other affirmative relief. Counsel should also consider disclosing in debtor's bankruptcy Schedule D that the debt is disputed or subject to dispute, so that the issue is not deemed waived and is reserved.

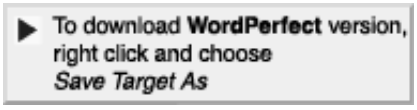
On proposed legislation to amend Bankruptcy Code to empower bankruptcy judges to modify principal amount and terms of loans and loan documents secured only by debtor's principal residence, see Note in §7.118.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.106 b. Checklist: Defenses to Stay Relief

§7.106 b. Checklist: Defenses to Stay Relief





Although many motions for relief from stay are not opposed by the debtor, some bankruptcy courts will not sign a default order granting an unopposed stay relief motion or sign a stipulated order if certain requirements have not been met. The following Checklist is representative of the facts that many bankruptcy courts examine when reviewing unopposed stay relief motions; it also provides numerous issues for debtor's counsel to consider when preparing opposition to a stay relief motion.

- Has the motion been properly served on the appropriate parties? See §11.33.
- Does the motion state a prima facie case for relief from stay by establishing both factual and legal bases for the relief? See §§7.105, 11.39. A prima facie case requires the movant to show that it is entitled to enforce the note under one of the following scenarios (see Com C §3301):
- The movant is the original payee in possession of the original note;
- The movant is the payee because it is in possession of the original note and the note is endorsed to it;
- The note is endorsed in blank and the movant has possession of the original note;
- The movant has physical possession of the note, without an endorsement, but the movant has the rights of a holder; or
- The note is lost but Fed R Evid 1004 and applicable state law are satisfied.
- Has the movant shown that its lien is properly perfected (establishing its position as a secured creditor) and that it is entitled to proceed against the collateral? See §7.105.
- Has the movant shown by competent evidence that the debtor owes money under the note or has otherwise failed to perform under the note or deed of trust? See Fed R Evid 102, 104(a), 602, 801-802, 803(6); *American Express Travel Related Servs. Co. v Vinhee (In re Vinhee)* (BAP 9th Cir 2005) 336 BR 437, 444.
- Has the movant added illegal expenses, costs, or fees to the loan balance that are not supported by contract or statutory law? See §7.105.

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5. Effect of Dismissal or Lifting Stay

§7.107 a. Foreclosure Process Resumed

After a discharge in a Chapter 7 case is entered or relief from the bankruptcy stay is granted, the beneficiary can continue with foreclosure. See *Nghiem v Ghazvini (In re Nghiem)* (BAP 9th Cir 2001) 264 BR 557, aff'd (9th Cir 2002) 53 Fed Appx 489 (unpublished opinion); *Community Thrift & Loan v Suchy (In re Suchy)* (9th Cir 1985) 786 F2d 900. (On whether new notice of sale must be given, see §§2.88-2.94, 7.108.) Failure to obtain a stay pending appeal from an order granting stay relief (to permit foreclosure) moots an appeal from the order. *National Mass Media Telecommunication Sys. v Stanley (In re Nat'l Mass Media Telecommunication Sys.)* (9th Cir 1998) 152 F3d 1178. There are two recognized exceptions to this mootness rule:

(1) The debtor has a statutory right of redemption; or

(2) Other state law would permit the sale to be set aside.

Ewell v Diebert (In re Ewell) (9th Cir 1992) 958 F2d 276. Also, in the proper circumstances, a bankruptcy trustee may be able to have an order lifting the stay vacated. *State Bank v Gledhill (In re Gledhill)* (10th Cir 1996) 76 F3d 1070 (property value had increased and greater return for estate likely through open market sale). For further discussion, see chap 11.

CAUTION: Amendments to California foreclosure statutes under SB 1137 and SB 306 (see §§2.49, 7.38-7.39, 7.61) require a foreclosure trustee or beneficiary to attempt to contact the debtor before commencing foreclosure proceedings. After enacting SB 1137, the California legislature imposed a 90-day foreclosure moratorium; however, lenders and servicers could apply for an exemption from the delay on a showing that they created acceptable loan modification programs. CC §§2923.52-2923.55. See §§2.62-2.62A; chap 10. These requirements may cloud the issue of how a foreclosure may proceed both before and after commencement of a bankruptcy case.

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§7.108 b. Renoticing or Rescheduling Foreclosure Sale

Unless it states otherwise, an order of the bankruptcy court granting stay relief does not become effective until 10 days after its entry. Fed R Bankr P 4001(a)(3). A judgment on dismissal is effective when entered. See Fed R Bankr P 9021. (In bankruptcy cases, the 7-day waiting period under CC §2924g(d) (see §2.90) does not apply. See CC §2924g(e).)

After termination of the automatic stay or dismissal of the bankruptcy case, a new notice of trustee sale must be recorded if the postponement period exceeds 365 days. CC §2924g(c)(2). But whether federal bankruptcy law requires a new notice after a postponement period of 365 days or less is unsettled. See *Tome v Baer (In re Tome)* (Bankr CD Cal 1990) 113 BR 626. See also *In re Acosta* (D Az 1995) 181 BR 477. But contrary holdings appear in *Nghiem v Ghazvini (In re Nghiem)* (BAP 9th Cir 2001) 264 BR 557, aff'd (9th Cir 2002) 53 Fed Appx 489 (unpublished opinion); *Jauregui v Jauregui (In re Jauregui)* (Bankr ED Cal 1996) 197 BR 673; *Macalma v Bank United* (Bankr ND Cal 1995) 192 BR 751, 753. *Tome* was distinguished by a Ninth Circuit bankruptcy appellate panel in *Carl I. Brown & Co. v Anderson* (*In re Anderson)* (BAP 9th Cir 1996) 195 BR 87 (Arizona law does not require new notice after bankruptcy dismissal when foreclosure sale is held on originally scheduled date without postponement).

NOTE: Whether a new notice of sale is required for a sale held after a series of oral postponements precipitated by a bankruptcy stay has yet to be decided by the Ninth Circuit (see remarks made by the Ninth Circuit in the unpublished decision affirming *Nghiem v Ghazvini, supra,* indicating that the *Tome* rule could have been asserted by the debtor in earlier proceedings but was not). Renotice is a crucial issue because, among other things, it directly affects borrowers' reinstatement rights. For further discussion, see §§2.88-2.94. Additionally, under recent amendments to California's foreclosure statutes (SB 1137 and SB 306; see §§2.49, 7.38-7.39, 7.61) requiring additional notices prior to a foreclosure sale, there may be further issues and questions concerning proper notice.

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D. Treatment of Creditor's Claim

§7.109 1. Invalid Secured Claims

The fact that the creditor has recorded a deed of trust against the debtor's real property does not automatically guarantee that the bankruptcy court will recognize it as a secured claim. It may be defeated by the bankruptcy trustee either because it would fail against a BFP (see §7.110), it constitutes a fraudulent conveyance (see §7.111), it arises as a result of a preference (see §7.112), or it represents an illegal act by the creditor. After a hearing before the bankruptcy court (most likely an adversary proceeding to determine the extent, validity, or priority of the lien under 11 USC §506), the claim may be deemed unsecured. See *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1998) 223 BR 203, aff'd (9th Cir 2000) 234 F3d 1108. See §7.88 on distinction between determination of undersecured versus unsecured claims.

NOTE: The bankruptcy court may deny a bank's request to lift the automatic stay because it is not the "real party in interest" under Fed R Civ P 17. See *In re Kwan Jin Hwang* (Bankr CD Cal 2008) 393 BR 701, rehearing granted and opinion modified at (Bankr CD Cal 2008) 396 BR 757 (summarized in §7.15). See also *In re Lee* (Bankr CD Cal 2009) 408 BR 893. But it is not clear whether a bankruptcy court would also deny a bankruptcy claim presented by the loan servicer rather than by the alleged owner of the note. In any event, the *Hwang* and *Lee* cases invite further scrutiny of the status of assignees as holders in due course. See §§7.15, 7.105-7.106, 11.33, 12.37.

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§7.110 2. Unrecorded Claims

An unrecorded mortgage or deed of trust may be set aside under the trustee's "strong-arm" powers as a hypothetical BFP. 11 USC §544(a)(3). However, if the circumstances impose inquiry or constructive notice under state law, the instrument may be protected. *Briggs v Kent (In re Professional Inv. Props.)* (9th Cir 1992) 955 F2d 623; *Robertson v Peters (In re Weisman)* (9th Cir 1993) 5 F3d 417; *Huber v Danning (In re Thomas)* (BAP 9th Cir 1992) 147 BR 526. If an unrecorded interest in real property is listed on the petition page of an involuntary petition, the trustee is deemed to have constructive notice of that interest. *Briggs v Kent,* 955 F2d at 628. But if the unrecorded interest is only listed in the debtor's Schedules or Statement of Financial Affairs, the trustee does not have constructive notice. *Taxel v Chase Manhattan Bank (In re Deuel)* (BAP 9th Cir 2006) 361 BR 509, 511. For further discussion, see §§11.80-11.81.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.111 3. Fraudulent Transfers

§7.111 3. Fraudulent Transfers

Under 11 USC §548(a), a bankruptcy trustee has the power to set aside as a fraudulent transfer a lien created within 1 year before commencement of the bankruptcy case (2 years under the BAPCPA, but only effective for cases filed after April 20, 2006 (*i.e.,* after 1 year following the BAPCPA enactment date); see Pub L 109-8, §§1402, 1406(b)(2), 119 Stat 23) if

- the debtor made the transfer with actual intent to hinder, delay, or defraud creditors; or
- the debtor received less than "reasonably equivalent value" and (1) was insolvent or became insolvent as a result of the transfer; (2) was left with unreasonably small capital for a business or business transaction; (3) incurred or believed that it would incur debts beyond its ability to pay; or (4) made the transfer to or for the benefit of an insider under an employment contract and not in the ordinary course of business.

These tests are comparable to CC §3439.04 in California's version of the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12), which permits liens to be set aside within 4 years after their creation or within 7 years if not reasonably discoverable within 4 years (CC §3439.09). Trustees are also empowered to challenge transfers under UFTA as hypothetical lien creditors (11 USC §544(a)(1)-(2)) or as successors of actual creditors (11 USC §544(b)).

In *BFP v Resolution Trust Corp.* (1994) 511 US 531, 128 L Ed 2d 556, 114 S Ct 1757, the Supreme Court (by a 5-4 decision) resolved a conflict among the circuits and affirmed the Ninth Circuit rule that a foreclosure sale does not constitute a fraudulent transfer merely because of an inadequate bid price if the sale was regularly conducted and noncollusive. The Bankruptcy Code's requirement of "reasonably equivalent value" of the property (rather than "market value") is satisfied by a regularly conducted and noncollusive sale. See *Lindsay v Beneficial Reins. Co. (In re Lindsay)* (9th Cir 1995) 59 F3d 942. The timely recording of a foreclosure deed has been held to perfect a prepetition foreclosure as of the date of the sale notwithstanding an intervening bankruptcy petition. *Bebensee-Wong v FNMA (In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820. For further discussion, see §11.86.

Some "leaking around the edges" of the *BFP* decision has occurred, and the policy of "finality" following a regularly conducted sale may not be absolute. For example, relying on the Restatement (Third) of Property: Mortgages §8.3 (1997) and common law, an Arizona appellate court, accepting a certified question from a United States bankruptcy judge, held that a court has residual discretion to set aside a sale when the foreclosure sale price is so grossly low as to "shock the conscience of the court." *Krohn v Sweetheart Props., Ltd. (In re Krohn)* (Ariz. 2002) 52 P3d 774. The Ninth Circuit in *40235 Washington St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, while following *BFP*, has given it a narrow interpretation and declined to extend its application to other provisions of the Bankruptcy Code, specifically 11 USC §549.

Further "leakage" may occur when the foreclosure sale is not regularly conducted, *e.g.,* if the sale is not actually conducted at the date, time, or place of notice or in accordance with the statutory duty of the foreclosure trustee. A trustor should not dismiss the possibility that a sale has not been regularly conducted. A guarantor of the debt would be well advised to attend the sale as published or as continued in order to ascertain whether the sale has been regularly conducted. See form complaint to set aside a sale in §7.73.

Under 11 USC §548(e), added by the BAPCPA, the trustee has the power to avoid a transfer by the debtor of a property interest to a self-settled trust (a so-called "asset protection trust") if the debtor is a beneficiary of the trust and the transfer was made within 10 years before the date of the bankruptcy filing with the actual intent to "hinder, delay, or defraud" creditors. 11 USC §548(e).

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§7.112 4. Preferences

If the lien was created within 90 days before commencement of the bankruptcy (1 year in certain insider cases) while the debtor was insolvent in order to secure a preexisting debt, and if the transfer enabled the creditor to receive more than it would have in a Chapter 7 liquidation of the debtor, the trustee (or debtor in possession) may have the lien set aside (or avoided) as a preference. 11 USC §547(b). For further discussion, see §§11.82-11.85.

The Bankruptcy Code sets forth ten specific exceptions to transfers that would otherwise be avoidable preferences. See 11 USC §547(c). For example, payments made in the ordinary course of business on long-term debt are not regarded as preferences even if made on an antecedent debt within 90 days before the bankruptcy. 11 USC §547(c)(2); *Union Bank v Wolas* (1991) 502 US 151, 116 L Ed 2d 514, 112 S Ct 527. Also, a transfer that was intended to have been, and in fact was, a contemporaneous exchange for new value is not avoidable as a preference. 11 USC §547(c)(1). "New value" includes a new advance to the debtor but does not include an obligation substituted for an existing obligation. 11 USC §547(a)(2).

The purchase of the property by the secured creditor at a regularly conducted, noncollusive foreclosure sale conducted within 90 days before the bankruptcy filing is not an avoidable preference (11 USC §547(b)), because the purchaser has not received more than it would have under a Chapter 7 liquidation. *Ehring v Western Community Moneycenter (In re Ehring)* (9th Cir 1990) 900 F2d 184. See *Elliott v Frontier Props. (In re Lewis W. Shurtleff, Inc.)* (9th Cir 1985) 778 F2d 1416 (prepetition payments to fully secured creditor not preferential, because creditor would not receive more in Chapter 7 proceeding). For further discussion of setting aside prebankruptcy foreclosures under the avoidable preference doctrine, see 1 Nelson & Whitman, Real Estate Finance Law §8.17 (5th ed 2007).

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§7.113 5. Undersecured Claims

Under 11 USC §506(a), in certain situations, a creditor's claim that is undersecured, *i.e.,* supported by collateral worth less than the amount due, may be bifurcated into separate secured and unsecured claims. 11 USC §506(a). See *Associates Commercial Corp. v Rash* (1997) 520 US 953, 138 L Ed 2d 148, 117 S Ct 1879; *Taffi v U.S. (In re Taffi)* (9th Cir 1996) 96 F3d 1190 (en banc). The secured portion of the claim preserves its status as a secured claim, although its size is reduced (or "stripped down"). The creditor is treated as an unsecured creditor with respect to the remainder of the amount owed. For further discussion of the treatment of secured and unsecured claims in bankruptcy cases, including the extent to which "lien-stripping" remains a viable strategy for debtors after the BAPCPA, see §§7.88, 11.90-11.95, 11.101-11.102, 11.121, 11.137.

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§7.114 6. Completed Sales

A bankruptcy court may set aside a foreclosure on grounds that would have supported invalidation by a state court. *Rosner v Worcester (In re Worcester)* (9th Cir 1987) 811 F2d 1224 (irregularities at sale and gross inadequacy of price sufficient to set aside sale under California law). If a trustee's deed is invalidated because of a bankruptcy stay, CC §1058.5(b) permits the trustee to record a notice of rescission of the trustee's deed. This notice restores the condition of title and the priority of lienholders. For further discussion of foreclosing trustee's authority to rescind sale, see §2.101.

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§7.115 7. Truth in Lending Act Violations

The federal Truth in Lending Act (TILA) (15 USC §§1601-1667f) (see §§7.36, 12.59-12.73) permits a borrower to rescind a loan agreement if the lender fails to deliver certain forms or to disclose important terms accurately when a loan is made in a consumer credit transaction secured by the borrower's principal dwelling. 15 USC §1635. Although the rescission right may not be raised as a defense by the debtor in a stay relief motion, it may be the subject of a federal district court or state court action or of an adversary proceeding in the bankruptcy case. See, *e.g., Lynch v GMAC Mortgage Corp. (In re Lynch)* (Bankr D NH 1994) 170 BR 26 (after deciding adversary proceeding in favor of debtor, bankruptcy court equitably applied TILA rescission remedy in debtor's Chapter 13 case). See also §§7.36, 7.84, 12.150. On the limitations period in which to bring a TILA action and procedures for rescission under TILA, see §§12.63-12.69D.

Even if rescission is unavailable to the borrower, an offset (such as damages incurred by the borrower because of a TILA violation) to the amount claimed by the creditor to be in default may preclude foreclosure or provide the basis for a viable reorganization plan. See, *e.g., Lynch v GMAC Mortgage Corp., supra*. On reorganization plans involving secured creditors, see §§12.59, 12.65, 12.69, 12.79, 12.96.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/7 Debtor Strategies/§7.116 E. Reinstatement and Modification Rights

§7.116 E. Reinstatement and Modification Rights

Through a confirmed Chapter 11 reorganization plan, a debtor may reinstate the maturity of a secured debt even though reinstatement would not be permitted under state law, provided that the plan treats the creditor's claim in accordance with the requirements of Chapter 11. 11 USC §§1123(a)(5), 1124(2). See §§11.97-11.118. A Chapter 13 debtor has similar rights. 11 USC §1322(c)(1). See §§11.119-11.132. On reinstatement in California, see §§2.57-2.61, 2.73.

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§7.117 1. Reinstatement

In Chapter 11 cases, for a debt to be reinstated, the debtor's plan must provide for the cure of defaults. See 11 USC §1124(2). The cure nullifies the consequences of the default, including default penalties such as higher interest, and allows the debtor to reinstate the original interest rate. *Florida Partners Corp. v Southeast Co. (In re Southeast Co.)* (9th Cir 1989) 868 F2d 335; *Great W. Bank & Trust v Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)* (9th Cir 1988) 850 F2d 1338. See also §11.100. The Chapter 11 reinstatement provisions (see §§11.100-11.102) are different from those in Chapter 13 (see §11.127); in Chapter 11, a cure must be made in cash at plan confirmation for de-acceleration to occur without impairment of the claim. 11 USC §1124(2). Until there is a cure of defaults through a confirmed plan, however, reinstatement has not occurred; this provides the secured creditor with further argument in a relief from stay motion that the debtor cannot have a plan in prospect, because the entire amount is due through acceleration as a matter of law. See §§2.51-2.61.

In Chapter 13 cases, under 11 USC §1322(c)(1), a debtor may cure home mortgage defaults up until the time a foreclosure sale has been completed. The plan may provide for reinstatement of a mortgage debt on the debtor's principal residence even though this would not be permitted under state law. 11 USC §1322(b)(5); *Downey Sav. & Loan Ass'n v Metz (In re Metz)* (9th Cir 1987) 820 F2d 1495. See §11.123. Even a debt that had fully matured prepetition may nevertheless be paid in installments thereafter through a confirmed plan. 11 USC §1322(c)(2); *In re Jones* (Bankr D Or 1995) 188 BR 281, 284.

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2. Modification

§7.118 a. Home Mortgages

The Bankruptcy Code draws a distinct line between the treatment of home mortgages and other secured debt by providing that a Chapter 13 plan may generally modify the rights of secured creditors. See §11.123. But a debt secured only by a home mortgage on the debtor's principal residence may not be modified under a Chapter 13 plan (11 USC §1322(b)(2); *Metropolitan Mortgage & Sec. Co. v Rubottom (In re Rubottom)* (BAP 9th Cir 1991) 134 BR 641), except as follows:

- The plan may cure a default within a reasonable time (11 USC §1322(c)(1); *Philadelphia Life Ins. Co. v Proudfoot (In re Proudfoot)* (BAP 9th Cir 1992) 144 BR 876);
- The plan may extend the maturity of the obligation through the duration of the plan (11 USC §1322(c)(2)); or
- The plan may modify debt if the creditor is wholly undersecured (*Lam v Investors Thrift (In re Lam)* (BAP 9th Cir 1997) 211 BR 36; *Zimmer v PSB Lending Corp. (In re Zimmer)* (9th Cir 2002) 313 F3d 1220). See §11.126.

This antimodification rule does not apply to a mortgage claim that is secured by personal property in addition to the debtor's principal residence. See *Hammond v Commonwealth Mortgage Corp. (In re Hammond)* (3d Cir 1994) 27 F3d 52. See also chap 2.

Under 11 USC §1123(b)(5), the same antimodification rules also apply in Chapter 11 cases if the security is the debtor's principal residence. *Lievsay v Western Fin. Sav. Bank (In re Lievsay)* (BAP 9th Cir 1996) 199 BR 705. See §11.102. The antimodification rules do not apply to the debtor's income property. See *Enewally v Washington Mut. Bank (In re Enewally)* (Bankr CD Cal 2002) 276 BR 643, rev'd in part on other grounds (CD Cal 2002) 2002 US Dist Lexis 28113.

The antimodification rule of 11 USC §1322(b)(2) precludes bifurcation of home mortgage debt owed to a partially undersecured creditor under 11 USC §506(a). *Nobelman v American Sav. Bank* (1993) 508 US 324, 124 L Ed 2d 228, 113 S Ct 2106. But the debtor may bifurcate payment of income property loans in a bankruptcy reorganization. See *Enewally v Washington Mut. Bank, supra*. Also, on entry of a discharge, the lien of a junior home mortgage may be avoided (stripped off) under 11 USC §506(d) when the value of the real property is less than the amount secured by senior liens. Because there is no equity to which the junior mortgage lien is attached, the debt is not an allowed secured claim under §506(a) and is not protected against modification. *Lam v Investors Thrift (In re Lam)* (BAP 9th Cir 1997) 211 BR 36; *Bartee v Tara Colony Homeowners Ass'n (In re Bartee)* (5th Cir 2000) 212 F3d 277 (rejecting minority view to contrary).

The Federal Emergency Economic Stabilization Act of 2008 and the Troubled Assets Relief Program (together, Pub L 110-343, 122 Stat 3765) (the 2008 Act) authorize federal agencies to, among other things, reduce foreclosure rates by reducing principal or interest rates or by modifying other terms of troubled loans. When this edition went to press, no implementing regulations were in effect.

NOTE: At the time of publication, there are pending before the United States Congress HR 1106, 111th Cong, 1st Sess (2009) and S 61, 111th Cong, 1st Sess (2009) to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence. Proposed language also may provide additional remedies for violations of TILA or other consumer statutes. Counsel for all parties in interest—debtors, bankruptcy trustees, trustors, beneficiaries, trustees, and foreclosure trustees, as well as such entities as MERS—must be aware of the impact that the passage of such legislation may have on their clients' rights and remedies. For further information, go to http://www.govtrack.us/congress/bill.xpd?bill=h111-1106 and http://www.govtrack.us/congress/bill.xpd?bill=s111-61.

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§7.119 b. "Cram-Down" Powers

A Chapter 11 debtor may obtain confirmation of a plan of reorganization even without the secured creditor's consent if the plan provides for the secured creditor to receive deferred payments on its secured claim structured so that the present value of the payments equals or exceeds the value of the security. 11 USC §1129(b)(2)(A). Under this "cram-down" power, the interest rate or payment schedule may be altered despite the secured creditor's opposition to the plan. See *Idaho Dep't of Lands v Arnold (In re Arnold*) (9th Cir 1986) 806 F2d 937. Cram-down powers are also available in the context of Chapter 12 and Chapter 13 with respect to debt secured other than solely by the debtor's principal residence. See §§11.109-11.112, 11.128-11.130, 11.139-11.141.

The unsecured part of an undersecured creditor's debt is deemed impaired if the plan does not provide for payment in full in accordance with the loan agreement. 11 USC §1124. But the plan may be confirmed over the objection of an impaired class of unsecured claims (including the undersecured creditor's deficiency claim) if it is found to be fair and equitable with respect to those claims. 11 USC §1129(b). When the debtor proposes to keep the real property, its proposed plan can be fair and equitable to an objecting undersecured creditor only if the plan provides either (1) that the undersecured and unsecured creditors will receive value equal to the allowed amount of their unsecured claims or (2) that no claim junior to the claims of such creditors and no equity interest will receive any distributions under the plan. 11 USC §1129(b)(2)(B). This requirement is known as the "absolute priority rule." *Norwest Bank Worthington v Ahlers* (1988) 485 US 197, 99 L Ed 2d 169, 108 S Ct 963; *Everett v Perez (In re Perez)* (9th Cir 1994) 30 F3d 1209. See §11.109-11.112.

In the Ninth Circuit, the absolute priority rule is subject to a "new value" exception, which provides that the infusion of new capital into a reorganized business permits confirmation of the Chapter 11 plan even when the absolute priority rule is not satisfied. The debtor may thereby retain an interest in the property even if the plan does not provide for payment in full to objecting undersecured creditors. *Bonner Mall Partnership v U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)* (9th Cir 1993) 2 F3d 899, motion to vacate denied, appeal dismissed (1994) 513 US 18, 130 L Ed 2d 233, 115 S Ct 386. The proposed infusion of capital must be new, substantial money (or money's worth) necessary for a successful reorganization and reasonably equivalent to the value or interest received by the investor. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650.

For further discussion of the "new value" exception and the standards that govern its application, see §11.113.

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§7.120 c. Acceptable Modifications

A confirmable Chapter 11 plan must give a secured creditor deferred cash payments totaling the allowed amount of its secured claim and having a present value at least equal to the value of the creditor's interest in the real property security. 11 USC §1129(b)(2)(A)(i)(II). See §§11.104-11.115. That standard requires payments of principal having a present value equal to the value of the real property security. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650. It also requires payment of interest at a market rate. *Farm Credit Bank v Fowler (In re Fowler)* (9th Cir 1990) 903 F2d 694. On how to determine proper market rate, see *Till v SCS Credit Corp*. (*In re Till*) (2004) 541 US 465, 158 L Ed 2d 787, 124 S Ct 1951. See also §§11.109-11.112.

"Dirt for debt" plans, which propose to transfer the real property to the secured creditor to satisfy the debt, may be rejected if they do not provide the creditor with payment in full, as it might receive from a solvent debtor in a Chapter 7 liquidation. *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149, overruled on other grounds in *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199. They may also fail to give the creditor the indubitable equivalent of its secured claim, even though the value of the real property is equal to or greater than the debt. *Arnold & Baker Farms v U.S. (In re Arnold & Baker Farms)* (9th Cir 1996) 85 F3d 1415. But see *Sandy Ridge Dev. Corp. v Louisiana Nat'l Bank (In re Sandy Ridge Dev. Corp.)* (5th Cir 1989) 881 F2d 1346.

The fairness of a Chapter 11 reorganization plan that provides for negative amortization of a debt secured by real property is decided on a case-by-case basis. Negative amortization is not per se unfair. 11 USC §1129(b)(2)(A)(i); *Great W. Bank v Sierra Woods Group* (9th Cir 1992) 953 F2d 1174.

A debtor may not use a Chapter 11 plan as a substitute for a duly noticed objection to a secured creditor's claim, *i.e.,* filing a "gotcha plan" that modifies the debt underlying the claim without adequate notice and opportunity for the creditor to be heard. *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)* (BAP 9th Cir 2003) 293 BR 489.

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§7.121 F. Treatment of Property During Bankruptcy

The trustee in bankruptcy or debtor in possession is permitted to use, sell, or lease the security in the ordinary course of business as long as the creditor remains adequately protected (see §7.94). 11 USC §363. See §§11.66-11.76. The bankruptcy court may authorize the debtor in possession or bankruptcy trustee to obtain new credit secured by a lien on the estate's property, with priority senior to a preexisting security interest, if alternative financing is not available and the adequate protection requirement is met. 11 USC §364. See *Woods v Pine Mountain, Ltd. (In re Pine Mountain, Ltd.)* (BAP 9th Cir 1987) 80 BR 171; *In re Chevy Devco* (Bankr CD Cal 1987) 78 BR 585. Similarly, the security may be sold free of the lien if the standards of 11 USC §363(f), concerning substantive and procedural safeguards for the owner of the security, are met.

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§7.122 G. Postpetition Interest and Charges

If the value of the security exceeds the value of the claim, a secured creditor is entitled to postpetition interest and reasonable fees, costs, and charges provided for in the note and allowed under applicable nonbankruptcy law. 11 USC §§506(b), 1123(d), 1322(e); *Joseph F. Sanson Inv. Co. v 268 Ltd. (In re 268 Ltd.)* (9th Cir 1986) 789 F2d 674. These charges are subject to a judicial determination of reasonableness. See *Kord Enters. II v California Commerce Bank (In re Kord Enters. II)* (9th Cir 1998) 139 F3d 684. See also §§11.94-11.95. The Supreme Court held that a company that provided services to a business during a bankruptcy case was not entitled under 11 USC §506(c) to recover payment from benefited property that was fully encumbered by a prepetition security interest. See *Hartford Underwriters Ins. Co. v Union Planters Bank* (2000) 530 US 1, 147 L Ed 2d 1, 120 S Ct 1942.

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§7.123 H. Default Interest Provisions

Provisions in the note increasing the interest rate on default should be enforceable in bankruptcy cases if they would be enforceable under applicable nonbankruptcy law. 11 USC §502(b). See §§8.1, 8.5, 8.34-8.35. But failure to provide notice of acceleration may result in denial of recovery of default interest for the period before actual notice was given. See *Beal Bank v Crystal Props., Ltd. (In re Crystal Props., Ltd.)* (9th Cir 2001) 268 F3d 743. Default interest may be collectible in conjunction with a sale of the property during the bankruptcy. See *Casa Blanca Project Lenders v City Commerce Bank (In re Casa Blanca Project Lenders)* (BAP 9th Cir 1996) 196 BR 140; *In re Terry Ltd. Partnership* (7th Cir 1994) 27 F3d 241. Default interest and late charges, however, may be avoided by reinstatement of the obligation under a reorganization plan. See §7.117.

If the reorganization plan proposes to cure defaults, the necessary amount will be calculated according to the underlying agreement and applicable nonbankruptcy law. 11 USC §§1123(d), 1222(d), 1322(e). Alternatively, the debtor may propose to impair the creditor's claim and propose a market rate of interest under a "cram-down" plan. See §7.119.

Partially undersecured and wholly undersecured creditors have no right to postpetition interest. 11 USC §502(b)(2). See *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626. They are treated the same as general creditors in this respect. For further discussion, see §§11.23, 11.134.

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I. Postpetition Rents

§7.124 1. Lender's Entitlement to Rents

Under 11 USC §552(b)(2), lenders have valid security interests in postpetition rents "to the extent provided in such security agreement." This section abolished the earlier requirement that a lender must perfect or enforce its security interest to have access to postpetition rents. See *In re Goco Realty Fund I* (Bankr ND Cal 1993) 151 BR 241. Whether the security interest in the rents is choate or inchoate under state law, all rents are cash collateral that must be sequestered and may not be used without the secured lender's consent or a court order giving the lender adequate protection. 11 USC §363(c)(2). See chap 11. Judicial approval of the trustee's use of such funds cannot be given unless the beneficiary remains adequately protected. 11 USC §363(c)(1).

Collection of rents by the lender does not violate the one-action rule or other antideficiency statutes in California. CC §2938(e). See *Metropolitan Life Ins. Co. v Sunnymead Shopping Ctr. (In re Sunnymead Shopping Ctr.)* (BAP 9th Cir 1995) 178 BR 809; *Resolution Trust Corp. v Bayside Developers* (ND Cal 1993) 817 F Supp 822, aff'd (9th Cir 1995) 43 F3d 1230.

Rents accumulated during a bankruptcy case are additional security, so that the value of the lender's collateral is the property value plus all accumulated rents. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650. Under this view, net rents paid to the lender during the bankruptcy case would be applied to the portion of the lender's claim secured by rents. *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284. See §11.59. Such rents, although additional security, have not been deemed such additional security as would allow for the modification of a debt secured only by the debtor's principal residence.

EXAMPLE: If a debtor uses its principal residence as owner-occupied rental property (such as a triplex) and collects rents from apartments, the rents would not be deemed such additional security that would overcome the antimodification provisions of Chapter 11 and Chapter 13. *Lee v Home Savs. (In re Lee)* (BAP 9th Cir 1997) 215 BR 22. See §11.102.

On proposed legislation to amend Bankruptcy Code to empower bankruptcy judges to modify principal amount and terms of loans and loan documents secured only by debtor's principal residence, see Note in §7.118.

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§7.125 2. Commercial Lodging Property

Rents and charges for the use or occupancy of hotel, motel, or other lodging property are treated differently from "proceeds, products, offspring or profits" of property under the Bankruptcy Code. Compare 11 USC §552(b)(1) with 11 USC §552(b)(2).

State law determines whether income derived from operations conducted on real property constitutes rents rather than some other kind of revenue. *Steinberg v Crossland Mortgage Corp. (In re Park at Dash Point, L.P.)* (9th Cir 1993) 985 F2d 1008. This distinction is important not only under 11 USC §552 but also in determining whether perfection of a security interest in the income stream at issue should be accomplished by (1) recordation of a rents assignment or (2) the filing of a Uniform Commercial Code financing statement. See §§11.56, 11.67 (reviewing cases making distinction).

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8

Payment and Related Disputes

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§8.1 I. CHAPTER SUMMARY AND SCOPE

This chapter discusses disagreements between the parties about whether an obligation is due or payable now or later and how much is owed at a given time. Demand notes are rare, and most secured notes provide for some sort of periodic payment (either amortizing installments of principal and interest or calling for payments of interest alone) (see §1.18). This installment feature of notes secured by real property inevitably generates concern about the consequences of a missed payment: Is the creditor limited to collecting only the unpaid installment, or may it treat the entire debt as unpaid? To resolve uncertainties, secured notes usually contain an acceleration clause permitting the creditor to declare the entire obligation due when the debtor defaults on an installment. For discussion of acceleration clauses, see §§8.2-8.7. Acceleration of the note when there is a sale or encumbrance of the property rather than a default in payment depends on inclusion in the note of a "due-on" clause (see 8.8-8.23), which functions much like an acceleration clause.

When an installment is missed but is paid before the creditor attempts to accelerate the remaining installments, there is the question of appropriate relief for late payment. Interest is probably due on the unpaid installment as of its original due date (CC §3302), but many promissory notes include a late charge or "default interest" provision requiring that an additional amount be paid after the installment is *x* number of days overdue (see §§8.25-8.34). Depending on the language of the note, the creditor may also refuse a payment that is premature (*i.e.,* reject a "prepayment") or demand a prepayment penalty for accepting it (see §§8.36-8.53).

Other monetary issues concerning the amount the debtor owes the creditor are also discussed in this chapter (see §§8.54-8.90), including demands by the creditor-beneficiary for (1) additional sums to cover insurance premiums that the debtor-trustor failed to pay and (2) application of the proceeds of a casualty insurance award toward reducing the indebtedness rather than restoring the property (see §§8.57-8.64). The amount owing may also be affected if the beneficiary makes tax payments because the trustor failed to do so (see §§8.74-8.76). Disagreements over the amount due or the date due may eventually result in litigation and claims by either party for reimbursement of attorney fees (see §§8.83-8.90). Other issues that may arise under the promissory note and relating to payment of the obligation are discussed in §§8.92-8.99.

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II. LOAN ACCELERATION PROVISIONS

§8.2 A. Acceleration-on-Default Clause

A note payable in installments usually contains a clause permitting the creditor to accelerate the balance of the debt following a default in an installment payment or a breach in the performance of covenants in the deed of trust. Other types of clauses may refer to an "event of default" as grounds for declaring the entire balance immediately due and payable. Although an acceleration clause fits most appropriately in the note where all other provisions for payment are set out, the clause is also often included in the deed of trust. If both documents contain printed acceleration clauses, counsel should make sure that they are consistent with one another or should indicate the respective scope and effect of each clause. See Com C §§3106, 3117; *Bryan v Swain* (1880) 56 C 616. See also *Pacific Fruit Exch. v Duke* (1930) 103 CA 340, 284 P 729.

An acceleration clause included in the note binds all parties liable under the note, *i.e.,* those who either sign or guarantee it (see *Burrill v Robert Marsh & Co.* (1934) 138 CA 101, 31 P2d 823), and it overrides any inconsistent provisions in the deed of trust (*Pacific Fruit Exch. v Duke, supra; San Gabriel Valley Bank v Lake View Town Co.* (1906) 4 CA 630, 89 P 360). An acceleration clause in the recorded deed of trust gives constructive notice to all subsequent purchasers and lienors of the encumbered property who might otherwise have no means of seeing the original note. CC §1214.

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1. Effect of Absence of Acceleration Clause

§8.3 a. Judicial Foreclosures

If no language in the loan documents permits the creditor to accelerate on default, the creditor is limited to collecting the single unpaid installment and repeating the procedure as further installments fall due and are not honored. If judicial means are used to collect the debt, the creditor can face serious consequences under the "one-action" rule (CCP §726) (see §§4.3-4.5). However, the creditor sometimes may achieve acceleration indirectly. Code of Civil Procedure §728 provides that an indivisible piece of security may be sold in its entirety, and the entire debt paid off, in a foreclosure action. *Yoakam v White* (1893) 97 C 286, 32 P 238.

If the property is divisible, however, the foreclosure sale must cease as soon as a bid is sufficient to cover the installments unpaid as of the date of the foreclosure judgment. *Bank of Napa v Godfrey* (1888) 77 C 612, 20 P 142. After the sale, the beneficiary may hold further foreclosure sales to cover later unpaid installments, either after supplementary motions in the same action (*Byrne v Hoag* (1899) 126 C 283, 58 P 688) (for which the original decree should provide; see *Bank of Napa v Godfrey, supra*) or perhaps by filing periodic, successive foreclosure actions (CCP §1047; *Higgins v San Diego Sav. Bank* (1900) 129 C 184, 61 P 943; *McDougal v Downey* (1872) 45 C 165; *Zingheim v Marshall* (1967) 249 CA2d 736, 57 CR 809). See §3.48. But see effect of one-action rule in §§4.12-4.13, 9.5-9.9.

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§8.4 b. Power of Sale Clause

A power of sale clause in a mortgage or deed of trust (see §§2.14-2.17) may operate as an acceleration clause if it provides (1) for a sale on default and (2) that the beneficiary will use the sale proceeds to pay off the entire debt. *Phelps v Mayers* (1899) 126 C 549, 58 P 1048; *Kuster v Parlier* (1932) 122 CA 432, 10 P2d 124. See CC §2924. Such a clause may not be an adequate substitute if the encumbered property is divisible and can be sold piecemeal. See *Yoakam v White* (1893) 97 C 286, 32 P 238; *Bank of San Luis Obispo v Johnson* (1878) 53 C 99. See also §§8.3, 9.4; *Hall v Jameson* (1907) 151 C 606, 91 P 518 (accelerated sale allowed; deficiency judgment postponed until end of entire installment period).

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§8.5 2. Validity of Acceleration Clause

The acceleration clause is a valid accessory to a secured note. See Com C §3108(b). It is not an illegal penalty, because it governs only the time of payment. See *Maddox v Wyman* (1892) 92 C 674, 28 P 838. It gives the maker the limited privilege of delaying full repayment only as long as the maker keeps the installment payments current. *Jump v Barr* (1920) 46 CA 338, 189 P 334. The courts have stated that an acceleration clause does not work a forfeiture, because the size of the obligation is not increased. *Whitcher v Webb* (1872) 44 C 127. If acceleration would cause the trustor sufficient hardship, however, a court may invoke some equitable defense, such as waiver, to prohibit it. *Bisno v Sax* (1959) 175 CA2d 714, 346 P2d 814. Inclusion of an acceleration clause in the note may not compel the beneficiary to accelerate if good reasons can be shown for seeking some other relief (*e.g.,* piecemeal foreclosure). See *Furesz v Garcia* (1981) 120 CA3d 793, 174 CR 803. An acceleration may not be valid or sufficient to support default interest until notice of the acceleration is communicated to the borrower. *Beal Bank v Crystal Props., Ltd. (In re Crystal Props., Ltd.)* (9th Cir 2001) 268 F3d 743. For discussion of collection of default interest and prepayment penalties on acceleration, see §§8.47-8.50.

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§8.6 3. Income Tax Effects of Acceleration

A seller who provided some financing and reported gain on the installment method (under IRC §453) loses the right to further defer gain once the debt is accelerated and paid. For discussion of installment sales, see RIA Fed Tax Coordinator 2d, ¶¶G-6000-6550 (Nov. 1999); California Real Property Sales Transactions, chap 9 (4th ed Cal CEB 2007).

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§8.7 4. Disclosure of Acceleration Provisions

The Truth in Lending Act (TILA) (15 USC §§1601-1667f) (see §§7.36, 12.59-12.69) requires the disclosure of an acceleration provision (see 15 USC §§1631, 1638), but Reg Z (12 CFR §226.18(p)) permits the disclosure to refer the consumer to the appropriate contract document for information on the right to accelerate and on related matters. Most creditors, following model form H-1 in Reg Z (12 CFR pt 226, App H), use this language:

> See your promissory note for additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

On validity of prepayment penalties on acceleration, see §§8.47-8.50.

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B. "Due-on" Provisions

1. Types of Clauses

§8.8 a. Acceleration on Transfer of Property

Property subject to a mortgage or deed of trust is no less transferable than is unencumbered property. CC §1044. The encumbrance, of course, is "transferred" with the property, so that a purchaser takes subject to all duly recorded encumbrances whether or not the parties have so recited in their deed. Nearly all security instruments contain "due-on" provisions, either in the form of a due-on-sale clause or by making a sale, lease, exchange, assignment, conveyance, encumbrance, transfer of possession, or other transfer or disposition of the secured property an event of default (see §8.2). On the occurrence of a sale or other transfer, the lender may accelerate the balance of the debt.

During the 1980s and 1990s, lenders rewrote earlier versions of the simple "due-on-sale" clause and made them the broader "due-on-transfer" clauses, which do not have any universal or constant wording. See, *e.g.,* California Real Estate Finance Practice: Strategies and Forms, chaps 3-4 (Cal CEB 2000). They are therefore referred to throughout this discussion as "due-on" clauses.

A "due-on" clause may appear in both the note and the deed of trust, but commercial loan documents vary. See, *e.g.,* note and deed of trust forms in Real Estate Finance §§3.65, 4.43-4.45, 4.85-4.86. The presence of a "due-on" clause in the note does not impair negotiability (Com C §3104) and may be necessary under CC §2924.5 (requiring that this provision appear in both the note and the deed of trust for any post-June 1972 loan on small residential properties). The clause is also included in the deed of trust to comply with CC §2924.5 and to give constructive notice to subsequent purchasers and encumbrancers (CC §1214).

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§8.9 b. Covenant Not to Convey

A document labeled as an agreement (or covenant) not to sell (or convey or encumber), sometimes called a "negative pledge," may serve purposes similar to those of a "due-on" clause. Such a document is usually used in lieu of a mortgage or deed of trust, but it is a poor substitute. If a covenant not to convey is connected with an installment obligation, it will permit the covenantee to accelerate the obligation, but it does little else. Once accelerated, there is no follow-up right to sell the property, because these documents inevitably lack any power of sale clause (see §§2.14-2.17, 3.3). A power of sale clause cannot be included without defeating a major purpose of the covenant, *i.e.,* to camouflage the fact that the holder of a note is taking security for it. To contain an effective power of sale clause, the agreement must acknowledge that it functions as a deed of trust (or mortgage), which is what lenders usually seek to avoid. The lender may still be able to contend, as it did in *Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379, that the covenant amounts to an equitable mortgage (lacking all the fine print), but that characterization will justify only judicial foreclosure. *Kaiser Indus. Corp. v Taylor* (1971) 17 CA3d 346, 94 CR 773. In addition, the debtor may successfully contend that the parties did not intend to create a mortgage, in which case the lender becomes entirely unsecured. *Tahoe Nat'l Bank v Phillips* (1971) 4 C3d 11, 92 CR 704; *Orange County Teachers Credit Union v Peppard* (1971) 21 CA3d 448, 98 CR 533. For additional discussion of enforcing hidden mortgages, see §3.44.

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2. Historical Development and Validity

§8.10 a. Covenants Not to Convey: *Coast Bank* and *Tahoe Bank*

The "due-on" clause has had a remarkable history in the state and federal courts and in the United States Congress. Its first judicial recognition was as a separate document, *i.e.,* an Agreement Not To Encumber or Transfer Property. In holding that such an instrument could be construed as an equitable mortgage, the California Supreme Court added that an agreement providing for acceleration of an installment debt on the transfer of real property would not be an invalid restraint on alienation under CC §711. *Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379. The court later backed away from that position when it declared, in *Tahoe Nat'l Bank v Phillips* (1971) 4 C3d 11, 92 CR 704, that a document similar in appearance was not a mortgage. The *Tahoe* court held that it was only "poetic justice" if the lender chose to use an ambiguous agreement and that ambiguity was later construed in the borrower's favor. 4 C3d at 20. This left the bar in great doubt about which covenants not to convey would be deemed mortgages and which would not.

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§8.11 b. Due-on-Encumbrance Clause: *La Sala*

In *La Sala v American Sav. & Loan Ass'n* (1971) 5 C3d 864, 877, 97 CR 849, the supreme court—dealing with a due-on-encumbrance clause in a deed of trust—held that the senior beneficiary could not automatically accelerate the loan when the trustor imposed a junior deed of trust on the same property. The court stated that automatic acceleration amounted to an unlawful restraint on alienation and would be allowed only if the senior could show that it was reasonably necessary to protect the security from impairment.

Civil Code §2949, enacted in 1972, prohibits enforcement of a due-on-encumbrance clause in a loan secured by a single-family, owner-occupied dwelling. In addition, CC §2924.6(a)(5) (see §8.18) prohibits automatic acceleration of a loan secured by residential real property of one to four units when the property is subjected to a junior encumbrance or lien.

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c. Balancing Quantum of Restraint Against Justification

§8.12 (1) Installment Land Sale Contracts: *Tucker*

In 1974, the supreme court ruled that a lender could not automatically accelerate its loan under a due-on-sale clause when the trustor had executed an installment land contract for sale of the property. *Tucker v Lassen Sav. & Loan Ass'n* (1974) 12 C3d 629, 116 CR 633. The court held that the right to accelerate depended on balancing the "quantum of the restraint" on alienation imposed on the trustor against the justification for the restraint on behalf of the lender. 12 C3d at 636. In the case of an installment land contract, the balance tipped against the lender. The quantum of restraint was heavy: Automatic acceleration effectively prohibits such sales. Conversely, the justification for the restraint was light: The lender was adequately protected against the risks of waste and default, and the lender's desire to use the sale as a device to correct interest rates in a rising market was not considered a legitimate justification.

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§8.13 (2) Outright Sales: *Wellenkamp* and *Dawn*

In 1978, the California Supreme Court ruled that an institutional lender could not automatically accelerate the due date of the loan even when the borrower sold the property outright, *i.e.,* transferred full legal title to the purchaser. *Wellenkamp v Bank of America* (1978) 21 C3d 943, 148 CR 379. Reconsidering and rejecting its earlier, contrary dicta, the court held that a restraint on alienation existed whenever the seller's lender threatened to call its loan or demanded an increased interest rate from a prospective buyer. The fact that acceleration merely compelled the buyer to borrow at current market rates did not lessen the restraint if a market rate loan was "economically unfeasible." 21 C3d at 950. The court found no counterbalancing justification for such restraint. In previous decisions, the court had held the restraint unjustified because the seller's retention of an interest in the property constituted an incentive to keep the loan current. This incentive is obviously absent when the seller has been cashed out, but the court held that the downpayment would probably give the buyer enough of a stake in the property to deter a default. Thus, there was no justification for automatic acceleration, even with an outright sale of the property. The court again rejected the lender's argument that acceleration was justified as a device to keep loans at current interest rates, admonishing the lending industry that the burden of bad economic projections should not fall on homeowners selling their properties.

In 1982, the supreme court held that automatic acceleration was prohibited, even for noninstitutional private lenders financing commercial real property. *Dawn Inv. Co. v Superior Court* (1982) 30 C3d 695, 180 CR 332. The same reason was given, *i.e.,* that the quantum of restraint outweighed its justification.

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3. Legislative and Industry Responses to *Wellenkamp* and *Dawn*

§8.14 a. Federally Chartered Banks and Adjustable Rate Loans

The decisions in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 148 CR 379, and *Dawn Inv. Co. v Superior Court* (1982) 30 C3d 695, 180 CR 332 (see §8.13), were extremely unpopular in the lending industry and among many housing economists. Institutional lenders, who "lend short but borrow long," were trapped with portfolios of fixed-rate, low-interest loans that they had expected would be paid off in the average 7-year ownership cycle by automatic enforcement of due-on-sale clauses. Meanwhile they had to pay depositors higher interest rates. Home prices rose when sellers discovered that their ability to transfer low-interest loans to buyers without acceleration added value to their properties.

Many other jurisdictions rejected the *Wellenkamp* logic, treating it either as bad economics or as inappropriate judicial intervention in the real estate market. More significantly, the former Federal Home Loan Bank Board (FHLBB) authorized federally chartered savings and loan associations to enforce "due-on" clauses "according to their terms" (*i.e.,* automatically and without proof that the sale impaired the security) despite California's inconsistent law. See former 12 CFR §545.8-3(f). (Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Pub L 101-73, 103 Stat 183), the FHLBB was replaced by the Office of Thrift Supervision (OTS) in the Treasury Department. See 12 USC §1462a(a). On regulation of institutional lenders, see California Real Estate Finance Practice: Strategies and Forms §§1.17-1.24 (Cal CEB 2000).)

The United States Supreme Court upheld the FHLLB action. See *Fidelity Fed. Sav. & Loan Ass'n v de la Cuesta* (1982) 458 US 141, 73 L Ed 2d 664, 102 S Ct 3014. California lenders began to convert to federal charters. In 1982, Congress enacted the Alternative Mortgage Transaction Parity Act (12 USC §§3801-3806), authorizing adjustable rate mortgage (ARM) loans and preempting state laws that restrict alternative mortgage loan terms (see, *e.g.,* §§8.31, 8.46). Under the act's implementing regulations, state-chartered banks are permitted to make ARM loans on the same terms as national banks (12 CFR §34.24), and other state-chartered lenders are permitted to make ARM loans on the same terms as federally chartered savings and loan associations (12 CFR §560.220). (On the scope of preemption under the act and its effect on jurisdiction and California's lending laws, see *Ansley v Ameriquest Mortgage Co.* (9th Cir 2003) 340 F3d 858 (in prepayment penalty case, act was not so broadly preemptive as to confirm exclusive federal court jurisdiction); *Black v Financial Freedom Sr. Funding Corp.* (2001) 92 CA4th 917, 112 CR2d 445 (act interpreted narrowly; does not preempt state laws regulating reverse mortgages); *Quicken Loans, Inc. v Wood* (9th Cir 2006) 449 F3d 944 (act does not preempt California's per diem interest limitation under Fin C §50204(o) and CC §2948.5). But see Whitman, *Preemption of State Laws Protecting Mortgage Borrowers: The Parity Act May Be Broader Than You Think,* 24 CEB Real Prop L Rep 223 (Aug. 2001).)

The state's legislative response was to authorize various nonfixed-rate loans, such as the "adjustable-payment, adjustable-rate loan" (see CC §1916.7), the "renegotiable rate mortgage loan" (see CC §1916.8), and the "shared appreciation" mortgage (see CC §§1917-1917.006 and former CC §§1917.010-1917.075, 1917.110-1917.175). When state-chartered lenders elect to take advantage of federal statutes concerning alternative mortgage transactions, they operate under a preemptive federal statutory scheme, although the scope of preemption is often unclear. Compare *Black v Financial Freedom Sr. Funding Corp., supra,* with *Illinois Ass'n of Mortgage Brokers v Office of Banks & Real Estate* (7th Cir 2002) 308 F3d 762; *National Home Equity Mortgage Ass'n v Face* (4th Cir 2001) 239 F3d 633; *Shinn v Encore Mortgage Servs., Inc.* (D NJ 2000) 96 F Supp 2d 419, discussed in 24 CEB Real Prop L Rep 223 (Aug. 2001). See generally Real Estate Finance, chaps 1-3.

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§8.15 b. Preemption Under Garn Act and Federal Regulations

The enactment of the Garn-St. Germain Depository Institutions Act of 1982 (12 USC §1701j-3) was *the* development of overriding importance. The Garn Act preempted the area and validated automatic enforcement of "due-on" clauses according to the terms of the contract despite contrary state law. (An initial "window period," during which state invalidation remained in effect, expired in 1985.) The Garn Act's validation of "due-on" clauses was formalized in regulations promulgated by the former Federal Home Loan Bank Board (FHLBB) (now the Office of Thrift Supervision).

NOTE: The preemption issue has been relatively quiescent since the 1980s. However, the full details and scope of federal preemption of laws concerning mortgage lending are by no means fully resolved and can be expected to take a more central place during the legal aftermath of the "sub prime mortgage" crisis and the broader tremors in national mortgage markets. The U.S. Supreme Court held in *Watters v Wachovia Bank, N.A.* (2007) 550 US 1, 167 L Ed 2d 389, 127 S Ct 1559, that state law could not significantly impair or impede a bank from exercising powers granted under the National Bank Act (12 USC §§21-216d).

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§8.16 (1) Loans Secured by Residential Property

Under the regulations implementing the Garn-St. Germain Depository Institutions Act of 1982 (12 USC §1701j-3), "due-on" clauses generally are valid according to their terms (*i.e.,* automatically); however, their exercise is prohibited for loans secured by a home "occupied or to be occupied by the borrower" in the following situations (12 CFR §591.5(b)(1)):

- Creation of a subordinate lien;
- Transfer on the death of a joint tenant;
- Grant of a leasehold interest of no more than 3 years;
- Transfers to certain named relatives; and
- Transfer to an inter vivos trust in which the borrower remains the occupant of the property.

Although the Garn Act (see §8.15) originally excepted all junior financing arrangements from its validating provisions, an amendment to 12 USC §1701j-3(d) limited the exceptions to owner-occupied residential dwellings, as the regulation does. Exceptions are embodied in state law in CC §2924.6 (see §8.18). That section, however, does not require owner occupancy for the exceptions to apply.

The effect of the Garn Act on existing state law regulation of "due-on" clauses (see §8.18) is unknown.

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§8.17 (2) Loans Secured by Nonresidential Property

It appears that due-on-encumbrance clauses as well as due-on-sale clauses involving commercial real property are enforceable under the Garn-St. Germain Depository Institutions Act of 1982 (12 USC §1701j-3) (see §8.15). The act's definition of "due-on-sale clauses" is broad enough to include due-on-encumbrance clauses within its validating language. The original version of the Garn Act excepted junior financing arrangements from its validating provisions, but 12 CFR §591.5(b)(1) limits the exceptions to owner-occupied residential dwellings. See §8.16. Although there was some question whether the FHLBB (now the Office of Thrift Supervision) exceeded its authority in regulations it adopted on this issue, the Garn Act itself was later amended to incorporate the FHLBB's interpretation of the scope of the exception, thus implicitly validating due-on-encumbrance clauses in the commercial context. See 12 USC §1701j-3(d).

NOTE: The "due-on" wars of the late 1970s and very early 1980s ended with remarkable abruptness in 1982-1983 because of several factors. Certainly the "one-two punch" delivered by the Garn Act and the Supreme Court's decision in *Fidelity Fed. Sav. & Loan Ass'n v de la Cuesta* (1982) 458 US 141, 73 L Ed 2d 664, 102 S Ct 3014 (see §8.14), was of great importance. However, the decline of interest rates and the burgeoning use of variable and adjustable rate instruments also removed much of the energy from the controversy. Because of this abrupt end to hostilities, there remain to this day several unresolved textual disputes concerning due-on clauses that could emerge the next time interest rates rise dramatically. One such potential dispute is whether the text of the Garn Act and the accompanying regulations apply to permit automatic enforcement of due-on-encumbrance clauses in commercial transactions. The legislative history and text suggest that they do, but some practitioners would argue that a California deed of trust transaction is not a "transfer" as that term is used in 12 USC §1701j-3(a)(1). This argument is reinforced because §1701j-3(a)(3) omits any reference to "deeds of trust" and uses the term "liens." (This latter point is significant because in California, a deed of trust is a non-lien security interest in land.) Although these text-based arguments may be long shots, one borrower (in a rare post-Garn Act decision) making a similarly esoteric and text-based argument was successful in its argument to the Idaho Supreme Court. See *O'Boskey v First Fed. Sav. & Loan Ass'n* (Idaho 1984) 678 P2d 1112, which held that the placement of a due-on-sale clause in a deed of trust (after the heading "To Protect the Security of this Deed of Trust …") prohibited automatic enforcement of the due-on-sale clause. Instead, the court required proof that the transfer impaired the security because the instrument, by its language, adopted as a contractual matter an "impairment of security" standard similar to that imposed in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 148 CR 379 (see §8.13).

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§8.18 c. California Residential Exemptions

Although the Garn-St. Germain Depository Institutions Act of 1982 (12 USC §1701j-3; see §8.15) preempted the regulation of "due-on" clauses, existing California exemptions have not been repealed. Under CC §2924.6, the following transactions are exempt from automatic enforcement of a "due-on" clause in connection with a deed of trust on residential real property if the loan was executed or refinanced on or after January 1, 1976 (CC §2924.6(a)(2)-(5)):

- A transfer by the obligor in which the obligor's spouse becomes a co-owner of the property;
- A transfer resulting from a decree of dissolution of marriage or legal separation or a property settlement incidental to such a decree in which the obligor is required to continue loan payments by which a spouse who is an obligor becomes sole owner of the property;
- A transfer by the obligor to an inter vivos trust of which the obligor is the beneficiary; and
- The imposition of a junior lien or encumbrance on the property.

NOTE: Civil Code §2924.6 does not require owner occupancy. The term "residential property" is merely defined as "any real property which contains at least one but not more than four housing units." CC §2924.6(c).

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4. Effect of "Due-on" Clauses

§8.19 a. Enforcement

A "due-on" clause does not prohibit the trustor from conveying (or encumbering) the property. Rather, it makes a conveyance (or subsequent encumbrance) without the lender's consent (1) an event entitling the lender to accelerate the existing installment loan or (2) an event of default (see §§8.2, 8.8). In the former event, the lender must first declare an election to accelerate the loan. If the accelerated total is not paid, the lender then records a notice of default and election to sell. See *Miller v Cote* (1982) 127 CA3d 888, 179 CR 753 (notice of default is defective if it states that transfer is the specified default). In other words, the debtor's failure to pay the accelerated balance after the beneficiary accelerates is the default. However, when the clause makes a transfer of the property an event of default, the lender may not need to declare an acceleration before proceeding with a notice of default. In either case, reinstatement is probably impossible. See §2.51.

Under existing case law, the lender is limited to acceleration and foreclosure when the specified event occurs, and nothing in the Garn-St. Germain Depository Institutions Act of 1982 (12 USC §1701j-3; see §8.15) suggests the existence of any additional remedies. Language in *Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379, indicated that any more vigorous form of enforcement (*e.g.,* an outright prohibition against a transfer) might constitute an unlawful, "disabling" restraint on alienation. The "due-on" provision does not entitle the beneficiary to void the objectionable transfer. *People v Klopstock* (1944) 24 C2d 897, 151 P2d 641; *Randol v Tatum* (1893) 98 C 390, 33 P 433; *Weisman v Clark* (1965) 232 CA2d 764, 43 CR 108. Similarly, the beneficiary cannot instruct the escrow agent to delay closing a sale until the beneficiary consents to the transfer. *Moss v Minor Props., Inc.* (1968) 262 CA2d 847, 69 CR 341.

For sample due-on clauses in commercial deed of trust form, see California Real Estate Finance Practice: Strategies and Forms §§4.43-4.45, 4.85-4.86 (Cal CEB 2000).

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§8.20 b. Effect on Reinstatement Rights

A default declared because of a transfer, or because of failure to pay an accelerated debt following a transfer, is unlikely to be subject to reinstatement under CC §2924c. In this respect, the "due-on" clause functions differently from the acceleration-on-default clause (see §§8.2-8.5). If the real default is regarded as the transfer itself, it is a nonmoney default and therefore hardly qualifies for reinstatement by payment of arrearages under §2924c. See *Crowell v City of Riverside* (1938) 26 CA2d 566, 80 P2d 120. If the default is treated as failure to pay the entire debt after it was accelerated (because of the transfer), then that default can be cured only by payment of the entire debt (*i.e.,* redemption) and the right to reinstatement is meaningless (see §§2.51, 2.73). On lender's right to impose prepayment penalty following acceleration under "due-on" clause, see §§8.47-8.50.

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§8.21 c. Covered Transactions

When the transaction involved is not covered by the "due-on" clause, or if there is no "due-on" clause at all, the lender has no right to accelerate on that transaction, because property subject to a deed of trust is always fully alienable unless subject to a contrary agreement. CC §1044. See *Miller v Cote* (1982) 127 CA3d 888, 179 CR 753 (memorandum of intent is not transfer and therefore not covered by "due-on" clause, even if accompanied by change of physical control of property).

Leases of the real property security are included within the class of transactions that may be covered by "due-on" clauses under the Garn-St. Germain Depository Institutions Act of 1982 (12 USC §1701j-3; see §8.15). Statutory permission, however, is not the same as documentary inclusion; *e.g.,* the less inclusive due-on-sale clause described in §8.8 does not usually affect leasing of the encumbered property.

The parties must pay careful attention when reviewing the "due-on" clause to ascertain what kinds of transfers come under it—such as sale of corporate assets, reorganizations, and shifts in partnership interests. See California Real Estate Finance Practice: Strategies and Forms §§4.43-4.44 (Cal CEB 2000).

PRACTICE TIP: Attorneys enforcing or defending against a "due-on" clause should scrutinize the deed of trust language to ascertain whether the transaction is covered. For instance, on the transfer of a partnership interest, successful coverage is more likely if the clause says so explicitly than if it merely says "any kind of transfer whatsoever." See *Sexton v Nelson* (1964) 228 CA2d 248, 39 CR 407 (transfer from trustor to trustor's wholly owned corporation); *Ser-Bye Corp. v C.P. & G. Mkts.* (1947) 78 CA2d 915, 179 P2d 342 (sale of corporate stock).

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§8.22 5. Purchase Option and "Due-on" Clause

"Due-on" clauses usually do not include the granting of an option to purchase as an action that will lead to acceleration, and it is doubtful whether such clauses could do so, because an option gives the optionee only a potential interest in the property. *Pacific Southwest Dev. Corp. v Western Pac. R.R.* (1956) 47 C2d 62, 301 P2d 825; *Vierneisel v Rhode Island Ins. Co.* (1946) 77 CA2d 229, 175 P2d 63.

Once an option is exercised, however, the parties to the option become vendor and purchaser, and the principle of equitable conversion transfers equitable title to the purchaser. *Cates v McNeil* (1915) 169 C 697, 147 P 944. See *Parr-Richmond Indus. Corp. v Boyd* (1954) 43 C2d 157, 272 P2d 16. Depending on the wording of the "due-on" clause, the beneficiary may be entitled to accelerate either when the parties execute a purchase and sale agreement or when the transaction closes.

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§8.23 6. Waiver of "Due-on" Clause

A lender risks waiving its right to accelerate by knowingly accepting payments from the new purchaser after a transfer. *Rubin v Los Angeles Fed. Sav. & Loan Ass'n* (1984) 159 CA3d 292, 205 CR 455. See *Trubowitch v Riverbank Canning Co.* (1947) 30 C2d 335, 182 P2d 182 (lender accepted payments for a year with full knowledge of transfer).

WARNING: It is imprudent to purchase real property in the hope that a court will hold that the lender has waived its right to accelerate. If existing loan documents include a "due-on" clause, any offer to purchase should be contingent on obtaining the lender's written consent to transfer the loan (even though doing so may lead to an increase in interest). The problem is far easier to solve if it is confronted before escrow closes—and the purchaser is still able to withdraw—than if it arises after title has passed and the lender has accelerated the loan.

The lender's acceptance of payments under a reservation of rights may avoid the waiver defense. *Rubin v Los Angeles Fed. Sav. & Loan Ass'n, supra* (dictum). The lender's lack of knowledge of the transfer is probably a good defense to a waiver claim. See *German-American Sav. Bank v Gollmer* (1909) 155 C 683, 102 P 932; *Weisman v Clark* (1965) 232 CA2d 764, 43 CR 108; *Weintraub v Weingart* (1929) 98 CA 690, 277 P 752; *Goodwin v Grosse* (1922) 56 CA 615, 206 P 138. For an unpublished case rejecting a borrower's waiver claim and also the borrower's tactic of attempting to "return title" and thus reverse the conveyance that violated the due-on-sale clause, see *Bhandari v California Fed. Bank* (Dec. 17, 2003, G031453; not certified for publication) 2003 Cal App Unpub Lexis 11725, 2003 WL 23015077.

"Due-on" clauses commonly include an antiwaiver provision declaring that failure to accelerate the debt on one occasion does not constitute a waiver of the right to accelerate on others. This provision avoids any possibility that the "rule of *Dumpor*'s case" (see *Crowell v City of Riverside* (1938) 26 CA2d 566, 571, 80 P2d 120) will be applied (*Crowell* held that consent to one assignment bars landlord from objecting to all later assignments).

PRACTICE TIP: If there is no antiwaiver language in the "due-on" clause, a lender permitting the transfer should specify that the consent is limited to this transfer and that it reserves the right to object to further transfers. See *Rubin v Los Angeles Fed. Sav. & Loan Ass'n, supra*.

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§8.24 C. Discretionary Loan Balance Acceleration

A California anti-predatory lending law enacted in 2001 (Fin C §§4970-4979.8; see discussion in §12.56) prohibits a lender from reserving in the note a "call provision" allowing the lender, in its sole discretion, to accelerate the indebtedness. This law applies only to real property secured consumer loans in an amount that does not exceed the most current conforming loan limit for a single-family first mortgage established by the Federal National Mortgage Association. Acceleration-on-default provisions (see §§8.2-8.7) are unaffected. See Fin C §4973(i).

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III. LATE CHARGES, DEFAULT INTEREST, AND PREPAYMENT PROVISIONS

A. Late Charges

§8.25 1. Invalidity as Unreasonable Liquidated Damages

Institutional notes usually impose an additional charge on borrowers for failure to make timely payment of an installment. Late fees are generally drafted as a specified dollar amount, a percentage of the late installment, or some combination of these two. Lenders may also charge a default interest rate (see §§8.34-8.35). These clauses are designed to compensate lenders for administrative expense and loss of use of funds arising from delayed payment and to pressure the borrower to pay on time. In the absence of a late-charges clause, the lender cannot impose an additional fee on the borrower for making a late payment (*Roth v Department of Veterans Affairs* (1980) 110 CA3d 622, 167 CR 552); the lender should be entitled only to additional interest for the delay under CC §3302. The validity of collecting this additional interest from the next payment, reducing the amount of principal thus paid, has not been tested judicially.

In *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845, a note provided that if the borrower was late in making a payment, the unpaid principal balance would bear an additional annual interest of 2 percent until the borrower paid the late installment. The supreme court held that this late fee—calculated as a percentage of the loan's entire unpaid principal balance of the loan rather than as a percentage of the delinquent installment—was punitive and invalid. See §8.26 on liberalization of liquidated damages rules and §8.27 on reaffirmation of *Garrett*. See also *Poseidon Dev., Inc. v Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 1115, 62 CR3d 59 (late charge applicable to installment payments did not apply to balloon payment because it was not reasonable estimate of lender's administrative expenses; see §8.27).

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§8.26 2. Revision of Liquidated Damage Statute: Presumption of Validity

In 1977, the legislature significantly liberalized the liquidated damage rules for lenders in nonconsumer transactions. Civil Code §1671(b) places the general burden of proving that a liquidated damage clause is unreasonable on the person attacking it. Presumptive validity replaced the former rule of presumptive invalidity. *Californians for Population Stabilization v Hewlett-Packard Co.* (1997) 58 CA4th 273, 287, 67 CR2d 621, disapproved on other grounds in *Cortez v Purolator Air Filtration Prods.* (2000) 23 C4th 163, 96 CR2d 518; *Weber, Lipshie & Co. v Christian* (1997) 52 CA4th 645, 654, 60 CR2d 677.

The case of *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845 (see §§8.25, 8.27, 8.30, 8.34), was decided under the former rule—that a liquidated damage clause was valid only if actual damages were difficult to ascertain—but that standard has been confined to retail consumer purchases and residential leases. CC §1671(c)-(d); *Bondanza v Peninsula Hosp. & Med. Ctr.* (1979) 23 C3d 260, 265 n6, 152 CR 446. However, even in the commercial field, excessive late charges are unenforceable. See §8.27.

On regulation of late charges in residential secured loans, see §§8.31-8.33.

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3. Judicial Interpretation: *Ridgley v Topa Thrift*

§8.27 a. *Garrett* Rule on Excessive Late Charges Preserved

Despite the legislative overhaul of the field (see §8.26), the supreme court reaffirmed in 1998 the court's holding in *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845, that excessive late charges are unenforceable penalties (see §8.25). The court in *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378, held that nothing in the 1977 legislation indicated any intent to "abrogate *Garrett*'s analysis of unjustified late fees as unenforceable penalties." 17 C4th at 981 n5.

Subsequently, the court of appeal in *Poseidon Dev., Inc. v Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 1115, 62 CR3d 59, ruled that as a matter of law the 10-percent late charge did not apply to the balloon payment because "it could not possibly be considered a reasonable estimate" of the lender's administrative expenses. See analysis of *Poseidon* in Bernhardt, *Midcourse Corrections: Later Thoughts on Late Charges,* 30 CEB Real Prop L Rep 140 (Sept. 2007). See also *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 931, 216 CR 345; *Baypoint Mortgage Corp. v Crest Premium Real Estate Inv. Retirement Trust* (1985) 168 CA3d 818, 829, 214 CR 531; *Hitz v First Interstate Bank* (1995) 38 CA4th 274, 44 CR 2d 890.

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§8.28 b. Indirect Late Charges Invalidated

Courts may invalidate other charges arising from the loan as indirect late charges. In *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378 (see §8.27), the duty to make timely payments was enforced not by a late charge but by loss of the right to prepay without penalty. The note provided that the borrower could prepay "provided [that] all scheduled payments have been received not more than 15 days after their scheduled due date, and further provided that there have been no other defaults under the terms of this note or any other now existing or future obligation of borrower to Topa"; otherwise, the prepayment fee was 6 months' interest. 17 C4th at 974. The supreme court held that despite the form of the provision (as a prepayment clause), it constituted, in substance, a late charge, intended to induce the borrower to pay on time. As such, it was an unenforceable penalty because it had no relationship to any potential damages the lender would suffer from receiving a late payment. Because there is significant interlocking of many rights and privileges in modern secured loan transactions, *Ridgley* warns drafters that the courts will freely recharacterize them whenever they believe fairness requires it. See §8.38.

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§8.29 4. Late Charges as Interest

Other state courts have treated late charges as interest rather than as liquidated damages. See Anno, 63 ALR3d 50 (1975). As such, they were subject to usury restrictions but were usually upheld on the ground that they came into play only at the debtor's election and were not conscious attempts by lenders to collect usurious interest. See, *e.g., Lew v Goodfellow Chrysler-Plymouth, Inc.* (Wash App 1971) 492 P2d 258; *Randall v Home Loan & Inv. Co.* (Wis 1944) 12 NW2d 915. In California, earlier decisions often referred to late charges as interest, especially in cases involving lenders who were exempt from usury restrictions. See *Clermont v Secured Inv. Corp.* (1972) 25 CA3d 766, 102 CR 340. However, the court in *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845, disapproved of that logic and declared that such clauses could not be treated as provisions for alternative performance, because the debtors had no real option to elect to pay late.

TAX CONSIDERATION: Late charges received by the beneficiary may be treated as additional interest for federal income tax purposes and therefore constitute ordinary income. See *Al S. Reinhardt* (1980) 75 TC 47; Rev Rul 74-187, 1974-1 Cum Bull 48. The trustor may treat such payments like other interest payments. See §1.23.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/8 Payment and Related Disputes/§8.30 5. Form Provision: Late-Charge Clause

§8.30 5. Form Provision: Late-Charge Clause

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The following clause has been drafted to meet the requirements of CC §1671(b) (liquidated damages in nonconsumer transactions) and the decision in *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845, but its validity has not been tested in the courts (see §§8.26-8.27).

Late Charge. Borrower acknowledges that default in the payment of any sum due under this Note will result in losses and additional expenses to Lender in servicing the indebtedness evidenced by this Note, handling such delinquent payments, and meeting its other financial obligations. Borrower further acknowledges that the extent of such loss and additional expenses is extremely difficult and impractical to ascertain. Borrower therefore agrees that, if any payment due under this Note is not made within _ _[*number spelled out _ _(numeral)_ _]_ _*** days when due, a charge of _ _[***number spelled out***]_ _ cents _ _[***$._ _(numerals, e.g., 10)_ _]_ _*** for each dollar ($1.00) that is not paid when due would be a reasonable estimate of expenses so incurred (the Late Charge). If any payment is not received within _ _[***number spelled out _ _(numeral)_ _]_ _*** days when due, Borrower shall pay the Late Charge to Lender (without prejudicing or affecting any other rights or remedies of Lender) as liquidated damages to cover expenses incurred in handling such delinquent payment.**

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6. Restrictions on Late Charges for Residential Loans

§8.31 a. Monetary Limitations

Civil Code §2954.4 limits late charges on post-1975 loans on owner-occupied, single-family dwellings to the greater of $5 or 6 percent of the past-due installment. It does not apply to loans made by industrial loan companies, personal property brokers, or consumer or commercial finance lenders or to loans made or arranged by real estate brokers. This section was enacted in 1975 presumably to resolve some of the doubts created by *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845. It does not preclude a lender from charging a fee to inspect the security when the borrower defaults. *Walker v Countrywide Home Loans, Inc.* (2002) 98 CA4th 1158, 121 CR2d 79 (noting property inspection furthered legitimate business of protecting lender's interest in protecting security). Civil Code §2954.5 requires the lender to give notice to the delinquent borrower before imposing a late fee.

For loans negotiated by real estate brokers, Bus & P C §10242.5 limits late charges on loans to 10 percent of the installment. If a balloon payment is involved, Bus & P C §10242.5(c) limits the permissible charge for the final payment to the maximum that could have been assessed on the largest single monthly installment previously due (but multiplied by the number of months the balloon payment remains unpaid).

Late charges in the form of "default interest" are expressly prohibited in certain residential real property secured loans as defined in Fin C §4970(b). See Fin C §4973(e). See also §§8.91, 12.56. On default interest, see §§8.34-8.35.

Late charges are limited to 2 percent of the installment after 15 days (24 CFR §241.1105) on loans insured by the Federal Housing Administration and to 4 percent on loans guaranteed by the Veterans Administration after the same 15 days for manufactured home loans (38 CFR §36.4212(d)). In 1996, the Office of Thrift Supervision (OTS) issued 12 CFR §560.33, a regulation that allows (but imposes no limit on the amount of) late fees in home mortgage loans made by federal savings associations (and by state-chartered lenders opting to enforce their loans under federal law). See §8.14.

It has not been determined in California or in the Ninth Circuit whether the Alternative Mortgage Transaction Parity Act (12 USC §§3801-3806) preempts the late payment provisions of CC §2954.4 and Bus & P C §10242.5 on loans subject to the Act. See §8.46 on possibility of preemption.

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§8.32 b. Pyramiding Prohibited

Civil Code §2954.4(b) prohibits the pyramiding of late charges. If the borrower pays an installment on time, the lender may not assess a late charge on it even when an earlier installment remains unpaid.

EXAMPLE: A lender that receives no payment in January, assesses a late charge, and then receives a timely payment in February cannot assess a late charge for February even though the payment may lawfully be applied to the January arrearage. The lender may be entitled to reject the February payment because this constituted only partial performance of the 2-month debt (under CC §1486, an offer of partial performance is ineffective), but it still cannot assess a second late charge for February, because that payment was not independently late.

It has not been determined in California or in the Ninth Circuit whether the Alternative Mortgage Transaction Parity Act (12 USC §§3801-3806) preempts the pyramiding of late charges on loans subject to the Act. See §8.45 on possibility of preemption.

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§8.33 c. Notice and Disclosure Obligations

Before imposing a late charge, the lender must give a 10-day advance notice. CC §2954.5. The lender may either (1) send written notice to the borrower, giving 10 days after the date of mailing to cure, or (2) include in the regular monthly billing the date after which the late charge will be assessed. CC §2954.5(a). Most lenders use the latter method because it is less expensive.

The Truth in Lending Act (TILA) (15 USC §§1601-1667f) (see §§7.36, 12.59-12.69) requires advance disclosure to the borrower of late-charge provisions. See 12 CFR §§226.17(b), 226.18(*l*) for "closed-end" credit and 12 CFR §§226.5(b), 226.6(b) for "open-end" credit. (On meaning of "open-end credit plan," see 12 CFR §226.2(a)(20).) A similar requirement, as well as limitations on the amounts of such charges, is in Uniform Consumer Credit Code §§2.502 and 3.201. Misleading statements about late-charge provisions may violate a lender's or loan broker's duty of truthful disclosure and good faith dealing, even if the loan documents themselves contain accurate information. *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392. Even in the absence of an agency relationship and therefore of fiduciary duties, a mortgage broker owes a duty to avoid making affirmative misrepresentations. See *Stetler v Greenpoint Mortgage Funding, Inc.* (ED Cal, Jan. 23, 2008, No. 1:07cv0123 DLB) 2008 US Dist Lexis 4880 (refusing to apply *Wyatt* in transaction in which loan broker made no affirmative misrepresentations to borrower).

Even if late charges in the form of default interest are otherwise valid, a failure by the creditor to provide notice of acceleration may result in denial of the late charges for the period before the lender gives actual notice. See *Beal Bank v Crystal Props., Ltd. (In re Crystal Props., Ltd.)* (9th Cir 2001) 268 F3d 743. On default interest, see §§8.34-8.35.

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B. Default Interest

§8.34 1. Restrictions on Default Interest for Commercial Loans

Contemporary commercial loans, which are not subject to the statutory residential late-charge restrictions (see §§8.31-8.33), often provide that a higher interest rate will apply on default or if a payment is late, sometimes increasing in size as the delay increases (see §§7.123, 8.1, 8.5, 8.33, 11.94). Lenders view this interest as compensation for the costs and risks associated with defaulted loans. Enforceability issues arise if the default interest rate is applied not only to the particular missed installment but also to the entire unpaid balance. In the latter instance, it may not satisfy the statutory liquidated damage standards of CC §1671(b) (see §8.26) and of *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845 (see §§8.25-8.27, 8.29).

PRACTICE TIP: In light of the reaffirmation of *Garrett* in *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378 (see §8.27), the concern that default interest may involve a penalty tends to make it one of the more negotiable items in lender-borrower litigation and workouts.

NOTE: Courts are split on whether default interest rates should be analyzed under the unconscionability standard applied under freedom of contract principles or the reasonableness standard applied to liquidated damages provisions. For discussion of these analyses of default interest, see Bender & Madison, *The Enforceability of Default Interest in Real Estate Mortgages,* 43 Real Property, Trust and Estate Law Journal 199 (Summer 2008).

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§8.35 2. Impact of Chapter 11 Bankruptcy Plan

The issue of the enforceability of default interest provisions generally arises in federal bankruptcy proceedings. Although bankruptcy issues are beyond the scope of this chapter, bankruptcy decisions can sometimes shed light on state law issues relating to default interest. In *General Elec. Capital Corp. v Future Media Prods., Inc.* (9th Cir 2008) 536 F3d 969, the court considered the rule that an oversecured creditor who is paid in full at the non-default rate under a Chapter 11 bankruptcy plan is not entitled to interest at the default rate. Further, the court rejected application of that rule in the context of the *Future Media* dispute, which stipulated an asset sale outside of the Chapter 11 plan. This left the court to confront the issue of whether a 2-percent default interest rate enhancement was unreasonable under applicable nonbankruptcy law. The court—while noting the general bankruptcy practice of presuming the validity of a contracted-for default interest rate—rejected a bright-line rule approving the 2-percent bump as reasonable and remanded the case to the Bankruptcy Court for further consideration.

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C. Prepayment and "Yield Maintenance" Charges

§8.36 1. No Automatic Right to Prepay

Under common law rules, a borrower has no automatic right to pay the note before its stated due date, *i.e.,* to prepay it. For example, on a note due July 1, the borrower has no greater right to prepay it on June 15 than to postpay it on July 15. Both early and late payments constitute a technical breach of the promise to pay on the stated date. *Smiddy v Grafton* (1912) 163 C 16, 19, 124 P 433. But see *James Talcott, Inc. v Gee* (1968) 266 CA2d 384, 388, 72 CR 168.

On one hand, if the note is completely silent on the prepayment issue, the borrower must negotiate with the lender on how much the borrower must pay in order to induce the lender to accept the early payment. On the other hand, the note may provide for full and free prepayment without charge, may condition prepayment rights on the payment of a fixed charge or formula, or may allow prepayment without any charges after a period of time (see, *e.g.,* terms described in §§8.40-8.43).

Statutory law has modified the common law rule in residential loans (see §8.45).

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§8.37 2. Justification for Charges

Many courts recognize that prepayment increases the lender's administrative costs (in making a replacement loan) (see, *e.g., Sacramento Sav. & Loan Ass'n v Superior Court* (1982) 137 CA3d 142, 147, 186 CR 823; *Hellbaum v Lytton Sav. & Loan Ass'n* (1969) 274 CA2d 456, 459, 79 CR 9, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379), may cause its funds to lose their earning power (before a replacement loan is placed) (see *Sacramento Sav. & Loan Ass'n v Superior Court, supra*), and may cause loss of interest earning power (when old loan at high interest rates can be replaced only with new loan at lower rates because of market changes) (see *Hellbaum v Lytton Sav. & Loan Ass'n, supra*).

Some courts have opined that a prepayment charge may give the lender the equivalent of unearned interest. See *Furesz v Garcia* (1981) 120 CA3d 793, 174 CR 803. See also *Mann v Earls* (1964) 226 CA2d 155, 37 CR 877 (unsecured note). Nevertheless, most judicial decisions have upheld prepayment charges. See *Golden Forest Props. v Columbia Sav. & Loan Ass'n* (1988) 202 CA3d 193, 248 CR 316; *Trident Ctr. v Connecticut Gen. Life Ins. Co.* (9th Cir 1988) 847 F2d 564; *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 99 CR 417. But see *Williams v Fassler* (1980) 110 CA3d 7, 167 CR 545 (criticizing decisions in *Hellbaum v Lytton Sav. & Loan Ass'n, supra,* and *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n, supra*).

For further discussion of validity of prepayment clauses, see §8.38. On legislative changes to common law rules on prepayment charges, see §§8.45-8.46.

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§8.38 3. Validity

Courts have historically upheld prepayment charges in promissory notes. See *French v Mortgage Guar. Co.* (1940) 16 C2d 26, 104 P2d 655; *Abbot v Stevens* (1955) 133 CA2d 242, 284 P2d 159. Only if the courts find the charge exorbitant or shocking to the judicial conscience are they likely to intervene on the borrower's behalf. *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 99 CR 417; *Hellbaum v Lytton Sav. & Loan Ass'n* (1969) 274 CA2d 456, 79 CR 9, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 148 CR 379.

NOTE: Statutes modify these common law rules regarding prepayment charges in certain consumer loans (see §§8.45-8.46).

The existence of a prepayment charge in the note does not make the loan usurious. See *French v Mortgage Guar. Co., supra; Abbot v Stevens, supra; Grall v San Diego Bldg. & Loan Ass'n* (1932) 127 CA 250, 15 P2d 797. Prepayment is voluntary, and a debtor cannot convert a lawful transaction into a usurious one by a voluntary act. (In any event, most commercial lending institutions are exempt from California's usury laws. See Cal Const art XV, §1. Other categories of lenders are exempt by statute. For listings of exempt lenders and loan types, see California Real Estate Finance Practice: Strategies and Forms §§3.39-3.40 (Cal CEB 2000).)

Contentions that prepayment charges are penalties or forfeitures have also been rejected on the ground that a prepayment does not really constitute a breach by the borrower. *Meyers v Home Sav. & Loan Ass'n* (1974) 38 CA3d 544, 113 CR 358; *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n, supra*. Prepayment may also be viewed as "alternative performance." See *Blank v Borden* (1974) 11 C3d 963, 115 CR 31.

Similarly, claims that prepayment charges are invalid liquidated damages provisions have generally failed. See *Pacific Trust Co. TTEE v Fidelity Fed. Sav. & Loan Ass'n* (1986) 184 CA3d 817, 229 CR 269 (prepayment charge upheld against junior lienor who sought to redeem property following senior acceleration). Courts have also rejected assertions that prepayment charges constitute invalid restraints on alienation. See *Sacramento Sav. & Loan Ass'n v Superior Court* (1982) 137 CA3d 142, 186 CR 823.

Conversely, if a stated prepayment charge is seen as masking a charge of a different sort, the stricter standards applicable to the true underlying charge may be applied to invalidate the ostensible prepayment charge. For example, in *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378, because the borrower's right to avoid a prepayment charge depended on never making late payments, the supreme court viewed the charge as a late fee (a penalty of $114,622.42 for being late with any payment) and ruled the amount invalid under late-charge standards. For further discussion of *Ridgley*, see §§8.27-8.28.

For statutory limitations on prepayment charges in consumer loans, see §8.45. For further discussion of prepayment clauses, see Loubier & del Castillo, *The New Age of Real Estate Loan Defaults,* 31 CEB Real Prop L Rep 6 (Jan. 2008).

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§8.39 4. Waiver of Right to Collect

A lender who inadvertently accepts payment without imposing a prepayment charge does not waive the right to collect the charge, as long as the lender acts promptly to collect it. *Sanguansak v Myers* (1986) 178 CA3d 110, 223 CR 490. Nor does the one-action rule prohibit later attempts to recover prepayment charges or other amounts mistakenly omitted from a payoff demand. See *Ghirardo v Antonioli* (1996) 14 C4th 39, 57 CR2d 687.

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5. Types of Prepayment Provisions

§8.40 a. Phrases Construed to Permit Prepayment

The simplest provisions construed to permit prepayment are the "or more" and "on or before" phrases, which are simply added at appropriate places in installment notes. If a note recites that it is to be paid in "monthly installments of one thousand dollars *or more*" or is to be paid in "monthly installments *on or before* the first day of each month," the borrower thereby acquires the right to prepay the entire loan at any time without penalty. See *Fugate v Cook* (1965) 236 CA2d 700, 46 CR 291; *Born v Koop* (1962) 200 CA2d 519, 19 CR 379.

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§8.41 b. Prepayment Charge Clause

Notes used by lending institutions sometimes provide a limited right of prepayment, which involves a charge to the borrower for exercising that right. These clauses take many forms, some quite elaborate, with varying terms, conditions, and charges. See California Real Estate Finance Practice: Strategies and Forms §§3.22-3.34 (Cal CEB 2000). Lenders call these clauses "prepayment privilege" clauses because there would be no right of prepayment at all without them; borrowers refer to them as "prepayment penalty" clauses because of the charge they impose. Some lenders omit all reference to prepayment in the note, leaving for negotiation at a later time how much the borrower must pay in addition to the principal to pay off the loan (see §8.36). Residential loan prepayment terms are regulated by statute (see §8.45). See discussion and commercial note form in Real Estate Finance, chap 3.

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6. Lock-In Provisions

§8.42 a. Prohibition on Prepayment for Specified Time

Prepayment clauses may include a "lock-in" provision that temporarily or permanently prohibits all prepayment. See *Trident Ctr. v Connecticut Gen. Life Ins. Co.* (9th Cir 1988) 847 F2d 564. A clause that permits prepayment "at any time" involves no lock-in period. A provision that includes a lock-in period usually states, *e.g.,* that the borrower has the privilege or reserves the right to make additional payments on the principal of the indebtedness "after 3 years from the date of the note." During the lock-in period, no prepayment—even for compensation—is permitted unless the lender consents. See discussion and form in California Real Estate Finance Practice: Strategies and Forms, chap 3 (Cal CEB 2000).

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§8.43 b. Validity of Lock-In Provisions

A lock-in provision may be held to constitute an invalid restraint on alienation if there is too great an imbalance between the quantum of restraint so created and the justification for that restraint. See *Gutzi Assocs. v Switzer* (1989) 215 CA3d 1636, 264 CR 538 (upholding 25-year note locked in for its entire term in absence of any factual showing of restraint on alienation made by borrower). The balancing standard of *Wellenkamp v Bank of America* (1978) 21 C3d 943, 148 CR 379 (see §8.13) could arguably be applied to this issue, although courts in both Oregon and Washington have held that lock-ins are not unreasonable restraints on alienation. See *McCausland v Bankers Life Ins. Co.* (Wash 1988) 757 P2d 941; *Hartford Life Ins. Co. v Randall* (Or 1978) 583 P2d 1126 (cited in *Gutzi Assocs. v Switzer, supra*).

Lock-in provisions are more vulnerable to challenge as illegal restraints on alienation than are "due-on" clauses. A "due-on" clause requires that the loan be paid off on a sale or other transfer, while a lock-in provision prevents the loan from being paid off. When the lender is willing to continue to accept payments from a new owner, the lock-in provision only indirectly restrains alienation by requiring the new owner to take subject to the existing loan and payment schedule. However, the lender is probably forced to choose between enforcing the "due-on" clause and the lock-in provision when both are violated, because both can be fully and jointly enforced only if sale is literally and absolutely prohibited. Such a direct and disabling restraint is more likely to be successfully challenged than is an indirect restraint. See *Coast Bank v Minderhout* (1964) 61 C2d 311, 38 CR 505, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379.

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§8.44 7. Yield Maintenance Provisions

Many prepayment clauses contain a yield maintenance provision intended to compensate the lender who receives an early payoff by imposing a fee sufficient to enable the lender to (1) reinvest the funds if the rates are lower when the payoff is made and (2) earn what the lender would have earned had no prepayment occurred. These provisions set the prepayment fee at an amount equal to the difference (discounted to the then-present value) between the original contract rate ("original yield") and the then-current market rate ("current yield") multiplied by the amount prepaid. See generally Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis,* 40 UCLA L Rev 851 (1993). For further discussion, including example of calculating prepayment charges under yield maintenance provision, see California Real Estate Finance Practice: Strategies and Forms §3.32 (Cal CEB 2000).

PRACTICE TIP: Institutional lender yield maintenance provisions can be extremely long and complex, with some taking multiple pages of dense text and mathematical formulas. Sometimes even bankers, in deposition, have trouble explaining the provisions. Such hyper-complexity can create ambiguities and give the borrower the argument that the formula is incomprehensible and adhesive.

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8. Regulation of Prepayment Charges

§8.45 a. Right to Prepay Certain Loans

Civil Code §2954.9 and Bus & P C §10242.6 reverse many of the common law rules of prepayment in consumer transactions. If owner-occupied one-to-four-unit residential properties secure the loan, there is a complete right to prepay in the absence of a clause to the contrary, thus eliminating the lender's former right to demand consideration for accepting prepayment if the note is silent (see §8.36). Although a prepayment clause may be included in the promissory note, (1) the allowable charge is limited to 6-months' advance interest, and (2) prepayment of 20 percent of the original principal in any 12-month period (or the entire loan balance after 5 years) can be made without charge. Similar restrictions apply to loans made under the California Finance Lenders Law (Fin C §§22000-22780) or the Veterans' Farm and Home Purchase Act of 1943 (Mil & V C §§985-987.31). Prepayment charges may not be imposed after a rate increase in a variable interest mortgage (CC §1916.5(a)(5)). By virtue of a California anti-predatory lending law enacted in 2001, prepayment fees are also restricted in real property secured consumer loans in an amount that does not exceed the most current conforming loan limit for a single-family first mortgage established by the Federal National Mortgage Association (see Fin C §4970(b)). See Fin C §4973(a), allowing prepayment fees only during the first 36 months of the loan under specified conditions. On predatory lending, see §§8.91, 12.56.

An exception under CC §2954.9(a)(3) allows a noninstitutional seller who carries the financing to prohibit prepayment in the year of sale. See *Donahue v LeVesque* (1985) 169 CA3d 620, 215 CR 388. See also *Garver v Brace* (1996) 47 CA4th 995, 55 CR2d 220 (construed CC §2954.9(b) to protect borrower from prepayment charge on purchase money loan originally secured by unimproved agricultural land on which borrower later built residence).

A lender cannot require prepayment penalties after acceleration under "due-on" clauses in residential loans. CC §2954.10. See §8.48. Civil Code §§2954.9(c) and 2954.11(d) prohibit prepayment charges following the destruction of residential property by a natural disaster or incident to a bona fide sale of any real property or if the charge was not properly disclosed to the borrower at the outset of an open-end credit plan. (On meaning of "open-end credit plan," see 12 CFR §226.2(a)(20).)

It has not been determined in California or in the Ninth Circuit whether the Alternative Mortgage Transaction Parity Act (12 USC §§3801-3806) preempts the prepayment provisions of CC §2954.9 and Bus & P C §10242.6. The Act, designed to place state-chartered financial institutions on an equal footing with federally chartered institutions in granting alternative loans, has been held to preempt not only state alternative loan provisions but also other provisions —such as prepayment—of loans to which the Act is applicable. See *National Home Equity Mortgage Ass'n v Face* (4th Cir 2001) 239 F3d 633; *Shinn v Encore Mortgage Servs., Inc.* (D NJ 2000) 96 F Supp 2d 419. But see *Quicken Loans, Inc. v Wood* (9th Cir 2006) 449 F3d 944 (Act does not preempt California's per diem interest limitation under Fin C §50204(o) and CC §2948.5). See also Whitman, *Preemption of State Laws Protecting Mortgage Borrowers: The Parity Act May Be Broader Than You Think,* 24 CEB Real Prop L Rep 223 (Aug. 2001). The scope of the Act is so uncertain that a federal district court in California, noting that some claims in the transaction might be preempted by the Act, refused to allow the lender to remove the state court action to federal court (which is appropriate when preemption is so broad that it requires exclusive federal jurisdiction to adjudicate the claims). See *Ansley v Ameriquest Mortgage Co.* (9th Cir 2003) 340 F3d 858, 864.

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§8.46 b. Federal Regulation and Preemption

Regulations promulgated under the Garn-St. Germain Depository Institutions Act of 1982 (12 USC §1701j-3; see §8.15) prohibit prepayment penalties following acceleration under "due-on" clauses on loans on owner-occupied residences. 12 CFR §591.5(b)(2). Prepayment restrictions also apply to Federal Housing Administration insured loans (24 CFR §207.253) and Veterans Administration guaranteed loans (38 CFR §36.4310). The Truth in Lending Act (TILA) (15 USC §§1601-1667f) (see §§7.36, 12.59-12.69) also requires disclosure of prepayment charges. 15 USC §1638(a)(11); 12 CFR §226.18(k).

The Office of Thrift Supervision (OTS, formerly the Federal Home Loan Bank Board) occasionally modifies lending and investment regulations. Currently, it permits federal savings associations (and state-chartered lenders opting to enforce their loans under federal law; see §8.14) to impose a fee for any prepayment subject only to the loan contract. See 12 CFR §560.34.

The OTS has exclusive authority (under 12 USC §§1463(a), 1464(a); 12 CFR §560.2(b)(5)) to regulate prepayment penalties charged by federal savings associations. *Weiss v Washington Mut. Bank* (2007) 147 CA4th 72, 53 CR3d 782. For further discussion of preemption issues in borrower claims against lenders, see Whitman, *Preemption of State Laws Protecting Mortgage Borrowers: The Parity Act May Be Broader Than You Think,* 24 CEB Real Prop L Rep 223 (Aug. 2001); California Real Estate Finance Practice: Strategies and Forms, chap 3 (Cal CEB 2000).

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9. Prepayment Charges on Accelerated Loans

§8.47 a. After Acceleration on Default

Earlier cases support the conclusion that a lender may both accelerate for default and charge a prepayment penalty as long as the penalty and the interest actually paid do not exceed the maximum allowable interest over the entire life of the loan. See *French v Mortgage Guar. Co.* (1940) 16 C2d 26, 104 P2d 655 (if not usurious to accelerate for default, it is also not usurious to charge prepayment penalty); *Sharp v Mortgage Sec. Corp.* (1932) 215 C 287, 9 P2d 819 (if interest amount is otherwise proper, it does not become excessive or usurious when loan is shortened because of acceleration for borrower; debtor cannot make creditor guilty of usury by voluntarily defaulting). See also *Trident Ctr. v Connecticut Gen. Life Ins. Co.* (9th Cir 1988) 847 F2d 564.

More recent cases have been even clearer in permitting prepayment charges to be imposed on loans accelerated because of borrowers' delinquencies if the note provides for the charges. See *Biancalana v Fleming* (1996) 45 CA4th 698, 703, 53 CR2d 47 (upheld prepayment charge equal to additional income tax imposed on seller); *Pacific Trust Co. TTEE v Fidelity Fed. Sav. & Loan Ass'n* (1986) 184 CA3d 817, 229 CR 269 (junior paying off senior loan following borrower's default must also pay prepayment charge based on language of note). But see *Garver v Brace* (1996) 47 CA4th 995, 55 CR2d 220 (prepayment charge subject to and in excess of amount allowed by CC §2954.9(b) is not validated by tax justification recitals). On validity of prepayment charges, see §8.38.

By virtue of an anti-predatory lending law enacted in 2001, prepayment charges on acceleration resulting from a default are prohibited in California on real property secured consumer loans in an amount that does not exceed the most current conforming loan limit for a single-family first mortgage established by the Federal National Mortgage Association (see Fin C §4970(b)). See Fin C §4973(a)(2)(D). See also §12.56.

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§8.48 b. Under "Due-on" Clause

Civil Code §2954.10 bars imposition of a prepayment charge following loan acceleration under a "due-on" clause if the property consists of one to four residential units (not necessarily owner occupied). On other properties, the charge is valid only if there is an express provision in the note that is signed separately. For form provision for commercial loans, see California Real Estate Finance Practice: Strategies and Forms, chap 3 (Cal CEB 2000). See also *Tan v California Fed. Sav. & Loan Ass'n* (1983) 140 CA3d 800, 189 CR 775 (decided before enactment of CC §2954.10), and Fin C §4973(a)(2)(D) (enacted in 2001; cited in §§8.47, 12.56). On federal rule, see §8.46.

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10. Involuntary Prepayment

§8.49 a. Clause Allowing Charges

A limitation frequently included in the standard prepayment clause applies the charge whether prepayment is voluntary or involuntary, including any prepayment resulting from the lender's exercise of the acceleration clause. Prepayment of the loan can occur because of contingencies partially or entirely outside the parties' control. Justification for imposing a prepayment charge becomes more attenuated as the reason for the prepayment moves farther away from voluntary prepayment elected by the borrower (see §8.50). If the loan is prepaid because of events outside the borrower's control but within the lender's control, enforcing a prepayment charge may be problematic.

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§8.50 b. Exceptions: Property Destruction, Condemnation

Some forms of involuntary prepayment occur when external events produce payments from fire insurance proceeds or condemnation awards and the deed of trust gives the beneficiary the option of permitting the borrower to retain the funds or of applying them to the loan balance. When no protective legislation applies (see, *e.g.,* authorities in §8.45), the courts may hold either that the prepayment clause was not intended to be applied in this way (see *Tan v California Fed. Sav. & Loan Ass'n* (1983) 140 CA3d 800, 189 CR 775) or that the implied covenant of good faith prohibits the lender from simultaneously electing to have the funds applied to the loan and to impose a charge for prepayment (see *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57; *Milstein v Security Pac. Nat'l Bank* (1972) 27 CA3d 482, 103 CR 16; see also *999 v C.I.T. Corp.* (9th Cir 1985) 776 F2d 866).

Code of Civil Procedure §1265.240 provides that the lender may not collect a prepayment penalty in a condemnation action, but the scope of the section is apparently limited to the issue of whether the condemning agency must pay the penalty. It does not resolve the issue of whether the beneficiary may claim the penalty independently from the condemnee-trustor.

If neither party has discretion over how to apply proceeds arising from external events, so that the beneficiary's receipt of the prepayment is as involuntary as the trustor's prepayment, imposition of a prepayment charge is more likely to be held justifiable. See *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 99 CR 417 (charge upheld when trustor was forced to sell property under judgment for marital dissolution and buyer elected to obtain new financing).

For discussion of lender's right to accelerate for borrower's failure to maintain fire insurance on property, see §§8.57-8.58. Prepayment charges following acceleration for default or under a "due-on" clause are covered in §§8.47-8.48.

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11. Tax Considerations

§8.51 a. For Lender

Generally, prepayment charges are ordinary income to the lender. See *General Am. Life Ins. Co. v Commissioner* (1956) 25 TC 1265. See also *U.S. v Midland-Ross Corp.* (1965) 381 US 54, 14 L Ed 2d 214, 85 S Ct 1308. In limited cases, however, a prepayment charge can result in a deemed sale of the loan by the lender, thus becoming a capital gain transaction. The gain occurs when there has been a "significant modification of the debt instrument." Such cases are rare, and the rules to qualify are complicated. See RIA Fed Tax Coordinator 2d, ¶¶I-1050-I-1084 (Nov. 1999). See also *Prudential Ins. Co. v Commissioner* (3d Cir 1989) 882 F2d 832 (insurance company permitted to report prepayment charges collected on retired corporate loans as capital gains under former IRC §1232(a) (superseded by IRC §1271)).

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§8.52 b. For Borrower

Generally, the trustor may treat a prepayment charge as payment of additional interest expense. Rev Rul 57-198, 1957-1 Cum Bull 94. See §1.23. A discount received by the trustor as an inducement to prepay a loan is treated as income from discharge of debt. IRC §108; *Sutphin v U.S.* (1988) 14 Cl Ct 545. But if the discount comes from the seller as a price reduction, it is treated as a price adjustment (reducing the basis in the property) instead of as income to the buyer. IRC §108(e)(5). (The seller may correspondingly reduce the gain otherwise reported under IRC §453. See Rev Rul 72-570, 1972-2 Cum Bull 241. See also §8.53.)

The IRC §108(e)(5) adjustment frequently relates to personal-use real estate such as principal or second homes. An alternative to this is an exclusion from income provided by IRC §108(a)(1)(D) regarding "qualified real property business indebtedness," when the discount in the debt is associated with business real estate debt, as defined in IRC §108(c)(3). Taxpayers other than C corporations can elect to exclude income under this alternative. The basis of the taxpayer's depreciable property, however, is reduced by the amount of excluded income. IRC §108(c)(1). (Philosophically, §108(e)(5) puts personal-use real estate on a par with business real estate with respect to income exclusion from debt cancellation.)

If the reduction of the principal of the note is related to the debtor's bankruptcy or insolvency, then the debtor's other tax attributes are reduced before a basis decrease occurs. Internal Revenue Code §108(b) lays out the character and ordering for tax-attribute reduction. Also available is an election by a bankrupt or an insolvent to reduce basis instead of reducing tax attributes. IRC §108(b)(5). It is usually wise to retain the tax attributes for future use and reduce basis in the affected real estate.

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§8.53 c. For Seller

Sellers who carry all or part of the sale's financing often want to postpone prepayment in order to defer recognition of gain. See §8.52.

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IV. OTHER MONETARY ISSUES

§8.54 A. Payment of Interest on Residential Lender's Funds in Escrow

Under the California Residential Mortgage Lending Act (Fin C §§50000-50706), a licensed residential mortgage lender may not violate CC §2948.5, *i.e.,* require the borrower to pay interest for more than 1 day before the date that loan proceeds are disbursed out of escrow for the borrower's use. See Fin C §50204(o). See also 82 Ops Cal Atty Gen 233 (1999). The Ninth Circuit rejected a federal supremacy challenge to CC §2948.5 that was based on the claimed preemptive effect of the Depository Institutions Deregulation and Monetary Control Act of 1980 (Pub L 96-221, 94 Stat 132). *Quicken Loans, Inc. v Wood* (9th Cir 2006) 449 F3d 944 (following preemption analysis of *Wells Fargo Bank v Boutris* (9th Cir 2005) 419 F3d 949 and *Black v Financial Freedom Sr. Funding Corp.* (2001) 92 CA4th 917, 112 CR2d 445).

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§8.55 B. Payment of Multiple Notes

A debtor who is obligated to a single creditor under several notes may dictate how to allocate the payments. CC §1479. In the absence of any debtor indication, §1479 permits the creditor to make the allocation. If neither party makes an allocation, §1479 requires the creditor to apply the proceeds in the following order to

- interest then due;
- principal then due;
- the oldest matured obligation;
- unsecured obligations; and
- secured obligations.

See *Sunlight Elec. Supply Co. v Pacific Homes Corp.* (1964) 226 CA2d 110, 37 CR 802.

Among secured obligations, if the liens securing several notes held by one creditor are separated by third party intervening liens, then the creditor's senior note will be treated as first paid (absent contrary language by the parties) in order to protect the intervening lien. *Pike v Tuttle* (1971) 18 CA3d 746, 96 CR 403. On multiple obligations generally, see chap 9.

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§8.56 C. Private Mortgage Insurance

A lender may sometimes require a borrower on a real estate secured loan to obtain private mortgage insurance or mortgage guaranty insurance (PMI). See Mortgage Guaranty Insurance Act (Ins C §§12640.01-12640.20). For definition of "mortgage guaranty insurance," see Ins C §12640.02. The PMI premiums are typically paid by the borrower through the lender by an impound account (see CC §§2954-2954.2, 2954.8, 2955) and are added to the monthly installments of principal and interest. Nonpayment of the premiums is an event of default and a ground for loan acceleration (see §8.2).

A lender may establish impound accounts on loans secured by single-family, owner-occupied property in the circumstances allowed under CC §2954(a)(1), including when

- impound account is required by law;
- loan is guaranteed or insured by governmental agency;
- property taxes are delinquent;
- loan-to-property-value ratio meets specified criteria;
- loan meets definition of higher-priced mortgage loan in regulations issued under federal Truth in Lending Act (TILA) (15 USC §§1601-1667f; see §12.59); and
- loan is refinanced or modified under governmental or nonprofit incentive program.

A lender or servicer of the loan may not charge or collect future payments from a borrower for PMI under specified conditions, the most significant of which is the borrower's right to cancel the insurance when the loan-balance-to-value ratio decreases to 75 percent. CC §2954.12(a). The lender must also notify the borrower about the borrower's right to cancel PMI. CC §2954.6(a). See also CC §2954.7. These provisions apply to owner-occupied, one-to-four-unit residential property loans. CC §2954.12(a)(1).

Disputes over PMI may occur if the lender requires the insurance in situations not authorized by law, improperly handles the impound account, or neglects to notify the borrower of its cancellation rights. In the latter event, the borrower may recover treble damages and attorney fees and costs. CC §2954.6(e).

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§8.57 D. Casualty Insurance

A clause found in most deeds of trust provides that, to protect the security of the deed of trust, the borrower must provide hazard insurance and often other insurance coverage, with proceeds payable to the lender. The lender usually reserves the right (1) to purchase the insurance if the borrower does not do so, and (2) in the event of a covered loss, to apply any amounts paid under any such policy to the secured debt. On effect of borrower's failure to insure, see §8.58. On effect of lender's failure to require insurance, see §8.60. On lender's right to insurance proceeds, see §§8.62-8.63. For discussion of lender loss-payable clauses and circumstances in which borrower's faulty renovation or willful or negligent destruction of the security will preclude lender's claim, see *Wilson v Farmers Ins. Exch.* (2002) 102 CA4th 1171, 126 CR2d 305; *Home Sav. of Am. v Continental Ins. Co.* (2001) 87 CA4th 835, 104 CR2d 790.

Lenders may not require borrowers to carry hazard insurance in an amount that exceeds the replacement value of the improvements on the property. CC §2955.5.

Loan documents often require the borrower to pay installments of the insurance and taxes to the lender on a regular monthly basis if (1) the equity cushion is small (*e.g.,* the borrower's downpayment is 10 percent or less of the purchase price), (2) state or federally guaranteed loans require the payments, or (3) the borrower defaults on tax payments. See CC §2954(a). The lender holds these funds in an impound account (see §§8.56, 8.77) and uses them to pay the insurance and taxes directly. See CC §§2954-2954.2, 2954.8, 2955 for statutory regulation of impound accounts.

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§8.58 1. Trustor's Failure to Insure

If the trustor fails to insure as required by the deed of trust (see §8.57), the beneficiary may declare a default and accelerate the balance owing under the standard acceleration clause, which appears in nearly all institutional form promissory notes and allows the beneficiary to accelerate if the trustor defaults on any obligation in the deed of trust (see §8.2). See also California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000). Most title company and institutional form deeds of trust contain a similar provision.

Civil Code §2924.7(a) and Fin C §§1227.2(a) and 7461 validate the lender's right to enforce these provisions and accelerate and foreclose for the borrower's failure to keep insurance payments on the property current (as well as for failure to pay taxes, rents, and assessments). These sections eliminate any need for the lender to show that the security has been impaired, negating earlier decisions that enforcement required a showing of impairment of security. See Stats 1988, ch 179, §3. See also §§8.62-8.63, 12.142.

PRACTICE TIP: Although the deed of trust and applicable statutes do not require the beneficiary to actually pay the insurance premiums to enforce the acceleration clause, this should be done so that there is coverage in the event of a loss. The amounts advanced (see §8.74) can be added to the principal debt. *Campbell v Realty Title Co.* (1942) 20 C2d 195, 124 P2d 810.

After an uninsured casualty, it is unclear what rights a beneficiary has against a trustor who has not properly insured the property. Apart from foreclosure, monetary recovery may be limited to the unpaid insurance premiums or prohibited entirely by the antideficiency rules (if this is treated as a form of non-bad faith waste) (see §§4.51, 5.57). See *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557; Leipziger, *The Mortgagee's Remedies for Waste,* 64 Cal L Rev 1086 (1976). The practice of some lenders in charging a premium for buying an insurance policy when the borrower has failed to insure has generated inconclusive class litigation. See *Gibson v World Sav. & Loan Ass'n* (2002) 103 CA4th 1291, 128 CR2d 19 (in class action alleging that lender's administrative charge for buying insurance violated unfair competition law, claim was not preempted by federal law); *Silvas v E*Trade Mortgage Corp.* (SD Cal 2006) 421 F Supp 2d 1315, 1320, aff'd (9th Cir 2008) 514 F3d 1001 (distinguishing *Gibson* on federal preemption issue on grounds that *Gibson* involved general legal duties, not lending activities).

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§8.59 2. Beneficiary's Failure to Require Loss-Payable Clause

The insurance clause described in §8.57 usually requires that any policy obtained be loss payable to the beneficiary. If the documents merely require the trustor to carry insurance but do not provide for proceeds to go to the beneficiary, the beneficiary may not be able to claim them. Compare *Alexander v Security-First Nat'l Bank* (1936) 7 C2d 718, 62 P2d 735, with *Lee v Murphy* (1967) 253 CA2d 205, 61 CR 174.

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§8.60 3. Beneficiary's Failure to Require Insurance

When a lender does not require the trustor to insure against particular risks, such as earthquakes, but the trustor does so voluntarily for its own sake, the lender may not rely on the insurance provisions in the deed of trust (see §8.57) to claim any proceeds resulting from that hazard. *Ziello v Superior Court* (1995) 36 CA4th 321, 42 CR2d 251. See *Foothill Village Homeowners Ass'n v Bishop* (1999) 68 CA4th 1364, 81 CR2d 195. More recently, policies or loan documents often make acquisition of earthquake insurance optional to the borrower but require that the lender be made a loss payee if such insurance is obtained. These provisions have been held fully enforceable according to their terms. See *JEM Enters. v Washington Mut. Bank* (2002) 99 CA4th 638, 121 CR2d 458; *Martin v World Sav. & Loan Ass'n* (2001) 92 CA4th 803, 112 CR2d 225.

The beneficiary can acquire rights in the proceeds of insurance coverage that is not *required* by the loan documents if the loan documents so provide. In *Martin*, the court distinguished *Ziello* on the basis that the *Martin* deed of trust contained a clause providing that *if* the borrower obtained earthquake insurance, the lender was to be named as the loss payee. The court held the clause enforceable.

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§8.61 4. Loss After Foreclosure

If a loss occurs after a foreclosure sale and the policy has not been rewritten to reflect the beneficiary's interest as the foreclosure purchaser (and did not previously name the beneficiary as loss payee), the proceeds are not payable to the beneficiary. *Reynolds v London & Lancashire Fire Ins. Co.* (1900) 128 C 16, 60 P 467. But see *Countrywide Home Loans, Inc. v Tutungi* (1998) 66 CA4th 727, 78 CR2d 203, discussed in §2.129.

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5. Right to Insurance Proceeds

§8.62 a. Lender's Option

The provision described in §8.57 gives the beneficiary the option to apply the insurance award toward the debt or permit the trustor to take the funds. Overturning earlier, contrary judicial decisions, CC §2924.7(b) and Fin C §7462 make this provision enforceable without regard to whether the security has been impaired. The legislative Comment to CC §2924.7(b), however, acknowledged an exception to this rule, which was created in *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57 (cited in §8.63), when the trustor uses the proceeds to restore the security. See Stats 1988, ch 179, §3. For analysis of application of CC §2924.7 in circumstances in which trustor does not wish to rebuild, see unpublished decision in *California Fair Plan v Boktor* (Dec. 8, 2003, B160299; not certified for publication) 2003 Cal App Unpub Lexis 11450, 2003 WL 22883998.

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§8.63 b. Using Proceeds to Restore Property

When the trustor desires to use the insurance proceeds to restore or rebuild the real property, the implied covenant of good faith and fair dealing requires the beneficiary to show that the property is impaired before it can apply the proceeds to reduce the debt. In *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57, the court held that the trustor was entitled to use the proceeds to rebuild damaged improvements, despite a clause in the deed of trust allowing the beneficiary discretion on use of the proceeds. See Randolph, *A Mortgagee's Interest in Casualty Loss Proceeds: Evolving Rules and Risks,* 32 Real Prop, Prob & Trust J 1 (Spring 1997); Moless, *Fire Insurance Covenants in Deeds of Trust: Death of Contract?,* 16 Lincoln L Rev 97 (1986).

When the borrower seeks to use the proceeds to restore the property, it is difficult to see how impairment of security can ever be demonstrated as long as the repairs restore the property to its preloss condition and value. Only if the trustor is otherwise in default may the beneficiary reject the restoration proposal. See *Ford v Manufacturers Hanover Mortgage Corp.* (9th Cir 1987) 831 F2d 1520.

On impairment of security generally, see §§5.57-5.60 and extensive list of cross-references to other sections of this book in §5.57. For discussion of recovery of insurance proceeds *after* foreclosure sale, see §§2.129, 8.61, 9.24.

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§8.64 6. Multiple Beneficiaries

When there are multiple deeds of trust on the property, insurance proceeds are paid to the senior lienholder, up to the amount of its lien, before any surplus is distributed to juniors (*Woody v Lytton Sav. & Loan Ass'n* (1964) 229 CA2d 641, 40 CR 560), as long as the senior security instrument so provides (*Alexander v Security-First Nat'l Bank* (1936) 7 C2d 718, 62 P2d 735). See *Caruso v Great W. Sav.* (1991) 229 CA3d 667, 280 CR 322, and other authorities discussed in §8.87.

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7. Tax Considerations

§8.65 a. For Trustor

Federal income tax treatment of the trustor's insurance proceeds depends on how they are used. If the trustor uses the funds to repair the damage, the insurance funds are not income and there are no tax consequences. IRC §1033; Treas Reg §1.1033(a)-2(c). If the trustor pockets the proceeds, there is gain or loss equal to the difference between the amount received and the trustor's basis in the property. Treas Reg §1.1033(a)-2(c). There is also gain or loss to the trustor if the beneficiary elects to have the funds applied to reduce the debt and the trustor does not later acquire a replacement property. Treas Reg §1.1033(a)-2(c)(9)(ii). Whether the trustor takes the insurance proceeds in cash or applies them to pay principal on the debt, the tax result is the same.

In the case of a principal residence, $250,000 of gain ($500,000 for married trustors filing a joint return) is excluded from income under IRC §121(d)(5)(B). In applying IRC §1033, the amount realized is the amount determined without regard to IRC §121, reduced by the amount of gain excluded.

If the trustor pockets the cash and later acquires a qualifying replacement property by obtaining a loan, the tax will be avoided.

EXAMPLE: The trustor owns an office building as a rental investment, which is destroyed by fire, resulting in fire insurance proceeds of $100,000 to the trustor (not paid to lender, because lender was secured by the land and loan agreement provided that insurance proceeds would be paid to trustor). The trustor pockets the $100,000 and does not rebuild. Then, within the time limit under IRC §1033, the trustor borrows $100,000 from another lender to purchase a like-kind property (another office building, eligible for involuntary conversion treatment). The trustor thus avoids tax liability on the proceeds from the first office building.

The time window for acquiring a replacement property under IRC §1033 begins at the time the casualty occurs and ends on the second anniversary of the last day of the owner's tax year in which the casualty occurred. IRC §1033(a)(2)(B)(i). For example, the casualty occurs October 31, 2009, for a calendar-year taxpayer. The general rule provides that the deadline for acquiring qualifying replacement property is December 31, 2011. For business or investment real estate, the deadline for acquiring replacement property is the third anniversary of the last day of the owner's tax year in which the involuntary conversion occurred. IRC §1033(g)(4). For a principal residence damaged in a federally declared disaster, to the extent that the gain is not excluded under IRC §121(d)(5)(B), the deadline for acquiring replacement property is the fourth anniversary. IRC §1033(h). Because §1033 does not apply to losses, any loss resulting from an involuntary conversion will be recognized or not recognized under other Internal Revenue Code sections, *e.g.,* IRC §§165, 1231.

WARNING: This chapter does not provide complete and in-depth coverage of the tax consequences of the use of casualty insurance proceeds. Counsel should confer with qualified tax counselors or attorneys for assistance in determining the tax impact of a casualty and of the use of casualty insurance proceeds by their clients.

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§8.66 b. For Lender or Seller

Receipt of insurance proceeds by the trustor and their ultimate use have no tax significance to a third party lender unless the trustor uses the proceeds to repay the loan. If the loan is repaid, then the lender recognizes income on the interest paid. See §8.65. Most notes provide that payments received shall apply first to interest and then to principal. The interest received is ordinary income to the lender, whether received by a third party lender (who was not a seller) or a seller-lender. For a seller reporting under the installment method, application of the funds to reduce the debt will accelerate gain under IRC §453 (see §8.6).

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§8.67 E. Condemnation and Damage Provisions

A clause in most deed of trust forms provides for an assignment to the beneficiary of any compensation, award, or payment of damages in condemnation actions or actions for injury to the property. The beneficiary may apply or release the proceeds in the same manner (and with the same effect) as in the disposition of insurance proceeds. Many commercial deeds of trust also reserve for the beneficiary the rights to appear in and defend these actions and to decide unilaterally how to use the proceeds. Although this clause and the insurance clause (see §8.57) contain similar language, the rules are different. A trustor can promise to keep the property insured but cannot promise to keep it free from governmental eminent domain actions or third party activities causing physical damage. Consequently, this clause deals only with the disposition of awards for taking or damaging the collateral. Note that CC §2924.7(b) and Fin C §§7461-7462 cover only insurance situations.

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1. Condemnation Awards

§8.68 a. As Substitute Security

When property is taken for public use, the condemning agency may deduct the amount of an indebtedness that is not due at the time from the judgment and allow the lien to continue until the indebtedness is paid, or it may pay the full amount. CCP §1265.220. See *People ex rel Dep't of Pub. Works v Cheda* (1957) 154 CA2d 531, 317 P2d 145. Unlike casualty insurance awards, the beneficiary does not need an entitling clause in the deed of trust to share in the award, because a public entity cannot take property subject to a deed of trust without compensating the beneficiary. See *Stratford Irrig. Dist. v Empire Water Co.* (1943) 58 CA2d 616, 137 P2d 867. See also *Bellows v Los Angeles Dock & Terminal Co.* (1922) 56 CA 168, 204 P 858. Any award made by the condemning authority to the trustor would be subject to the lien of the deed of trust under the doctrine of substitute security, which equitably converts the award into the land that it replaces. *American Sav. & Loan Ass'n v Leeds* (1968) 68 C2d 611, 614 n2, 68 CR 453.

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§8.69 b. Impairment of Security Requirement

Without an entitling clause in the deed of trust (see §8.67), a lender's claim to the condemnation award is limited to the amount necessary to protect its security interest from impairment. See *Sacramento & San Joaquin Drainage Dist. v Truslow* (1954) 125 CA2d 478, 499, 270 P2d 928. Similarly, the implied covenant of good faith requires the lender to exercise discretionary control over the award to permit the trustor to retain all except what is necessary to protect the lender's security from impairment. *Milstein v Security Pac. Nat'l Bank* (1972) 27 CA3d 482, 103 CR 16. See *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57. This rule may be less strictly applied in federal court. See *Miller v Federal Land Bank* (9th Cir 1978) 587 F2d 415. Thus, the entitling clause discussed in §8.67 constitutes only a security assignment, not an absolute assignment of the award. See *Duarte v Lake Gregory Land & Water Co.* (1974) 39 CA3d 101, 113 CR 893.

The *Milstein* rule was codified in CCP §1265.225, which provides that in a partial taking, the lienholder may share in the condemnation award only in an amount necessary to prevent impairment of the security. The extent to which this can be avoided by improved drafting of the condemnation clause in the deed of trust is open to question. For discussion and sample clause, see California Real Estate Finance Practice: Strategies and Forms §§4.27-4.28, 4.70 (Cal CEB 2000).

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§8.70 (1) Standards of Impairment

No generally accepted standard governs the point at which security is impaired. Compare *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, with *People ex rel Dep't of Transp. v Redwood Baseline, Ltd.* (1978) 84 CA3d 662, 670, 149 CR 11. See also discussion of *Cornelison* in §§5.57-5.58. (*Cornelison* involved waste rather than condemnation, and *Redwood Baseline* suggested that the differing policies involved in the two situations should lead to different tests.) The alternatives recognized in *Redwood Baseline* for deciding when security has been impaired are as follows:

- **Debt equivalency** (when the value of the security goes below the outstanding indebtedness) (*Cornelison* test);
- **Original ratio** (when the ratio of security to debt after the taking falls below the original ratio of security to debt) (*Redwood Baseline* standard); and
- **Pretake ratio** (when the ratio after the taking falls below what it was immediately before the taking) (*Redwood Baseline* standard).

The *Redwood Baseline* opinion mentioned but rejected three other possible standards (84 CA3d at 687): (1) The conservative lender rule (requires application of proceeds only to the extent necessary to return the ratio of debt to remaining security to that which a conservative lender would consider reasonable); (2) the market value rule (compares the market value of the secured debt before and after the partial condemnation); and (3) the rule in any other jurisdictions—giving the lender the entire award.

The *Redwood Baseline* decision suggests that the test to be applied should depend on the trial court's evaluation of all circumstances (84 CA3d at 687), including the following:

- Whether the original transaction was a sale or a loan;
- The availability of a deficiency judgment;
- The repayment terms;
- The interest rate as compared with prevailing rates;
- The original, pretaking, and posttaking ratios of security to debt;
- The size of the debtor's equity (absolutely and as compared with the loan);
- The debtor's payment record;
- The remaining life of the loan;
- The effect of the partial taking on the remainder of the property, taxes, and assessments;
- Whether the loan is or has been in default or is likely to be in the future; and
- The marketability and value of the security.

The court indicated that this was only a partial list of factors, meaning that trial court calculations are unlikely to risk appellate reversal.

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§8.71 (2) Application of Impairment Standards

Impairment of security is clear when the value of the remaining collateral falls below the remaining balance due on the loan (the debt-equivalency formula). Whether impairment occurs when the remaining value is greater than the loan balance is unclear because lenders generally bargain for a loan-to-value ratio that is significantly below 100 percent at the outset and that may be expected to improve as the loan is paid down and the property value appreciates. See *People ex rel Dep't of Transp. v Redwood Baseline, Ltd.* (1978) 84 CA3d 662, 149 CR 11.

EXAMPLE: Assume a loan of $100,000 secured by property worth $150,000 at the time of making, with an original loan-to-value ratio of 67 percent. Assume also that the property subsequently appreciates to $180,000 and the loan is paid down to $90,000, giving it a pretake ratio of 50 percent. If, at that point, there is a condemnation of part of the property, causing a loss of $80,000 and an award of that same amount paid by the condemnor, the lender's impairment of security could be measured in three ways:

- **Debt equivalency.** Because the remaining value of the security is $100,000 ($180,000 pretake value less the $80,000 loss) and that amount exceeds the loan balance ($90,000), there is no impairment of security and the lender has no claim to any funds.
- **Original ratio.** Because the original loan-to-value ratio was 67 percent, the lender should remain similarly protected after the condemnation. Because the value of the property is now only $100,000, it cannot support a loan of more than $67,000. Therefore, the lender should receive $23,000 of the condemnation award in order to bring its loan balance down from $90,000 to $67,000; the remaining $57,000 would go to the owner-borrower.
- **Pretake ratio.** Because the loan-to-value ratio immediately before the loss was 50 percent, the new $100,000 value of the property justifies a loan balance of only $50,000. Therefore, $40,000 of the condemnation award would go toward reducing the loan to that balance, and the other $40,000 would go to the borrower.

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§8.72 c. Taxation of Condemnation Awards

Condemnation awards receive federal income tax treatment similar to that given to insurance awards under IRC §1033 (see §§8.65-8.66). The replacement periods differ according to whether the property is for personal, business, or investment use (see §8.65). The triggering date for the beginning of the replacement period is the date of "disposition of the condemned property" or the earliest date of the threat or imminence of requisition or condemnation of the property, whichever is earlier. IRC §1033(a)(2)(B). This is generally before the transfer of the property to the eminent domain transferee. Thus, a taxpayer could acquire the replacement prior to the actual conveyance of the property under the eminent domain taking.

EXAMPLE: Calendar-year Taxpayer owns Blackacre, held as business real estate. City requires Blackacre to build freeway. On December 1, 2009, City notifies Taxpayer of its intent to purchase Blackacre under power of eminent domain. City does not complete its negotiations with Taxpayer until December 15, 2010, and actual closing does not occur until January 2, 2011. Taxpayer's window (see §8.65) to acquire replacement property begins December 1, 2009, and ends December 31, 2014. Thus, it is possible that Taxpayer could effect a "reverse" exchange of property interests to gain tax deferral under IRC §1033.

WARNING: This chapter does not provide complete and in-depth coverage of the taxation of condemnation awards. Counsel should confer with qualified tax counselors or attorneys for assistance in determining the tax impact of condemnation awards on their clients.

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§8.73 2. Damage Awards

The condemnation clause described in §8.67 usually also covers damages recovered by the trustor from nonpublic tortfeasors who have injured the collateral. See *U.S. Fin. v Sullivan* (1974) 37 CA3d 5, 112 CR 18. This type of clause is not construed, however, to cover an award received by the trustor, as purchaser, from the vendor for fraud in conjunction with the sale. *American Sav. & Loan Ass'n v Leeds* (1968) 68 C2d 611, 68 CR 453. The beneficiary may, of course, have direct rights of action against such third persons, and the condemnation clause does not interfere with those rights (see §§2.122, 4.48, 5.55, 9.80-9.82).

PRACTICE TIP: Taxpayers receiving damage awards should be alert to a possible exclusion from taxable income (*e.g.,* of damages awarded for personal "physical" injuries) provided by IRC §104. Sometimes a favorable finding under §104 can turn on the way the damages collected from a settlement are characterized in the settlement agreement. Practitioners may wish to consult a tax specialist for assistance with drafting any agreement that has payments potentially eligible for tax-free characterization.

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§8.74 F. Taxes, Senior Liens, Impound Accounts

A clause found in most deed of trust forms obligates the trustor to keep the property taxes and senior liens current. It may also require that the taxes be paid through an impound account (see §8.77). Standard language may state that the trustor will promptly pay (1) all general and special taxes, assessments, and water and sewer district charges and (2) all encumbrances, charges, and liens that are superior (in the beneficiary's judgment) to the deed of trust. If an impound account is established, the trustor must usually pay to the beneficiary, with each installment on the promissory note, 1/12 of the annual taxes, general and special assessments, and water and sewer district charges. The beneficiary estimates these amounts and adds them to the monthly installment.

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§8.75 1. Beneficiary's Right to Advance Funds to Protect Security

If the trustor fails to meet these obligations, most deed of trust forms also provide that the beneficiary may advance any sum necessary to protect the security, without obligation and without notice to or demand on the trustor. These clauses typically address the trustor's obligation to repay the advances, with provisions such as the following:

> At Beneficiary's request, Trustor will immediately pay any sum advanced or paid by Beneficiary or Trustee. Until repaid, all such sums shall be added to, and become a part of, the indebtedness secured by this Deed of Trust and bear interest from the date of advancement of payment at the same rate applicable under the Note. All sums advanced by Beneficiary, whether or not required to be advanced by Beneficiary, shall conclusively be deemed to be mandatory advances required to preserve and protect Beneficiary's security for the performance of Trustor's obligations under the Note, and shall be secured by this Deed of Trust to the same extent and with the same priority as the principal and interest payable under the Note.

As noted in §§8.76 and 8.79, even without such a provision in the deed of trust, the beneficiary may still pay taxes and senior liens (if necessary to protect its security) and add these sums to its own lien. On foreclosure, any sale proceeds should first be applied to reimburse the sums paid for taxes and senior liens (see §§2.102, 3.83, 8.78-8.80).

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§8.76 2. Trustor's Failure to Pay Taxes; Advances

Failure to pay the property taxes will lead to a tax sale of the property, and is thus a form of waste. See *Osuna v Albertson* (1982) 134 CA3d 71, 184 CR 338. On waste, see §§2.119-2.120, 3.55, 4.51-4.53, 5.57-5.59, 6.10-6.15. A tax sale eliminates all junior liens (see §2.99). Even though the unpaid taxes may not have arisen until after the deed of trust was executed, liens for property taxes have statutory priority over all other real property liens. Rev & T C §2192.1. Compare *California Loan & Trust Co. v Weis* (1897) 118 C 489, 50 P 697, with *Guinn v McReynolds* (1918) 177 C 230, 170 P 421. Other charges in the tax bill, however, may not have the same priority. See *County of Butte v North Burbank Pub. Util. Dist.* (1981) 124 CA3d 342, 177 CR 282.

The beneficiary is entitled to demand that the trustor keep the taxes current. *Donkin v Killefer* (1939) 32 CA2d 729, 90 P2d 810. If the trustor does not pay the taxes, most deeds of trust allow the beneficiary to either

- institute foreclosure proceedings directly; or
- pay the taxes and then foreclose if it is not reimbursed.

Such a clause is enforceable even if the trustor's failure to pay taxes does not result in an impairment of the beneficiary's security interest in the property. CC §2924.7. The failure to pay taxes by a borrower with the ability to do so may constitute bad faith waste, thereby creating a damages claim outside the scope of the borrower's antideficiency protections. *Nippon Credit Bank v 1333 N. Cal. Blvd.* (2001) 86 CA4th 486, 103 CR2d 421.

Additionally, most deed of trust forms permit the beneficiary to pay all debts necessary to protect its security and then recover them from the trustor (see §§8.75, 9.69). (This right exists even without enabling language in the deed of trust because CC §2876 permits the lienholder to satisfy prior liens, including tax liens, for its own protection and to recover any advances through its own lien. *Stafford v Russell* (1953) 117 CA2d 326, 255 P2d 814.) On senior liens and beneficiary's right to take action to protect its security interest, see §§8.78-8.80.

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§8.77 3. Impound Accounts

Property taxes and insurance are sometimes handled by imposing an impound account under which 1/12 is paid as part of each monthly payment to the beneficiary, who then makes these payments directly to the payees when due. Impound accounts are regulated by California statute (see CC §§2954-2954.2, 2954.8, 2955) and by mandatory disclosure requirements under the federal Real Estate Settlement Procedures Act of 1974 (RESPA) §10 (12 USC §2609); see 24 CFR §3500.17(g)-(j). Regulation X (24 CFR pt 3500) establishes accounting requirements for disbursements from impound accounts. These regulations apply only to certain enumerated types of loans; each should be consulted as to scope.

In some situations, the beneficiary must pay interest on the impound account. CC §2954.8. If a wraparound or all-inclusive deed of trust is used, the beneficiary may also collect from the trustor the amounts owed on the senior lien (see §§9.36-9.41).

A borrower who has agreed to an impound account may later terminate it unless the loan has come within one of five statutory categories for which the impound account may be mandatory. CC §2954. This right to later terminate cannot be waived by language in the original impound agreement or the deed of trust. *Kirk v Source One Mortgage Serv. Corp.* (1996) 46 CA4th 483, 54 CR2d 358.

It has not been determined in California or in the Ninth Circuit whether the Alternative Mortgage Transaction Parity Act (12 USC §§3801-3806) preempts the state provisions requiring interest payments on impounded funds. See §8.45 on possibility of preemption.

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4. Failure to Keep Senior Liens Current

§8.78 a. Effect of Senior Lien Foreclosure on Junior Lien

Failure of the trustor to keep senior liens current is similar to failure to pay property taxes. If the default is not cured, a foreclosure of the senior lien will eliminate all junior liens (see §§2.99, 3.32-3.33).

Like anyone else, the junior may bid at the senior foreclosure sale, but the junior bid must be all cash. Unlike the foreclosing senior, the junior cannot credit-bid even the amount of the junior lien at the senior sale, unless this has been prearranged with the senior. *Nomellini Constr. Co. v Modesto Sav. & Loan Ass'n* (1969) 275 CA2d 114, 79 CR 717. See §§2.78, 3.80. Any surplus from the sale (whether by virtue of the bid of the junior or of a third party) goes to the junior next in line. *Pacific Loan Mgmt. Corp. v Superior Court* (1987) 196 CA3d 1485, 1491, 242 CR 547. On distribution of proceeds from trustee sales and judicial foreclosure sales, see §§2.102, 3.83.

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§8.79 b. Junior Curing Senior Default; Advances

To avoid the problems described in §8.78, a junior may prefer to avert a senior foreclosure by making the payments required by the senior deed of trust to the senior lender (see CC §2924c), tacking these payments onto the junior deed of trust and then foreclosing on it (see discussion of right of junior to reinstate default on senior lien in §§2.5, 2.52, 2.72, 6.63, 8.82, 9.57). This technique permits the junior to sell the property subject to the senior lien, to credit bid at the sale, to be the one first entitled to the proceeds, and to eliminate the urgency created by an impending senior foreclosure. See *United Sav. & Loan Ass'n v Hoffman* (1973) 30 CA3d 306, 106 CR 275. The junior may also effect a presale redemption from the senior deed of trust (see CC §§2903-2905, discussed in §2.73), but this method compels the junior to produce cash in the full amount of that lien.

As with unpaid taxes (see §8.76), both the deed of trust and the Civil Code permit the junior lienholder to keep senior liens from default, add the amounts paid to the balance on the junior debt, and be subrogated to the extent of the amounts paid. CC §§2876, 2903-2905; *Windt v Covert* (1907) 152 C 350, 93 P 67; *Churchill v Woodworth* (1906) 148 C 669, 84 P 155; *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579. If the junior pays to reinstate a senior debt that is usurious, the junior may be able to charge its full payment, including the usurious interest, as an advance and add it to the junior debt because the junior is not entitled to assert protection under the usury laws. See *Roes v Wong* (1999) 69 CA4th 375, 81 CR2d 596. See also §§2.104-2.105. On junior's discretionary right to cure trustor's default on senior debt, see §8.82.

Payments made by a junior and added to its own lien may take on the characteristics of the senior lien. For instance, if the trustor is subject to personal liability on the junior deed of trust but not on the senior, a junior who pays off the senior lien and combines the amounts on foreclosure may obtain a deficiency judgment for the junior portion of the debt. See *Windt v Covert, supra*. In general, the validity of any deficiency judgment ultimately depends on the nature of the junior debt (purchase money or not) and the nature of the foreclosure sale (trustee or judicial) rather than on the nature of the curative advances (see §§5.4, 5.10-5.12, 5.24, 5.39-5.44).

Whether the junior lien can take on the priority of the senior lien (particularly when there is an intervening lienholder) by invoking the doctrine of equitable subrogation is an issue being litigated in many jurisdictions. Some courts hold that the junior lienholder can only advance in priority if it is unaware of the existence of an intervening creditor (*e.g., Countrywide Home Loans, Inc. v First Nat'l Bank of Steamboat Springs, N.A.* (Wy 2006) 144 P3d 1224) while others, following Restatement (Third) of Property: Mortgages §7.6 (1997), permit the advance in priority even if the junior knew of the existence of the intervening creditor (*Hicks v Londre* (Colo 2005) 125 P3d 452). But if the junior delays in asserting its subrogation rights (after paying obligations secured by senior liens) and an intervening creditor changes its position in reliance on the record of title, equitable subrogation may be denied. *Land Title Ins. Corp. v Ameriquest Mortgage Co.* (Colo 2009) 207 P3d 141. On effect of constructive versus actual notice of intervening creditor's interest, see authorities in *Foster v Porter Bridge Loan Co.* (Ala 2009) ___ S3d ___, 2009 Ala Lexis 166, and *Hicks v Londre, supra*.

If the junior is able to purchase an assignment of the senior deed of trust, it may exercise the rights in the senior instrument (including the power of sale) without automatically suffering a merger of the junior lien. *Strike v Trans-West Discount Corp.* (1979) 92 CA3d 735, 155 CR 132. Redeeming the senior lien, however, does not automatically entitle the junior to compel an assignment of it. *Snider v Basinger* (1976) 61 CA3d 819, 132 CR 637. Junior wraparound deeds of trust usually impose special duties on the holder of the "wrapping" debt concerning the servicing of the senior debt (see §9.36).

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§8.80 c. Priority of Payments to Cure Tax Default

When a senior beneficiary pays taxes or advances money to the trustor to pay them, lien creditors junior to the senior may claim that these are optional future advances not entitled to priority over their claims (see §9.69). The senior may, however, be able to claim that the payments (1) either were obligatory or were made to protect the security under CC §2876 and (2) were not future advances made under the future-advance clause. *Savings & Loan Soc'y v Burnett* (1895) 106 C 514, 39 P 922; *Turner v Lytton Sav. & Loan Ass'n* (1966) 242 CA2d 457, 51 CR 552; *Hesse v Railway Fed. Sav. & Loan Ass'n* (1941) 46 CA2d 111, 115 P2d 519. The senior's right to advance these funds, however, need not put the junior in jeopardy. The junior may (1) declare a default under the junior deed of trust because of the trustor's failure to pay these necessary expenses and (2) insist, as a condition for reinstating the junior deed of trust, that the trustor either reimburse the senior or pay the junior an amount equivalent to what the senior advanced. *Manning v Queen* (1968) 263 CA2d 672, 69 CR 734. For further discussion and enforcement strategies, see California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000).

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§8.81 5. Interest Rate on Advances

The type of clause discussed in §8.74 provides for interest at the legal rate on sums advanced by the beneficiary or trustee. Even without this provision, advances for taxes or other prior liens made by the beneficiary to protect its own interest become a part of the indebtedness secured by the deed of trust (CC §2876) and bear interest at the legal rate (Cal Const art XV). *Beeler v American Trust Co.* (1946) 28 C2d 435, 170 P2d 439; *Estreito v Citirealty Corp. (In re Estreito)* (BAP 9th Cir 1990) 111 BR 294.

The parties may provide that such advances be added to the principal and bear interest at the same rate as the promissory note rather than at the legal rate. See California Real Estate Finance Practice: Strategies and Forms §4.78 (Cal CEB 2000). Lenders subject to the usury law should provide that any sums advanced bear interest only at the maximum permissible rate. For discussion of usury restrictions, see Real Estate Finance, chaps 1, 3.

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§8.82 6. Beneficiary's Right to Cure

Because the clause discussed in §8.74 permits the beneficiary or the trustee to pay liens that in the judgment of the beneficiary are, or appear to be, prior or superior to the beneficiary's lien, the beneficiary need not obtain the trustor's consent to pay a prior lien directly if the trustor fails to pay. If a junior lienholder pays off a senior lien, however, its right to declare a default may turn on the validity of the discharged debt. For example, in *Security-First Nat'l Bank v Lamb* (1931) 212 C 64, 297 P 550, the beneficiary first paid off an assessment that was then under challenge by the trustor in court and later foreclosed when the trustor refused to reimburse. The supreme court held that the deed of trust permitted the beneficiary to pay off any claim that, in the beneficiary's sole discretion, either was or appeared to be a lien. (That decision may have rested in part on the facts that the trustor could have paid the assessment under protest, there were heavy penalties for nonpayment, and the trustor ultimately lost the challenge to the assessment.)

Conversely, in *Vilkin v Sommer* (1968) 260 CA2d 687, 67 CR 837, when the junior made payments on the senior deed of trust that benefited the junior rather than the trustor, the junior was not allowed to demand reimbursement. But see *United Sav. & Loan Ass'n v Hoffman* (1973) 30 CA3d 306, 106 CR 275, discussed in §8.79.

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§8.83 G. Attorney Fees

Most commercial and multifamily deeds of trust contain one or more clauses allowing the lender to recover reasonable (or necessary) costs and attorney fees (1) in actions to preserve or protect the security (whether the lender is a plaintiff or a defendant or intervenes in a third party action) and (2) in actions brought by the lender to foreclose the deed of trust or otherwise enforce its provisions. See, *e.g., RTC Mortgage Trust 1994-S2 v Shlens* (1998) 62 CA4th 304, 327 n7, 72 CR2d 581. Similar terms are found in the uniform deed of trust form for residential loans prescribed by the Federal National Mortgage Association. These clauses are governed by CC §1717 if they specifically provide for attorney fee awards in contract (*i.e.,* deed of trust) enforcement and foreclosure actions. Under CC §1717(a), which makes contract attorney fee provisions reciprocal, the trustor is entitled to recover attorney fees if it is the prevailing party and if the deed of trust provides for attorney fee recovery to a prevailing beneficiary. *Valley Bible Ctr. v Western Title Ins. Co.* (1983) 138 CA3d 931, 188 CR 335. See *Nasser v Superior Court* (1984) 156 CA3d 52, 202 CR 552 (no prevailing party in lessee's declaratory relief action to validate renewal option, thus trial court properly denied attorney fees under CC §1717). See also Warning in §8.87 on limitations on parties' rights to allocate attorney fees. See generally California Attorney Fee Awards (2d ed Cal CEB 1994).

Another clause found in nearly all deed of trust forms (see discussion of clause in §8.75) requires the trustor to reimburse the beneficiary for any sum expended by it under any of the deed of trust provisions. Because other standard clauses also entitle the beneficiary to appear in proceedings concerning senior liens, to bring judicial foreclosure, to appoint a receiver, to enforce payment of the trustor's obligations, and to conduct a private foreclosure sale, and in each instance permit it to employ counsel, a beneficiary should be able to recover attorney fees from the trustor for most litigated and nonlitigated disputes between them arising from the deed of trust. Certain foreclosure fees, however, are limited by statute (see §2.59).

The proceedings and actions enumerated in the deed of trust generally relate to the deed of trust rather than the note, making it appropriate for the attorney fee clause to appear in that document (see *Hellier v Russell* (1902) 136 C 143, 68 P 581), although the note usually contains such a clause as well. See California Real Estate Finance Practice: Strategies and Forms §3.69 (Cal CEB 2000). Attorney fees are not recoverable unless provided for by contract or statute. CCP §1021.

Although CCP §730 appears to provide for attorney fees in judicial foreclosure actions, it has been interpreted to mean that fees may be awarded only if the deed of trust so provides, and then in an amount set by the court, regardless of what the deed of trust says (see §§3.53, 8.85). *Hotaling v Montieth* (1900) 128 C 556, 61 P 95; *Chase Manhattan Mortgage Corp. v Lessel* (1997) 55 CA4th 10, 64 CR2d 113. See CCP §726(a). Although CC §2924c appears to require payment of attorney fees as a condition of reinstatement, whether or not the deed of trust calls for them (see §8.84), it is doubtful that §2924c would permit a beneficiary to recover attorney fees if reinstatement is not the issue (*i.e.,* after expiration of the reinstatement period).

By implication, CCP §580c and CC §2924d(e) both appear to authorize a discretionary award of attorney fees in judicial foreclosure actions. But because these two sections do not mandate an attorney fee award, they may be viewed only as a limitation on the amount and type of fees and costs otherwise allowed by the deed of trust and interpreted the same as CCP §730. See *Chase Manhattan Mortgage Corp. v Lessel, supra*. For example, if the deed of trust authorizes an award based on attorney fees "actually incurred," the party opposing the award has a strong argument that the foreclosure statutes require the judge to apply the same "reasonable fee" standard of CC §1717(a). See California Attorney Fee Awards, chaps 6, 14 (2d ed Cal CEB 1994).

NOTE: Counsel may argue that the discretionary language in both CCP §580c and CC §2924d(e) would permit a trial court to elect not to award fees to either party in a judgment of foreclosure. But see the supreme court's interpretation of CC §1717 attorney fee language in *Hsu v Abbara* (1995) 9 C4th 863, 39 CR2d 824. See also *Silver Creek, LLC v Blackrock Realty Advisors* (2009) 173 CA4th 1533, 93 CR3d 864.

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§8.84 1. Loan Reinstatement

If the beneficiary has recorded a notice of default and the trustor wishes to reinstate during the reinstatement period (see §§2.53-2.56, 2.72), CC §2924c requires payment of all arrearages and all trustee or attorney fees related to the default in a base amount not exceeding $300 if the unpaid principal is $150,000 or less, or $250 if the unpaid principal exceeds $150,000, plus a decreasing percentage of the unpaid balance over $50,000. See CC §2924c(a), (d). See also *Sweatt v Foreclosure Co.* (1985) 166 CA3d 273, 212 CR 350. Attorney fees are calculated under the formula in §2924c(d) regardless of whether the foreclosure is judicial or nonjudicial. *Bruntz v Alfaro* (1989) 212 CA3d 411, 260 CR 488.

Any charge for trustee or attorney fees calculated in accordance with the statutory formula "shall be conclusively presumed to be lawful and valid." CC §2924c(d). Because the statute refers to trustee and attorney fees disjunctively, it does not appear that the beneficiary may claim both, even though both are incurred (see Practice Tip in §2.59). Also, the beneficiary should have a bill from an attorney (or a trustee) for its claims or a statement of hours expended and tasks performed by house counsel. See *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198. See also *Wiener v Van Winkle* (1969) 273 CA2d 774, 78 CR 761.

If the beneficiary has incurred additional attorney fees that are for services related to the deed of trust other than default and foreclosure and that are specifically recoverable under the deed of trust, it may also be entitled to recover them from the trustor as a condition of reinstatement, if those fees are included in the notice of default. *Buck v Barb* (1983) 147 CA3d 920, 195 CR 461; *Bisno v Sax* (1959) 175 CA2d 714, 346 P2d 814 (see §§2.59, 3.53, 3.63). In that event, previously incurred attorney fees are like any collateral advances made by the beneficiary, which may be added to its claim (see discussion in §8.75). Whether a particular fee is treated as an advance or is limited by §2924c(d) will depend on the purpose of the fee and the terms of the deed of trust. *Bruntz v Alfaro, supra*. If the debtor fails to reinstate the loan and the matter proceeds to a judgment of foreclosure, the limitations in §2924c(d) do not apply. CC §2924d(e).

For comprehensive discussion of reinstatement, see chap 2.

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§8.85 2. Redemption and Foreclosure

Civil Code §2924c does not address attorney fees in all situations. When the borrower has not reinstated the loan and a foreclosure sale is pending or completed, CC §2924c's attorney fees provisions do not cover whether

- attorney fees are required as part of the cost of redemption (see CC §§2903-2905) when a trustor redeems before the sale (see §§2.73, 3.63);
- a lender may include its attorney fees as part of its credit bid (see §§2.82, 2.84, 3.53, 3.80);
- any surplus from the sale may be applied to attorney fees (see §§2.102, 3.83); and
- a beneficiary may recover attorney fees in a deficiency judgment against the trustor (see §§3.53, 3.89, 3.103, 3.113).

Several statutes address attorney fee awards in judicial foreclosure actions. They were enacted at different times and appear confusing and inconsistent with each other. For example, if the beneficiary brings an action for judicial foreclosure and the deed of trust provides for attorney fees, CCP §726(a) allows the trial court to award attorney fees in an amount "not exceeding the amount named in the mortgage." A similar provision, CCP §580c, establishes a "reasonable" attorney fee standard in judicial foreclosure actions, but it differs from CCP §726(a) in that it does not limit recovery to the amount stipulated in the deed of trust or require that attorney fees be authorized in the deed of trust. However, under *Hotaling v Montieth* (1900) 128 C 556, 61 P 95, attorney fees are allowed only when the security instrument provides for them. Finally, CC §2924d(e) provides that when a court issues a foreclosure decree, it has the discretion "to award attorney's fees, costs, and expenses as are reasonable, if provided for in the note, deed of trust, or mortgage, pursuant to [CCP §580c]." For discussion of how these varying fee provisions may be reconciled, see §8.83.

Not only should the beneficiary have an attorney fee clause in the note and deed of trust (see CC §1717), but as with loan reinstatement (see §8.84), it should also have an attorney's bill in its possession or, if in-house counsel expends time, a statement of exact hours and tasks performed. The clause entitles it to reasonable attorney fees as measured by the fair market rate, and therefore a prevailing party may collect fees not actually incurred by an outside attorney. See *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 1097 n5, 95 CR2d 198 (award of attorney fees for in-house counsel services is determined by number of hours expended by counsel multiplied by prevailing market rate for comparable legal services). In *Wiener v Van Winkle* (1969) 273 CA2d 774, 78 CR 761, a creditor was awarded attorney fees despite the fact that the attorney was working on a contingent fee basis; both the attorney fee clause and the contingent fee agreement in that case were specially worded.

Possessing a bona fide bill from an attorney, however, does not guarantee that the amount billed will be the amount recovered. The bill must be reasonable, which means that it will depend on the time spent by the attorney, the size of the debt, and the nature of the issues. See CC §1717(a); CCP §§580c, 726(a); *Melnyk v Robledo* (1976) 64 CA3d 618, 134 CR 602; *Shannon v Northern Counties Title Ins. Co.* (1969) 270 CA2d 686, 76 CR 7; *O'Connor v Richmond Sav. & Loan Ass'n* (1968) 262 CA2d 523, 68 CR 882, disapproved on other grounds in *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 737, 108 CR 845. If the beneficiary foreclosed judicially and the attorney appeared in court to handle the proceedings, the trial judge already has sufficient evidence of the services and their value. *Hellier v Russell* (1902) 136 C 143, 68 P 581. However, if the services were for other aspects of the case, evidence of those services should be offered. See *O'Connor v Richmond Sav. & Loan Ass'n, supra; Bisno v Sax* (1959) 175 CA2d 714, 346 P2d 814. For full discussion of making necessary showing for attorney fee award, see California Attorney Fee Awards, chaps 2, 6, 14-16 (2d ed Cal CEB 1994).

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§8.86 3. Accounting and Interpleader Actions

As part of whatever action is involved between the parties, either side may add a claim for an accounting under CCP §1050. Even if no judicial action is involved, as in a nonjudicial foreclosure (see chap 2), the beneficiary can file an independent action for an accounting. If the trustor claims that the balance due on the note is the amount required to redeem and to receive a release of the deed of trust, but the beneficiary improperly claims attorney fees, the trustor may add a cause of action for accounting to its bill to redeem or to vacate a completed trustee sale. See *Inskeep v Bear Creek Co.* (1942) 54 CA2d 723, 129 P2d 401. The beneficiary has the same right as the trustor to seek an accounting because it may incur damages and penalties for wrongful refusal to reconvey if the proper amount was tendered to it. CC §2941(d); *R.G. Hamilton Corp. v Corum* (1933) 218 C 92, 21 P2d 413; *Hewlett v Evans* (1922) 56 CA 344, 205 P 492.

An action for accounting brought by the trustor over an attorney fee dispute presents the added risk that the trustor may also have to pay the beneficiary's attorney fees in that action. *Hewlett v Evans, supra*. See *Hsu v Abbara* (1995) 9 C4th 863, 39 CR2d 824 (when party obtains unqualified victory on contract claim and contract contains attorney fee clause, court must award fees to it). Furthermore, CC §1717(a) provides that either party may recover attorney fees if there is an attorney fees clause in the contract favoring one party. Thus, a trustor who is victorious in an accounting action, in a claim to the surplus from a sale, or in opposition to a deficiency judgment is entitled to recover attorney fees from the beneficiary. See *Golden W. Credit Corp. v Maury* (1969) 270 CA2d Supp 913, 75 CR 757.

Assessing which party is the prevailing party for the attorney fee award in an accounting action may present difficulties. The supreme court established a formula for resolving this issue in *Hsu v Abbara* (1995) 9 C4th 863, 876, 39 CR2d 824, holding that the trial court must compare the parties' demands and their litigation objectives with the relief awarded. See, *e.g., Silver Creek, LLC v Blackrock Realty Advisors* (2009) 173 CA4th 1533, 93 CR3d 864.

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4. Other Actions

§8.87 a. Multiple Issues; Noncontract Judgments

When other issues are also involved in the litigation, attorney fees must be allocated according to the parties' agreement, subject to the requirements of CC §1717. See *Santisas v Goodin* (1998) 17 C4th 599, 71 CR2d 830. The trial court has discretion to apportion the award between fees incurred on the contract cause of action and those incurred on noncontract causes of action. See *Nazemi v Tseng* (1992) 5 CA4th 1633, 1642, 7 CR2d 762.

For example, in *Shannon v Northern Counties Title Ins. Co.* (1969) 270 CA2d 686, 76 CR 7, the holder of a third deed of trust spent 16½ days in trial resisting the trustor's suit for $50,000 damages for fraud and an injunction against foreclosure, but it was awarded only $500 attorney fees because most of the trial concerned the fraud, not the foreclosure, and the note was for only $1500. In *Wagner v Benson* (1980) 101 CA3d 27, 161 CR 516, however, the court awarded the lender attorney fees incurred in defending against fraud allegations because the defense was necessary to the lender's ability to collect on the note. See also *Caruso v Great W. Sav.* (1991) 229 CA3d 667, 280 CR 322; *IMO Dev. Corp. v Dow Corning Corp.* (1982) 135 CA3d 451, 185 CR 341; *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579.

In proceedings following the decision in *Nippon Credit Bank v 1333 N. Cal. Blvd.* (2001) 86 CA4th 486, 103 CR2d 421 (see §5.58), the court of appeal reversed the trial court's award of attorney fees to the secured lender who had prevailed on a bad faith waste claim. *Aozora Bank Ltd. v 1333 N. Cal. Blvd.* (2004) 119 CA4th 1291, 15 CR3d 340 (cost and fee proceeding). In *Aozora*, the loan was generally nonrecourse but contained recourse carve-outs, including one creating personal liability "if and to the extent that" the borrower committed waste. The court denied the prevailing creditor fees because the recourse carve-out did not expressly carve out fees on a waste claim. The *Aozora* court went on to note uncontradicted expert testimony in the trial court that carve-outs are "always expressed, and never implied." As an additional rationale, the *Aozora* court, in rejecting an argument that it was contradicting its prior decision in *Nippon Credit Bank v 1333 N. Cal. Blvd., supra,* noted that a bad faith waste claim sounds in tort, under *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, rather than in contract.

NOTE: A secured creditor may be able to avoid the *Aozora* preclusion with careful drafting that (1) specifically includes attorney fees in the carve-out and (2) emphasizes that the fees may be recovered in any action for waste, even if it is for bad faith waste in tort. For analysis of contract versus tort attorney fee language in contracts, see *Santisas v Goodin, supra*.

In cases involving the Resolution Trust Corporation, courts will apply state law on attorney fee awards unless (1) the claim for fees is based on federal law or (2) the disputed issues arise from federal law rather than from the loan enforcement. See *RTC Mortgage Trust 1994-S2 v Shlens* (1998) 62 CA4th 304, 327, 72 CR2d 581.

WARNING: Practitioners need to be aware of CC §1717's limitations on the parties' right to allocate fees. See, *e.g., Santisas v Goodin, supra,* holding that under CC §1717(b)(2) a defendant may not recover attorney fees incurred in defending a contract cause of action that is voluntarily dismissed before trial, despite contract language to the contrary. The court held, however, that the parties are free to allocate fees in noncontract causes of action. See also *Chase Manhattan Mortgage Corp. v Lessel* (1997) 55 CA4th 10, 64 CR2d 113; California Attorney Fee Awards, chap 6 (2d ed Cal CEB 1994).

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§8.88 b. Third Party Claims Against Security

Nearly all deeds of trust contain a clause entitling the beneficiary to attorney fees when it appears in an action to defend its security, whether it is a third party action or one initiated by the beneficiary (see, *e.g.,* clauses in commercial deed of trust form in California Real Estate Finance Practice: Strategies and Forms §§4.76-4.78 (Cal CEB 2000)). The clause usually covers cases in which the security is threatened by a paramount title or a senior lien. *Mitsuuchi v Security-First Nat'l Bank* (1951) 103 CA2d 214, 229 P2d 376. For additional description of attorney fee clause, see §8.83.

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§8.89 c. Subsequent Owners

A subsequent owner of the encumbered property who successfully enjoins the lender's attempt to accelerate the loan may be entitled to recover attorney fees under CC §1717 (see §8.83) even though the subsequent owner is a nonassuming grantee (and therefore technically not in privity with the lender or bound by the covenants in the deed of trust). *Saucedo v Mercury Sav. & Loan Ass'n* (1980) 111 CA3d 309, 168 CR 552 (overruling *Pas v Hill* (1978) 87 CA3d 521, 151 CR 98, on this issue). See *Jones v Drain* (1983) 149 CA3d 484, 196 CR 827. Although such a nonassuming grantee would not be personally liable for attorney fees, it would have practical liability for them to avoid foreclosure and, if successful, would be entitled under §1717 to recover them. For general discussion of nonsignatory parties' rights to attorney fees, see California Attorney Fee Awards §§6.10-6.12 (2d ed Cal CEB 1994).

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§8.90 d. Actions Involving Trustees

If the trustee does not know how to distribute the surplus from a completed sale because of disputes over attorney fees (or other disagreements), CC §2924j permits it to file an interpleader action, allowing both parties to make their claims. See *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579. The trustee may then recover attorney fees under CCP §386.6.

The trustee, as well as the beneficiary, may be entitled to attorney fees if there is a bona fide necessity for its appearance. See *Title Guar. & Trust Co. v Griset* (1922) 189 C 382, 208 P 673. But if the dispute is solely between the beneficiary and the trustor, the trustee's appearance is only technically necessary, and the trustee is not entitled to attorney fees. *Field v Acres* (1937) 9 C2d 110, 69 P2d 422; *Mitau v Roddan* (1906) 149 C 1, 84 P 145. Since 1996, CC §2924*l* has permitted a trustee to file a "declaration of nonmonetary status," setting forth its belief that it has no true interest in the action and agreeing to be bound by whatever judgment is entered, which will excuse it from all liability, including attorney fees (see §§1.42, 3.36, 3.61).

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§8.91 V. PREDATORY LENDING: LOAN PURPOSE AND REPAYMENT ISSUES

Financial Code §§4970-4979.8 (enacted in 2001) protect consumers against certain predatory lending practices for residential real property secured loans in an amount that (1) does not exceed the most current conforming loan limit for a single-family first mortgage established by the Federal National Mortgage Association and (2) meets the criteria in Fin C §4970. Financial Code §4973 does the following:

- Restricts negative amortization (Fin C §4973(c));
- Prohibits advance payment of consolidated periodic payments from the loan proceeds (Fin C §4973(d));
- Restricts payment of loan proceeds to home-improvement contractors (Fin C §4973(g));
- Prohibits the person who originates the loan from recommending or encouraging a consumer to default on an existing consumer loan (Fin C §4973(h));
- Requires any new loan that consists of the refinancing of a consumer loan debt consolidation or cash-out to "result in an identifiable benefit to the consumer" (Fin C §4973(j)); and
- Requires specific disclosures to be made on all affected loans no later than 3 business days before the signing of the loan documents (Fin C §4973(k)).

Furthermore, Fin C §§4973 and 4979.6 provide that a person who originates the loan must reasonably believe the consumer has the ability to repay the loan, taking certain factors into consideration (Fin C §4973(f)), and may not do the following:

- Steer, counsel, or direct any prospective borrower to accept a loan product that has a specified risk grade (Fin C §4973(*l*)(1));
- Evade this law by structuring the loan as an open-end credit plan or splitting the loan (Fin C §4973(m)(1));
- Engage in fraudulent acts concerning the loan (Fin C §4973(n)); or
- Make a loan that finances points and fees in excess of $1000 or 6 percent of the original principal balance, whichever is greater (Fin C §4979.6).

Remedies include rescission, reformation, damages (including punitive damages), and recovery of attorney fees. The law applies to loans applied for after June 30, 2002. Stats 2001, ch 732, §3; Stats 2001, ch 733, §10. For further discussion, see §12.56.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/8 Payment and Related Disputes/§8.92 VI. RECONVEYANCE

§8.92 VI. RECONVEYANCE

Civil Code §2941 establishes the standards for both beneficiaries and trustees in requests for and recordation of reconveyances to clear title after secured loans have been satisfied. A mortgagee or assignee must execute a certificate of discharge and record it or have it recorded within 30 days after the mortgage is satisfied. CC §2941(a).

A clause found in most deeds of trust provides that, when the obligation is fully paid or discharged, the beneficiary will instruct the trustee to reconvey the property to the trustor. The trustee (sometimes a title company or an affiliate of the lender) will require the lender to surrender both the note and the deed of trust before reconveying. Even without such a reconveyance clause, CC §2941(b)(1) requires the beneficiary, within 30 days after receiving full payment, to deliver to the trustee the original note and deed of trust and request full reconveyance, which the trustee must execute and record (or cause to be recorded) within the next 21 days. If the trustee is an affiliate of the beneficiary, however, the requirements for original documents may be satisfied by an "optically imaged reproduction." CC §2941(f). Instruments held in electronic form must be altered to indicate that the obligation has been paid in full unless the instruments are held solely for use as copies and have been marked as such. CC §2941(b)(1)(D). On effect of failure to timely reconvey after full payment, see §8.96.

Under CC §2941(b)(1)(B), the reconveyance instrument must specify an address for delivery of the recorded reconveyance to either (1) the borrower or its successor in interest at that person's last known address or (2) the trustee, who must then forward it to the borrower or its successor at that person's last known address. The county recorder has no duty to validate any of the addresses.

The phrase "cause to be recorded" allows the trustee to satisfy its obligations under the reconveyance statute by sending the recordable reconveyance or certificate of discharge to the recorder's office, with necessary recordation fees, by certified mail or courier service that tracks and documents receipt and delivery. Compliance with this procedure entitles the trustee to take advantage of the evidentiary presumption in Evid C §641. The recorder's office must record the document within 2 business days of receipt. CC §2941(c).

Requests for reconveyance by deed of trust beneficiary and deeds of reconveyance by the trustees are occasionally forged or otherwise created without proper authorization. See *Far W. Sav. & Loan Ass'n v McLaughlin* (1988) 201 CA3d 67, 246 CR 872. When the trustee executes and records the deed of reconveyance but this execution is based on a forged request for reconveyance, the deed of reconveyance has been treated as voidable but not void such that the interests of innocent third parties without actual notice who rely on the reconveyance will be protected. *Schiavon v Arnaudo Bros.* (2000) 84 CA4th 374, 100 CR2d 801. When the actual deed of reconveyance (rather than the mere request for reconveyance) is created through forgery, the instrument may be held void and thus give no protection even to third parties who innocently rely on the apparently clear title.

If any doubt exists about the validity of an unintended or improvident reconveyance, however, the lender should promptly evaluate and, if appropriate, bring unjust enrichment claims on the formerly secured obligation. See *FDIC v Dintino* (2008) 167 CA4th 333, 84 CR3d 38. In such situations, lender's counsel may not safely rely on generous contractual limitations rules or on the "trusts deeds never outlaw" rule (*i.e.,* the notion that trust deeds can be foreclosed nonjudicially even after the expiration of the applicable limitations period on the secured debt; see §§2.10, 3.10, 7.31-7.34). See analysis of *Dintino* and practice advice in Bernhardt, *The Editor's Take,* 31 CEB Real Prop L Rep 208 (Nov. 2008).

When the outstanding obligation is satisfied through an escrow, the beneficiary may substitute the title company conducting the escrow as trustee. The title company then assumes the trustee's obligations, prepares the reconveyance documents, and is entitled to the trustee's fees. CC §2941(b)(7).

WARNING: Extra caution should be exercised in monitoring reconveyances that are prepared and recorded through escrow, given that one court held that CC §2941 creates no duties or obligations for escrow holders. See *Markowitz v Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 523, 48 CR3d 217, and analysis in Bernhardt, *Midcourse Corrections: The Suborned Subescrow,* 29 CEB Real Prop L Rep 383 (Nov. 2006).

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§8.93 A. Reconveyance and Statement Fees

Civil Code §2941(e)(1) provides for a fee to cover the services of preparation, execution, and recordation of a full reconveyance. A fee not exceeding $45 is conclusively presumed to be reasonable. CC §2941(e)(2). The fee may be collected no earlier than the opening of a bona fide escrow or no more than 60 days before the payoff. CC §2941(e)(1). (Before the section was amended to so provide, some lenders collected payoff fees at loan origination, possibly 30 years ahead of time.) In addition, the beneficiary may charge the borrower a $30 fee to prepare a payoff demand statement unless the loan is federally insured. See CC §2943(a)(5), (e)(6). Failure to issue a payoff demand does not prevent collection of a reconveyance fee. CC §2941.1.

The limitations on payoff demand statements under §2943 may not apply to alternative mortgage loans (*i.e.,* loans not having fixed rates and fixed terms) made and enforced under federal law. See Whitman, *Preemption of State Laws Protecting Mortgage Borrowers: The Parity Act May Be Broader Than You Think,* 24 CEB Real Prop L Rep 223 (Aug. 2001).

Neither a reconveyance fee nor a payoff demand statement fee need be disclosed on a RESPA HUD-1 good faith estimate. *Bloom v Martin* (9th Cir 1996) 77 F3d 318. Neither fee is "the charge a borrower is likely to be required to pay at settlement." 24 CFR §3500.7(c)(2).

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§8.94 B. Return of Loan Documents

The trustee must return the note and deed of trust to the trustor, on written request, after reconveyance. CC §2941(b)(1)(C). However, the reconveyance clause described in §8.92 may provide for the trustee to retain the deed of trust, and many institutional lenders also acting as trustees do retain both the note and deed of trust even after the loan has been fully paid. Nothing in CC §2941 indicates that its provisions can be waived by contrary language in the loan documents, although many of the deadlines include a demand by the trustor for the requested action over and above the satisfaction of the debt.

Unless otherwise required by the deed of trust, in lieu of delivering the original note and deed of trust to the trustee, the beneficiary may execute and deliver a request for reconveyance to the trustee within 30 days after the loan is satisfied. The beneficiary then has 120 days from the date of satisfaction to deliver the original documents to either the trustee or the trustor after marking the instruments as paid in full. CC §2941(b)(8). Violations of §2941 carry penalties, including actual damages and a $500 statutory penalty. CC §2941(d).

See also CC §§2939, 2939.5, 2940 on discharge of mortgage.

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§8.95 C. Recitals in Reconveyance

The reconveyance clause in many deeds of trust (see discussion in §8.92) provides that recitals in the reconveyance instrument are conclusive. This language may have the effect of estopping the trustor, or any other party to the instrument, from denying their truthfulness. On effect of recitals in trustee's deed given to foreclosure purchaser, see §§2.99, 2.134, 7.62-7.63.

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§8.96 D. Damages to Borrower

Failure to follow statutory reconveyance procedures (see §8.92) after the obligation is satisfied generates liability for actual damages and a forfeiture of $500. CC §2941(d). See *Panagotacos v Bank of America* (1998) 60 CA4th 851, 70 CR2d 595 (affirming award of $300 statutory damages but also affirming denial of alleged actual damages, including emotional distress, because delay caused no actionable injury). (After the *Panagotacos* decision, the legislature amended CC §2941 to ease the standards for both beneficiaries and trustees in making requests for and recordation of reconveyances.) See also *Prudential Home Mortgage Co. v Superior Court* (1998) 66 CA4th 1236, 78 CR2d 566 (remedies under CC §2941 precluded any equitable relief under Bus & P C §17200; also class action for such forfeitures subject to 1-year statute of limitations in CCP §340(a) and not extended by discovery rule); *Pintor v Ong* (1989) 211 CA3d 837, 259 CR 577. A willful violation of CC §2941 may also constitute a misdemeanor. CC §2941.5.

Both the beneficiary and the trustee may be held liable for damages, but the trustee has certain defenses if it abides by the beneficiary's instructions. CC §2941(b), (d). See *Kachlon v Markowitz* (2008) 168 CA4th 316, 85 CR3d 532 (rejecting claims by borrower against trustee but allowing equitable relief, tort damages, and attorney fee award against lender who had intentionally refused to reconvey after repeated requests). Claims for wrongful failure to reconvey may be brought as class actions in proper cases. *Bartold v Glendale Fed. Bank* (2000) 81 CA4th 816, 97 CR2d 226. Statutory amendments in 2001 abrogated the decision in *Bartold* to the extent *Bartold* interpreted CC §2941 differently from the legislature's declaration of existing law in Stats 2001, ch 560, §3. See *Markowitz v Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 524, 48 CR3d 217 (holding CC §2941 creates no duties or obligations for escrow holders).

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§8.97 E. Substitute Procedures

Two options are available when a timely formal reconveyance has not been obtained. Under CC §2941(b)(2), the beneficiary must substitute itself in as trustee and issue a reconveyance when more than 60 days have passed after payment and the trustor requests it. Under CC §2941(b)(3) and after giving notice, a title insurance company may record a release of the obligation if 75 days have passed. The release is recordable and functions like a reconveyance. Civil Code §2941.7 provides an alternative procedure for obtaining a release of the deed of trust (if the beneficiary cannot be found or refuses to cooperate) on the trustor's delivery to the trustee and on recordation of a satisfactory declaration and a corporate surety bond. See also *Kachlon v Markowitz* (2008) 168 CA4th 316, 85 CR3d 532 (allowing equitable claims against lender for declaratory relief (seeking cancelation of note and reconveyance of deed of trust) and to quiet title when lender refused to reconvey after repeated requests).

The trustee also has the power to demand that the beneficiary provide a lost instrument indemnity bond if the original papers cannot be produced. *Huckell v Matranga* (1979) 99 CA3d 471, 160 CR 177. See California Title Insurance Practice §15.14 (2d ed Cal CEB 1997).

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§8.98 F. Liabilities and Rights of Party Reconveying

If a title insurance company records a CC §2941(b)(3) or (4) release of obligation, it is liable for damages, including attorney fees, caused by the issuance and recordation of the release. CC §2941(b)(6). Similarly, any violator of CC §2941 may be liable for statutory penalties and damages (see §8.96). Although the statutory language suggests liability without fault, courts are unlikely to hold liable a title company or a trustee whose behavior has been entirely proper. See *Cathay Bank v Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 266, 53 CR2d 595 (under CC §2943(d)(1), title company may rely on beneficiary's erroneous payoff demand in recordation of release).

On what constitutes a proper payoff demand, see *California Nat'l Bank v Havis* (2004) 120 CA4th 1122, 16 CR3d 245 (lender's use of term "payoff funds" in letter to escrow acknowledging unanticipated receipt of funds outside of escrow did not constitute statutory payoff demand under CC §2943), cited in §4.50. On the remedies available to a beneficiary who sends an erroneous payoff demand, see CC §2943(d)(3) and *Ghirardo v Antonioli* (1996) 14 C4th 39, 51, 57 CR2d 687 (cited in §§4.41, 4.50, 5.54), which characterized §2943(d)(3) as a codification of the "common law concepts of unjust enrichment, mistake, and estoppel."

A secured lender that fails to submit a beneficiary statement within 21 days of receipt of written demand or that negligently provides a materially inaccurate statement faces potential liability for tortious interference if the failure or inaccurate information prejudices the borrower. *Venhaus v Shultz* (2007) 155 CA4th 1072, 66 CR3d 432.

NOTE: The decision in *Venhaus*, reversing a judgment that was based on a jury instruction requiring proof of a willful violation of CC §2943, is somewhat surprising given that §2943(e) requires proof of a willful failure as a prerequisite to the statutory penalties imposed on the lender for failure to comply. However, *Venhaus* was addressing a claim for tortious interference rather than for statutory penalties under §2943(e).

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§8.99 G. Forged Reconveyance or Request

A forged deed of reconveyance is void and does not extinguish the lien or priority of the deed of trust, even against a subsequent bona fide purchaser or encumbrancer. *Wutzke v Bill Reid Painting Serv.* (1984) 151 CA3d 36, 198 CR 418. On the other hand, when it is the request for reconveyance that is forged, the reconveyance is merely voidable and not void. *Schiavon v Arnaudo Bros.* (2000) 84 CA4th 374, 100 CR2d 801. A bona fide purchaser may take valid title by way of a voidable instrument but not by way of a void instrument. The facts in the *Schiavon* case are somewhat unusual in that the creditors allowed the debtors to issue recordation instructions that had the original deed of trust returned to the *debtors* after recordation. The debtors then forged the request for reconveyance. The holding of this case was explored and questioned in 24 CEB Real Prop L Rep 53 (Jan. 2001).

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Multiple Security, Obligations, and Parties

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§9.1 I. INTRODUCTION

The model for discussion in the other chapters of this book is a single creditor, holding a single deed of trust, on a single parcel, securing a single note, and executed by a single debtor. This chapter discusses enforcement issues raised by situations involving the following:

- Multiple security for one obligation (§§9.2-9.25);
- Multiple obligations secured by the same security (§§9.26-9.41);
- The priority of multiple competing interests in the same real property (§§9.42-9.87); and
- Multiple parties who may be liable for the same obligation (§§9.88-9.136).

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§9.2 II. FORECLOSING ON MULTIPLE SECURITY FOR ONE OBLIGATION

In many transactions, a real property secured creditor holds multiple security for the obligation owed to it. Such multiple security might take the form of multiple parcels of real property or one or more parcels of real property together with personal property, tangible or intangible. The creditor might also have rights in related property such as rents, insurance proceeds, and the like.

Other chapters in this book discuss in detail the one-action rule (chapter 4) and the antideficiency and fair value rules (chap 5). In this chapter, §§9.3-9.25 examine how those rules and certain others apply specifically to judicial and nonjudicial foreclosure in multiple-security situations.

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§9.3 A. Preliminary Caution: Full Credit Bidding

Before addressing the enforcement rules applicable to particular combinations of multiple security, the issue of credit bidding merits special note as a pervasive caution applicable to all multiple-security situations.

In the enforcement of secured obligations, judicially and nonjudicially, the secured creditor typically credit-bids at a foreclosure sale of the collateral. Any amount successfully credit-bid at a sale *satisfies* the secured debt to that extent because the credit bid is offset against the amount due. See CC §2924h(b). The amount successfully bid is no longer available for credit bidding at any subsequent sale.

If the debt is *fully* satisfied by credit bids at one or more sales, there is no remaining secured debt. The result is no different than if the collateral had been sold to third party bidders for cash in like amount, with the cash paid to the secured creditor and applied to the debt. As a result, further sales and other recoveries from collateral will not be permissible, because there is no longer a debt to be collected.

EXAMPLE: *C* holds a promissory note given by *D* and secured by multiple parcels of real property, collected rents, and personal property. *C* also has rights to insurance proceeds and mortgage guaranty bonds and holds a guaranty of the debt. After default by *D* on the debt, *C* commences its enforcement by nonjudicially foreclosing on one parcel of real property. It makes a full credit bid at the sale and acquires that parcel.

The result of *C*'s full credit bid is that the debt has been satisfied in full. *C* has lost the right to recover further on the debt from the additional real property parcels, the rents, the personal property, the insurance proceeds, the mortgage bonds, and the guaranty. This is so even if the value of the property foreclosed on is insufficient to make *C* whole on the debt.

For detailed discussion of credit-bidding strategy and impact of credit bidding on full amount of debt, see §§2.78, 2.84-2.87, 2.120, 3.80-3.81.

In each of the multiple-security enforcement contexts discussed in the sections that follow, it is assumed that the creditor has not satisfied the debt by one or more credit bids.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.4 B. Multiple Parcels of Real Property

§9.4 B. Multiple Parcels of Real Property

When an obligation is secured by multiple parcels of real property, to determine how best to enforce if a default occurs, the creditor must assess how its foreclosure options will be affected by the one-action rule (see §§9.5-9.6), by the antideficiency and fair value rules (see §§9.7-9.8), and by the form of the documentation (see §§9.9-9.10).

Other rules affecting the order of sale and the question whether the parcels can or must be sold together or separately are discussed in §§2.75 (nonjudicial foreclosure; see CC §2924g(b)) and 3.77 (judicial foreclosure; see CCP §701.570(d)).

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1. One-Action Rule

§9.5 a. General Application

The one-action rule of CCP §726(a), as judicially interpreted, generally requires that if an obligation is secured by *any* real property, *all* of that property must be included in a single foreclosure lawsuit if the creditor seeks judicial foreclosure or a personal judgment on the debt. See §4.8. (Regarding real property that may be properly omitted, see §§4.36-4.46, 4.55; regarding personal property collateral, see §§9.12-9.23.) Failure to include all the required real property provides the defendant with an affirmative defense (see §§4.11, 4.24); if that defense is not timely asserted, a sanction effect is triggered (see §§4.11, 4.25-4.28).

Although multiple *judicial* foreclosure actions are prohibited by the one-action rule, multiple *nonjudicial* foreclosure sales are not. See *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 258, 120 P2d 869. See also §§4.9, 4.17. That is because a nonjudicial sale does not constitute an "action" within the meaning of the rule as interpreted by the courts, and thus multiple nonjudicial sales are not within the rule's prohibition of multiplicity of actions or its requirement that all real property collateral be included in a single action.

EXAMPLE: *C* holds a promissory note given by *D* and secured by Blackacre and Greenacre. The one-action rule applies as follows:

- The rule is triggered if *C* sues *D* on the note or sues to judicially foreclose on either Blackacre or Greenacre alone. The lawsuit ordinarily must include both Blackacre and Greenacre. The consequences of a one-action violation in this example are discussed in §9.6.
- The rule does not prohibit *C* from nonjudicially foreclosing on Blackacre and Greenacre, even in separate sales.

NOTE: The one-action rule would not prevent *C* from nonjudicially foreclosing on Blackacre and then judicially foreclosing on Greenacre. At the time of the judicial foreclosure, Blackacre is no longer security for the note, having been properly foreclosed on previously. (This is to be distinguished from a situation in which *C* attempts to unilaterally release its encumbrance on Blackacre. See §4.62.) However, because of the antideficiency rule of CCP §580d (see §9.7), a deficiency judgment would not be permissible (see *Freedland v Greco* (1955) 45 C2d 462, 467, 289 P2d 463), so a judicial foreclosure in this context would be unusual.

On the significance of whether Blackacre and Greenacre are encumbered together in one deed of trust or each in a separate deed of trust, see §9.9.

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§9.6 b. Consequences of One-Action Violation

The affirmative-defense and sanction consequences of violation of the one-action rule are discussed in detail in §§4.11, 4.23-4.28. As applied to a transaction involving multiple parcels of real property collateral, those consequences are as follows:

EXAMPLE: As in the Example in §9.5, *C* holds *D*'s promissory note secured by Blackacre and Greenacre. *C* files an action against *D* for recovery on the note and foreclosure on Blackacre. *C* omits Greenacre from the action, but this omission is not within any exception to the one-action rule (see §§4.36-4.46, 4.55).

Under the one-action rule,

- *D* has an affirmative defense to the action. If the defense is timely asserted, the action will be dismissed unless *C* includes Greenacre.
- if *D* does not timely assert the affirmative defense, *C* can obtain a judgment on the note even though Greenacre has been omitted. However, because Blackacre was included in the action, it is still a foreclosure action, and judgment on the note must be obtained in compliance with the rules governing a deficiency judgment (see §§3.86-3.89) after a foreclosure sale of Blackacre and a fair value hearing. See, *e.g., United Cal. Bank v Tijerina* (1972) 25 CA3d 963, 102 CR 234. On fair value hearings, see §3.88. (If *C* had omitted *both* Blackacre and Greenacre, and if *D* failed to assert the affirmative defense, then this would not be a foreclosure action and judgment would be obtained in the normal manner for civil litigation.)
- if *D* does not timely assert the affirmative defense, the sanction effect of the one-action rule terminates *C*'s encumbrance on Greenacre. *C* will be barred from judicially or nonjudicially foreclosing that encumbrance. (For this reason, only the value of Blackacre, and not the value of Greenacre, should be relevant to the fair value hearing that will be a prerequisite to *C* obtaining its deficiency judgment. See CCP §726(b) (fair value is determined for real property *sold*).)

NOTE: Although *C* has lost its encumbrance on Greenacre, if it obtains a judgment on the note it can enforce that judgment against Greenacre or any other property of *D* in the same way and to the same extent as any other judgment creditor. See *Walker v Community Bank* (1974) 10 C3d 729, 741 n6, 111 CR 897. But *C*'s rights as a judgment creditor will not date back to the priority of the deed of trust. See *Salter v Ulrich* (1943) 22 C2d 263, 268, 138 P2d 7.

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2. Antideficiency and Fair Value Rules

§9.7 a. CCP §§580d and 580a

Code of Civil Procedure §580d prohibits recovery of a deficiency after a nonjudicial foreclosure sale. See §§5.4-5.15. To whatever extent CCP §580d might not prohibit a deficiency, CCP §580a limits recovery of a deficiency after a nonjudicial sale based on the fair market value of the property sold. See §§5.16-5.20.

As CCP §580d is interpreted by the supreme court, recovery from additional collateral does not constitute recovery of a deficiency, and thus multiple foreclosure sales are not within that section's prohibition of deficiency judgments after a nonjudicial sale. See *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29. See also §5.3. Code of Civil Procedure §580a is interpreted by the court in the same way: It does not limit or otherwise apply to recovery from additional collateral. See §5.20. See also *Dreyfuss v Union Bank, supra; Freedland v Greco* (1955) 45 C2d 462, 466, 289 P2d 463; *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 259, 120 P2d 869.

EXAMPLE: *C* is owed $100,000, secured by Brownacre and Plumacre. *C* nonjudicially forecloses on Brownacre, in full compliance with the foreclosure statutes, and acquires the property with a credit bid of $45,000. Brownacre has a fair market value of $100,000. *C* then proceeds to foreclose judicially or nonjudicially on Plumacre.

As interpreted by the supreme court, CCP §§580d and 580a apply as follows:

- The nonjudicial foreclosure sale of Brownacre triggers the antideficiency rule of CCP §580d, which prohibits *C* from ever recovering a deficiency judgment on the note.
- CCP §580d does not prohibit foreclosure on Plumacre, because recovery against additional collateral does not constitute recovery of a deficiency.
- CCP §580a does not require any determination of Brownacre's fair market value nor application of that value to the debt. Thus, §580a does not prohibit foreclosure on Plumacre even though the value of Brownacre, acquired by *C* in the first sale, was sufficient to cover the full debt.
- CCP §580a likewise has no relevance to the amount that *C* may credit-bid at the foreclosure sale of Plumacre. The amount available for bid is $55,000, which is the remaining balance of the $100,000 debt after reduction by the $45,000 amount successfully credit-bid on Brownacre.

NOTE: The supreme court has held that there is no requirement that the sale price, and thus the bid, approximate the fair market value of the property or that the creditor make a full credit bid. *Dreyfuss v Union Bank* (2000) 24 C4th 400, 409, 101 CR2d 29. The court has expressly taken note of the approach of entering low bids: "Indeed, 'many creditors continually enter low credit bids … to provide access to additional security or additional funds.' … It has been said that this is what the creditor should do.… (*Cornelison v Kornbluth* (1975) 15 C3d 590, 607, 125 CR 557)." *Dreyfuss,* 24 C4th at 410.

On the significance of whether Brownacre and Plumacre are encumbered together in one deed of trust or each in a separate deed of trust, see §§9.9-9.10.

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§9.8 b. CCP §580b

Code of Civil Procedure §580b bars recovery of a deficiency judgment, even in a judicial foreclosure action, on vendor purchase money financing and certain third party purchase money financing. See §§5.24-5.44.

In some transactions, multiple parcels of real property are encumbered to secure an obligation that is within CCP §580b, sometimes including parcels that were not part of the purchase. Consistent with the judicial interpretation of CCP §§580a and 580d (see §9.7), for CCP §580b purposes, a recovery from additional collateral is held not to constitute recovery of a deficiency. See §5.30. Thus, multiple foreclosure sales are not within §580b's prohibition on deficiency judgments. See, *e.g., Hodges v Mark* (1996) 49 CA4th 651, 657, 56 CR2d 700; *Mortgage Guar. Co. v Sampsell* (1942) 51 CA2d 180, 183, 124 P2d 353, cited with approval in *Dreyfuss v Union Bank* (2000) 24 C4th 400, 409, 101 CR2d 29; *Freedland v Greco* (1955) 45 C2d 462, 466, 289 P2d 463.

EXAMPLE 1: *S* sells Whiteacre to *B*, taking back a note for the deferred purchase price. To secure the note, *B* encumbers both Whiteacre and another property, Redacre, already owned by *B*.

As judicially interpreted, CCP §580b applies to this transaction as follows:

- No deficiency judgment can be recovered on the note. No deficiency is permitted after sale of real property under a deed of trust "given to the vendor to secure payment of the balance of the purchase price of *that* real property," which refers in this example to Whiteacre. CCP §580b (emphasis added). This might suggest that a deficiency could somehow be recovered after foreclosure on the *other* property, Redacre. However, there would be no way to accomplish that result (assuming that *B* asserted its rights). If Redacre were nonjudicially foreclosed on, CCP §580d would bar any deficiency. If Redacre were combined with Whiteacre in a judicial foreclosure action, as the one-action rule would require, then CCP §580b would bar the deficiency. In addition, the note cannot be allocated after the fact into separate portions, only one of which is attributable to Whiteacre. See *Loretz v Cal-Coast Dev. Corp.* (1967) 249 CA2d 176, 178, 57 CR 188.
- ___ CCP §580b does not preclude foreclosure on Redacre, because recovery against additional collateral does not constitute recovery of a deficiency.

On the significance of whether Whiteacre and Redacre are encumbered together in one deed of trust or each in a separate deed of trust, see §§9.9-9.10.

The transaction in Example 1, in which multiple parcels secure an obligation that was purchase money for one of them, is to be distinguished from the following, differently structured transaction:

EXAMPLE 2: *S* sells Whiteacre to *B*, taking back two separate, non-overlapping notes, each for a separate portion of the deferred purchase price. To secure one note, *B* gives a deed of trust to *S* on Whiteacre. To secure the other note, *B* gives a deed of trust to *S* on Redacre. Code of Civil Procedure §580b precludes a deficiency judgment on the note secured by Whiteacre, but it does not preclude a deficiency judgment on the separate note secured by Redacre or otherwise apply to foreclosure on Redacre. See §5.40. See also *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873.

Example 2 differs from Example 1, and from every other example in §§9.5-9.8, in this key respect: It involves two separate obligations, each separately secured.

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3. Single Deed of Trust Versus Separate Deeds of Trust

§9.9 a. One-Action, Antideficiency, and Fair Value Rules

In each of the Examples in §§9.5-9.8 in which multiple properties secured the *same obligation*, the results would be unaffected under the one-action, antideficiency, and fair value rules regardless of whether the multiple properties were encumbered together by a single deed of trust or each property was encumbered separately by its own deed of trust. That is so because the applicability of each of those rules is based simply on whether an obligation is or is not secured by the real property, not on the form of the documentation. See CCP §§726(a), 580a, 580b, 580d. If it were otherwise, the rules might be easily evaded.

NOTE: Example 2 in §9.8 differs from all of the other Examples in §§9.5-9.8 because there the transaction involved *two separate obligations,* each secured by a separate deed of trust on a separate parcel. This is the only Example in which separate deeds of trust made a difference, and only because each deed of trust secured a separate underlying obligation.

Regarding effect of attempts to create appearance of separate obligations when there is in fact only a single obligation or to otherwise structure around these rules, see §§4.34, 5.37, 5.52.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.10 b. Foreclosure Trustees

§9.10 b. Foreclosure Trustees

Some title companies have historically taken the position that the power of sale in a deed of trust is, by law, a one-time power, exhausted by a single use, thus precluding multiple nonjudicial foreclosure sales on multiple parcels encumbered by a single deed of trust. There does not appear to be any statutory or judicial support for that position.

PRACTICE TIP: To avoid a problem with this issue, it may be advisable when documenting a transaction to use separate deeds of trust for each parcel or, if a single deed of trust is used, to include explicit provisions for multiple sales. If this has not been done, then at the time of foreclosure it may be advisable to obtain an advance commitment from a title company that it will conduct multiple sales as trustee under the single deed of trust and will insure the title resulting from each sale.

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§9.11 C. Real Property Rents

If there is an assignment of rents in the deed of trust or in a separate document, the beneficiary has a security interest in the rents generated by the property. CC §2938(a). After a default by the assignor in the secured obligation, the assignee has the right to enforce the assignment by several enforcement mechanisms, including appointment of a receiver and direct collection. CC §2938(c). See chap 6. The result may be that a pool of collected rents will accumulate before foreclosure on the real property. This places the creditor in the position of having multiple security for the debt — the property and the collected rents.

For assignments entered into on or after January 1, 1997 (CC §2938(i)), CC §2938 expressly provides that no enforcement action it authorizes and no collection, distribution, or application of rents by the assignee after such enforcement

- constitutes an action, renders the secured obligation unenforceable, or violates the one-action rule (CC §2938(e)(2)); or
- creates a bar to a deficiency judgment under any of the antideficiency rules (CC §2938(e)(3)).

See CCP §564(d) (action by secured lender to appoint receiver pursuant to §564 does not constitute action for purposes of CCP §726(a)'s one-action rule).

Enforcement of rent assignments is discussed in detail in chap 6. Regarding effect of one-action and antideficiency laws, see §§6.41-6.42.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.12 D. Real Property and Personal Property

§9.12 D. Real Property and Personal Property

In many transactions, a creditor holds multiple security in the form of personal property together with real property. The personal property might include intangible and tangible items with a direct relationship to the real property collateral, such as the following:

- Rights under contracts between the trustor and third parties relating to development, construction, management, or operation of the property;
- Trade names associated with the property;
- Plans, specifications, drawings, studies, maps, etc.;
- In a property held for lease, common-area furnishings and building-services equipment; and
- In a hotel or restaurant, extensive furnishings and equipment.

Alternatively, or in addition, the personal property security might include intangible or tangible items that have no relation to the real property but were taken simply to provide additional independent collateral for the debt. This might include such things as unrelated financial assets.

The presence of mixed real and personal property collateral for the same obligation implicates two very different sets of rules:

(1) The strict and limiting rules governing enforcement of obligations secured by real property set out in the Civil Code and Code of Civil Procedure, including the one-action, antideficiency, and fair value rules; and

(2) The liberal and flexible rules governing enforcement of obligations secured by personal property set out in Commercial Code Division 9.

Commercial Code §9604(a), a complex, nonuniform provision adopted in California instead of Uniform Commercial Code §9-604(a), governs the interaction of these two sets of rules. Commercial Code §9604(a) is often referred to as the "mixed-collateral rule."

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.13 1. Foreclosure Choices Under Com C §9604(a)

§9.13 1. Foreclosure Choices Under Com C §9604(a)

Commercial Code §9604(a) authorizes a creditor holding real and personal property collateral to elect, for each item of personal property, between the two choices discussed in §§9.14-9.15: (1) Proceed separately against the personal property under the Commercial Code, or (2) include the personal property in a real property foreclosure conducted under real property law. Commercial Code §9604(a) then provides rules for reconciling the enforcement provisions of real property law and personal property law, depending on the creditor's choice, as discussed in §§9.17-9.23.

NOTE: When California enacted the Uniform Commercial Code (UCC) in 1963, it adopted the uniform version of Article 9's very brief mixed-collateral rule. Because of difficulties in applying that rule to California's complex real property security law (see, *e.g.*, *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897), California replaced the uniform mixed-collateral rule in 1986 with a lengthy nonuniform rule (former Com C §9501(4)). Further amendments were made to that nonuniform rule in 1992. When revised UCC Article 9 was adopted effective July 1, 2001, California's nonuniform, mixed-collateral rule was carried over into revised Commercial Code Division 9 and is now Com C §9604(a). In reviewing older cases and commentary in this area, practitioners should be careful to consider which version of the mixed-collateral rule was then in effect.

For discussion of ambiguities in and enforcement problems of mixed-collateral rule and historical analysis, see Williams, *Mixed Collateral Foreclosures: New Turns on a Twisted Path,* 19 CEB Real Prop L Rep 116 (May 1996). See also Hirsch, Arnold, Rabin & Sigman, *The U.C.C. Mixed Collateral Statute—Has Paradise Really Been Lost?,* 36 UCLA L Rev 1 (1988); Hetland & Hansen, *The "Mixed Collateral" Amendments to California's Commercial Code—Covert Repeal of California's Real Property Foreclosure and Antideficiency Provisions or Exercise in Futility?,* 75 Cal L Rev 185 (1987); Bernhardt, *The Mixed Multiple Collateral Muddle,* 9 CEB Real Prop L Rep 101 (July 1986).

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§9.14 a. Separate Foreclosure

The creditor holding mixed collateral may elect to proceed separately against its real property collateral and all or part of its personal property collateral. This subjects the real property to the real property foreclosure rules and the separately pursued personal property to the much more flexible Commercial Code rules. Com C §9604(a)(1)(A).

This separate treatment is particularly appropriate when the personal property is unrelated to the real property and there is no advantage to either the creditor or the debtor in disposing of the two kinds of assets together in some unified proceeding. Indeed, one court has held that independent treatment of the two kinds of assets is mandatory when there is no functional or financial connection between them. See *Aspen Enters. v Bodge* (1995) 37 CA4th 1811, 44 CR2d 763 (debtor's tire inventory not closely enough related to debtor's residence to support unified sale). The *Aspen* decision applied a commercial reasonableness standard to the creditor's election between separate and unified pursuit of real and personal property, even though that standard does not appear in the mixed-collateral rule itself and the legislature twice rejected proposals to incorporate it expressly into the rule. See SB 1305 (1985); AB 2734 (1992). See also *Florio v Lau* (1998) 68 CA4th 637, 80 CR2d 409, discussed in §9.21; Hirsch, Arnold, Rabin & Sigman, *The U.C.C. Mixed Collateral Statute—Has Paradise Really Been Lost?,* 36 UCLA L Rev 1, 81 (1988).

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§9.15 b. Unified Foreclosure

The alternative option given to the creditor holding both real and personal property collateral is to include some or all of the personal property in the real estate foreclosure. In that event, the real property foreclosure rules apply to both the real property *and* the included personal property. Except for a few listed exceptions, the Commercial Code remedies provisions will not apply at all. Com C §9604(a)(1)(B). This option permits a unified foreclosure sale (judicial or nonjudicial), which often makes more financial sense when a going concern (*e.g.,* a hotel business) consists of both real and personal property and will produce the highest price on foreclosure if it can be sold together (building and furnishings) as a single entity.

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§9.16 2. Timing of Election

The creditor's election between separate foreclosure (see §9.14) and unified foreclosure (see §9.15) is available for each item of personal property collateral. Thus, the creditor may include some of the personal property (*e.g.,* furnishings) in a unified foreclosure sale under real property law but proceed against other personal property (*e.g.,* accounts) separately under the Commercial Code. Com C §9604(a)(1)(C). The creditor is not deemed to have elected irrevocably to include any particular personal property in a real property foreclosure sale until that particular personal property has actually been disposed of in a unified sale. Com C §9604(a)(1)(B).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.17 3. Application of Real Property Law Protections in Mixed-Collateral Foreclosures

§9.17 3. Application of Real Property Law Protections in Mixed-Collateral Foreclosures

The general rule is that the "provisions and limitations of any law respecting real property and obligations secured by an interest in real property" do not "in any way" apply to personal property collateral that is not included in a unified foreclosure sale or to the secured obligation itself. Com C §9604(a)(2)(A). The inapplicable laws include the one-action rule, the security-first rule, reinstatement rules, antideficiency rules, and fair value rules. The purpose of this general rule is to prevent personal property collateral from becoming subject to real property rules merely by virtue of the fact that the parties included the real property in the transaction.

The general rule of Com C §9604(a)(2)(A) is, however, expressly subject to several important qualifications stated in Com C §9604(a)(3). The purpose of those qualifications is largely to ensure that the protections of real property law are preserved *with respect to the real property* so that a debtor does not lose those protections merely because the parties included personal property collateral in the transaction.

Specifically, Com C §9604(a)(3) includes provisions addressing

- the purchase money antideficiency rule of CCP §580b (see §9.18);
- the one-action and security-first rules of CCP §726(a) (see §9.19);
- the trustee sale antideficiency rule of CCP §580d (see §9.20);
- the fair value rule of CCP §580a (see §9.21);
- the reinstatement rights and procedural requirements of CC §2924c (see §9.22); and
- consumer mixed-collateral situations (see §9.23).

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§9.18 a. Purchase Money Antideficiency Rule

Code of Civil Procedure §580b bars the recovery of a deficiency in the real property purchase money context. See §§5.24-5.43. Commercial Code §9604(a)(3)(A) provides that the general rule of Com C §9604(a)(2)(A) does not limit the application of CCP §580b. Thus, as long as any real property secures a purchase money obligation within CCP §580b, a deficiency judgment is barred even though the obligation is also secured by personal property, *i.e.,* there is no deficiency judgment after the sale of the personal property. *Sherwood-Trimble Med. Group v 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 89 CR2d 533 (buyer executed single purchase money promissory note secured by deed of trust on real property purchased from one party and by security agreement on personal property purchased from another party; court held that personal property vendor was barred by CCP §580b from seeking deficiency judgment from buyer).

On the other hand, CCP §580b has no effect on the creditor's ability to proceed separately against such personal property.

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§9.19 b. One-Action Rule and Security-First Rule

California's real property "one-action" rule, CCP §726(a), has at least two effects as applied by the courts: a "one-action" effect (see §§4.8-4.10) and a "security-first" effect (see §§4.6-4.7). Commercial Code §9604(a)(3) includes provisions addressing both of these effects:

- Commercial Code §9604(a)(3)(B) addresses the "one-action" effect by preserving the debtor's right to require the creditor to include all *real property* collateral in an action seeking a monetary judgment on the debt (the "affirmative defense" aspect of the one-action rule, which enables a debtor to defeat a money judgment entirely if the creditor does not include all real property collateral in the action). Section 9604(a)(3)(B) also preserves the debtor's right to assert the unenforceability of an encumbrance on any *real property* that the creditor excludes from such an action (the "sanction" aspect of the one-action rule). (On "affirmative defense" and "sanction" aspects of one-action rule, see §§4.11, 4.24-4.28.) This provision does *not* mention personal property collateral and thus leaves personal property to be governed by the general rule of Com C §9604(a)(2)(A), which makes real property law inapplicable. As a result, the debtor cannot require inclusion of personal property in the action nor argue that a failure to include personal property makes the encumbrance on it unenforceable.
- Commercial Code §9604(a)(3)(G) addresses the "security-first" effect by preserving any right the debtor may have to require correction of a violation of the "security-first" rule, any right the creditor may have to correct a violation, and any right the debtor may have to assert the subsequent unenforceability of the encumbrance on any interest in *real property* or unenforceability of the secured obligation. Again, the statute does not mention personal property collateral. Thus, the general rule of Com C §9604(a)(2)(A) governs that collateral, making real property law inapplicable to it. As a result, these "security-first" rights cannot be asserted to prevent the creditor from separately pursuing its personal property collateral, *e.g.,* by nonjudicially foreclosing on it. In *Kearns v Transamerica Home Loan (In re Kearns)* (BAP 9th Cir 2004) 314 BR 819, aff'd (9th Cir 2006) 201 Fed Appx 473 (unpublished opinion), the court held that a creditor's nonjudicial foreclosure on personal property did not violate the "security-first" aspect of CCP §726(a). This was true even though the general rule of Com C §9604(a)(2)(A) was inapplicable because the case involved consumer debt. See §9.23.

An important adjunct to these rules is provided by Com C §9604(a)(2)(B). It provides that if the secured obligation would become unenforceable by operation of CCP §726(a) or the "security-first" rule (*i.e.,* when the creditor has run afoul of those rules in the real property context), the obligation is nonetheless preserved and remains enforceable "to the full extent necessary" to permit the creditor to proceed against personal property collateral under the Commercial Code. This means that the creditor may foreclose on the personal property collateral and apply the proceeds of foreclosure to the obligation, even if it could not sue for a money judgment on that obligation.

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§9.20 c. Trustee Sale Antideficiency Rule

Code of Civil Procedure §580d precludes recovery of a deficiency judgment after most nonjudicial foreclosure sales of real property. See §§5.4-5.15. Commercial Code §9604(a)(3)(D) preserves the debtor's protection under CCP §580d from a deficiency judgment after a nonjudicial sale of the *real property* collateral. Personal property collateral is not mentioned, leaving it to be governed by the general rule of Com C §9604(a)(2)(A), under which real property law does not apply. As a result,

- a nonjudicial sale of real property will still trigger CCP §580d's prohibition of a deficiency judgment;
- a separate nonjudicial sale of personal property, however, will *not* trigger §580d. A creditor could foreclose nonjudicially against personal property and (if it has not foreclosed nonjudicially against real property) recover a deficiency judgment in a judicial foreclosure on the real property; and
- if the creditor does foreclose nonjudicially on any real property, §580d prohibits a deficiency judgment following the sale, but the creditor is not precluded from foreclosing separately on personal property that it may hold. (Nor, as discussed in §§5.3 and 9.7, is the creditor precluded from foreclosing separately on additional real property it may hold. *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29.)

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§9.21 d. Fair Value Rules and Deadlines

California real property law has two fair value rules, one applicable after judicial foreclosure sales, CCP §726(b), and the other applicable after nonjudicial foreclosure sales, CCP §580a. See §§5.16-5.23. Each of these rules includes a requirement that the creditor apply for a fair value hearing within 3 months after the foreclosure sale. The result of a fair value hearing is that the court-determined fair value of the property (if greater than the foreclosure sale proceeds) is applied against the debt for purposes of determining any deficiency.

Commercial Code §9604(a)(3)(F) preserves the protections of CCP §580a following a nonjudicial foreclosure of real property collateral. Thus, to whatever extent the §580a fair value rule would normally be triggered by a nonjudicial sale of real property (a somewhat difficult question; see §5.20), the rule will likewise be triggered in the mixed-collateral context.

Oddly, though, Com C §9604(a)(3)(F) does not mention the fair value rule of CCP §726(b), applicable to judicial foreclosures. Nor is §726(b) mentioned in any other subparagraph of Com C §9604(a)(3).

As discussed in §9.17, when Com C §9604(a)(3) does not provide otherwise, the general rule of Com C §9604(a)(2)(A) governs. That rule makes the protections of real property law, including fair value rules, inapplicable to personal property not included in a unified sale *and* to "the obligation." Is the effect of these rules, then, to negate the fair value rule of CCP §726(b) altogether in certain mixed-collateral situations?

In *Florio v Lau* (1998) 68 CA4th 637, 80 CR2d 409, a case of first impression, a creditor held real and personal property for an obligation. The creditor filed an action for judicial foreclosure of all the collateral. The real property collateral was sold separately from the personal property collateral (*i.e.,* there was no unified sale). The creditor then sought entry of a deficiency judgment but did so after the 3-month deadline of §726(b). The debtor argued that this barred entry of a deficiency judgment. Rejecting the debtor's argument, the court held that Com C §9604(a)(2)(A)'s predecessor (former Com C §9501(4)(b)(i), essentially identical to the current provision) "relieves a mixed collateral creditor entirely" from complying with the 3-month deadline of CCP §726(b). 68 CA4th at 653. Of course, on the same basis, it may be argued that §726(b)'s entire fair value rule, and not just the 3-month deadline, is inapplicable in the mixed-collateral context when a creditor separately pursues any personal property. The court in *Florio* took specific note of that argument but concluded that the question was not before it and therefore did not decide it. 68 CA4th at 652.

NOTE: Many practitioners believe the application of CCP §726(b)'s fair value rule and 3-month deadline in this context to be an unsettled issue, on which *Florio* may well not be the last word.

In any event, it is clear from Com C §§9604(a)(3)(F) and 9604(a)(2)(A) that no fair value rule applies to personal property that is not included in a unified sale. That is, a fair value determination does not take into account the value of such personal property.

When personal property *is* included in a unified sale, the fair value rules clearly apply to it. In a unified sale, whether nonjudicial or judicial, the included personal property is treated as part of the real property sold for purposes of the fair value rules of either CCP §580a (if the sale was nonjudicial) or CCP §726(b) (if the sale was judicial). Com C §9604(a)(8).

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§9.22 e. Acceleration and Reinstatement Rights

As a prerequisite to nonjudicial foreclosure on real property, CC §2924c (1) gives the trustor a several-month period to reinstate the unaccelerated maturity of the obligation by curing the default and (2) requires that notice of the right to reinstate, in statutorily prescribed language, be included in the notice of default required by CC §2924(a)(1). See §§2.51-2.61. The general rule of Com C §9604(a)(2)(A) does not excuse compliance with CC §2924c as a prerequisite to the sale of *real property*. Com C §9604(a)(3)(C). However, CC §2924c "has no application to the right of a secured party to proceed as to personal property," except to the extent that personal property is included in a unified sale. Com C §9604(a)(3)(C). This means that if the mixed-collateral creditor elects to proceed separately against some personal property, it may do so even though (1) a notice under CC §2924c has not been given, (2) the reinstatement period of CC §2924c is still open, or (3) a reinstatement under CC §2924c has in fact occurred. Thus, by curing the arrearages in accordance with CC §2924c, the debtor may terminate *real estate* foreclosure proceedings, including a unified sale, but separate dispositions of personal property under the Commercial Code could continue as long as the underlying obligation remained unsatisfied. This produces the odd result that a single obligation may be considered reinstated for some purposes but not others.

Commercial Code §9604(a)(4) takes this principle a step further. It provides that if the creditor receives proceeds from disposition of personal property collateral, that disposition, and the realization and application of the proceeds, does not cure

- any nonmonetary default (Com C §9604(a)(4)(A)); or
- any monetary default "so as to affect in any way" the creditor's rights to proceed against any remaining personal property under the Commercial Code, "although the application of the proceeds shall, to the extent of the proceeds, satisfy the secured obligation" (Com C §9604(a)(4)(B)).

This provision does not specify, however, how the personal property foreclosure proceeds are to be applied and so does not address the question whether they must be applied to reinstatement under CC §2924c. Rather, the provision directs only that such proceeds be applied to the obligation "in accordance with the agreement of the parties and applicable law." Com C §9604(a)(4)(C). Therefore, the creditor's receipt and application of personal property foreclosure proceeds

- *does* satisfy the secured obligation in that amount;
- *may or may not* cause reinstatement under CC §2924c with respect to the real property, a question that Com C §9604(a)(4) does not answer; but
- *does not* preclude continued enforcement proceedings against personal property, whether or not a reinstatement has occurred with respect to the real property.

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§9.23 f. Consumer Mixed Collateral

Commercial Code §9604(a)(3)(E) states that Com C §9604(a)(2), which encompasses the general rule of Com C §9604(a)(2)(A) (see §9.17) and the specific provision of §9604(a)(2)(B) (see §9.19),

> shall not affect, nor shall it determine the applicability or inapplicability of, any law respecting real property or obligations secured in whole or in part by real property with respect to a loan or a credit sale made to any individual primarily for personal, family, or household purposes.

The effect of this provision is to leave these questions to the courts in consumer mixed-collateral situations.

In *Kearns v Transamerica Home Loan (In re Kearns)* (BAP 9th Cir 2004) 314 BR 819, aff'd (9th Cir 2006) 201 Fed Appx 473 (unpublished opinion), the court held in a consumer case that §9604(a)(3)(E) does *not*, however, render inapplicable Com C §9604(a)(1), which establishes the election to proceed against personal property either separately or as part of a unified foreclosure. See §§9.13-9.16. The court applied Com C §9604(a)(1) as a "clarification" of the "security-first" aspect of CCP §726(a) to hold that the creditor did not violate §726 when it nonjudicially took and sold personal property collateral. Thus, the creditor's deed of trust on real property was unaffected. This result is the same as would be specified explicitly by Com C §9604(a)(2)(A) in a nonconsumer case.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.24 E. Real Property and Insurance

§9.24 E. Real Property and Insurance

Multiple collateral for an obligation might also take the form of secured real property and insurance proceeds that are payable as a result of an insured casualty such as fire or earthquake.

Preliminarily, it must be determined whether the beneficiary under the deed of trust has rights to the insurance proceeds. Absent a requirement in the loan documents, neither the trustor nor the beneficiary ordinarily has an interest in the proceeds of insurance obtained by the other on its own separate insurable interest. *Ziello v Superior Court* (1995) 36 CA4th 321, 326, 42 CR2d 251.

Thus, for a beneficiary to have the right to proceeds of insurance procured by the trustor, or to control disposition of the proceeds, the deed of trust must either assign the insurance proceeds to the beneficiary or otherwise give the beneficiary control over them. If the deed of trust does not do so, the proceeds will go to the trustor. *Foothill Village Homeowners Ass'n v Bishop* (1999) 68 CA4th 1364, 81 CR2d 195 (earthquake insurance); *Ziello v Superior Court, supra* (same). See §8.60. (This was true in *Ziello* even though the lender had been inadvertently named as a loss payee.) See *JEM Enters. v Washington Mut. Bank* (2002) 99 CA4th 638, 121 CR2d 458 (deed of trust contained both assignment of amounts payable for injury or damage to property and provision giving beneficiary control of insurance proceeds).

A deed of trust provision that gives the beneficiary the right to insurance proceeds must be carefully scrutinized to determine whether it applies to *any* insurance policy the trustor might obtain on the property (see, *e.g., JEM Enters. v Washington Mut. Bank, supra; Martin v World Sav. & Loan Ass'n* (2001) 92 CA4th 803, 112 CR2d 225) or only to proceeds of policies that the deed of trust required the trustor to procure (see, *e.g., Foothill Village Homeowners Ass'n v Bishop, supra; Ziello v Superior Court, supra*). If the latter, the provision will not give the beneficiary rights to proceeds of any insurance that the trustor procured voluntarily, *i.e.,* proceeds that the trustor was not required to procure by the deed of trust.

If the beneficiary does have rights to the insurance proceeds, the beneficiary's right to use the proceeds before a default is subject to special good faith constraints (see §8.63). On beneficiary's right to insurance proceeds apart from foreclosure, see §§8.57-8.63.

Insurance proceeds that the beneficiary has the right to apply to the debt are treated as additional security. See, *e.g., Redingler v Imperial Sav. & Loan Ass'n,* (1975) 47 CA3d 48, 120 CR 575. Thus, when the proceeds are paid after foreclosure for losses the trustor suffered before foreclosure, the beneficiary may reach such proceeds if the foreclosure sale of the property itself failed to produce enough to pay the entire debt. The antideficiency and fair value rules do not prevent recovery on additional collateral. See, *e.g., Redingler v Imperial Sav. & Loan Ass'n, supra* (CCP §580b does not prevent beneficiary from realizing on additional collateral, including insurance proceeds). See also §§9.7-9.8.

The cases discussed in this section make no mention of the Commercial Code. It should be noted, however, that unlike Article 9 of the Uniform Commercial Code, Division 9 of the California Commercial Code does not exclude insurance policies from its scope. See UCC §9-109(d)(8) (not adopted in California). Thus, in California it is possible to take a Division 9 security interest in an insurance policy, like other intangibles (but with a special perfection rule; see Com C §§9310(b)(11), 9312(b)(4) (written notice to insurer)). A security interest in an insurance policy would extend to proceeds of the policy. Com C §9315(a)(2).

It does not appear that California case law has yet explored the relationship between a Division 9 of the Commercial Code security interest in an insurance policy and the interests in an insurance policy that have been recognized in the real property cases. Possibly, an assignment of insurance policies or proceeds together with an encumbrance on the real property would be considered beyond the scope of Division 9 of the Commercial Code by virtue of §9109(d)(11), which (with limited exceptions) excludes "[t]he creation or transfer of an interest in or lien on real property." This might turn on whether the insurance proceeds are regarded as substitute collateral for the real property. See *Alexander v Security-First Nat'l Bank* (1936) 7 C2d 718, 722, 62 P2d 735 (when there is no contractual obligation to insure, insurance proceeds not substitute for real property; when there is obligation to insure, party for whose benefit agreement was made has equitable lien on proceeds of insurance obtained).

There are at least two questions relevant to this discussion. First, in order to perfect a security interest in insurance policies or proceeds, must the beneficiary comply with the Commercial Code perfection requirements, or is the interest perfected simply by recordation of the deed of trust? Second, for purposes of the one-action rule, must insurance proceeds be included in a judicial foreclosure action, as if they were additional real property collateral (see §§9.5-9.6), or may they be omitted, as if they were personal property collateral (see §§9.17, 9.19)? A cautious approach to these questions would be to perfect as required by the Commercial Code and to assume that insurance proceeds should be included in a judicial foreclosure.

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§9.25 F. Real Property Security Given for Judgments

This final multiple-security topic differs from all of the preceding topics in §§9.3-9.24 in that the multiplicity here does not involve multiple consensual liens; rather, it arises when a judgment creditor—who by law has access to *nonconsensual* liens and other rights as part of the judgment enforcement process—is given a note for the judgment amount and a deed of trust to secure it, typically in return for deferring execution. Ostensibly, if the debtor defaults in payment, the creditor would have access to both its judgment enforcement rights, including nonconsensual liens, and the consensual lien of the deed of trust.

California cases have held that this multiplicity is not permitted. When the judgment creditor takes a deed of trust, the obligation becomes subject to all the normal rules governing real property secured obligations, including the one-action and antideficiency rules. The creditor's rights to proceed under the judgment are supplanted. See *Marriage of Oropallo* (1998) 68 CA4th 997, 1008, 80 CR2d 669 (note and deed of trust taken for obligations under marital dissolution judgment; antideficiency rules apply, and creditor can no longer enforce remedies for nonpayment in family law court); *Rettner v Shepherd* (1991) 231 CA3d 943, 952, 282 CR 687 (note and deed of trust taken for liability on a judgment; one-action and antideficiency rules apply, and creditor could no longer enforce remedies as an unsecured judgment creditor).

NOTE: In the foregoing cases, a deed of trust was taken for a judgment obligation. In *O'Neil v General Sec. Corp.* (1992) 4 CA4th 587, 5 CR2d 712, the reverse occurred: a judgment was taken for an obligation already secured by a deed of trust. The beneficiaries of a senior deed of trust had sued for judicial foreclosure, together with other causes of action. They entered into a settlement agreement with the defendant for a stipulated money judgment, which the court entered. The settlement agreement also purported to preserve the beneficiaries' right to nonjudicially foreclose the deed of trust. In proceedings brought by holders of a junior deed of trust, the court held that the money judgment barred enforcement of the senior deed of trust on the basis of the one-action rule of CCP §726(a).

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§9.26 III. ENFORCING MULTIPLE OBLIGATIONS SECURED BY SAME SECURITY

Sections 9.2-9.25 focus on multiple security for one obligation. Sections 9.27-9.41 will focus on the reverse—multiple obligations secured by the same security—in four primary contexts:

- One creditor holds multiple notes secured by multiple deeds of trust all encumbering the same real property. See §§9.27-9.31.
- One creditor holds multiple notes all secured by one deed of trust. See §9.32.
- Multiple creditors hold multiple notes all secured by one deed of trust. See §9.33-9.35.
- One creditor holds a note secured by a deed of trust and another creditor makes a "wraparound" loan that includes the existing obligation and is also secured by the same property. See §9.36-9.41.

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§9.27 A. One Creditor, Multiple Notes, Multiple Deeds of Trust on Same Property

A creditor might hold multiple notes, each secured by a separate deed of trust on the same property, if the creditor made one loan that was segmented into multiple, separately secured notes or made multiple loans, perhaps at different times, each secured by a separate deed of trust. A creditor might also make a loan secured by a property and later acquire, from another creditor, a note also secured by that same property.

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§9.28 1. When Merger Occurs

An initial issue to consider is whether the deeds of trust do in fact separately secure the obligations. If one or more of the deeds of trust includes an enforceable dragnet clause (see §§9.59-9.73), thus sweeping in the other obligations, then the ostensibly separate positions might be treated as merged. See, *e.g., Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549 (applying CCP §580d to bar deficiency after nonjudicial foreclosure of senior deed of trust). See also §§4.44, 5.12.

NOTE: In *National Enters., Inc. v Woods* (2001) 94 CA4th 1217, 1229, 115 CR2d 37, the court observed that the precedential value of *Wendland*'s merger analysis is limited because it was not joined in by two members of the three-judge court.

Absent a dragnet clause, the mere fact that one creditor holds adjacent senior and junior positions should not result in a merger of the two security interests, because this situation does not involve greater and lesser estates coinciding in the same hands. See *National Enters., Inc. v Woods* (2001) 94 CA4th 1217, 1229, 115 CR2d 37.

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§9.29 2. Enforcement Issues for Unmerged Obligations

Even if the senior and junior positions are separate and unmerged, enforcement issues can result from the fact that one creditor holds senior and junior deeds of trust on the same property:

- If the creditor first forecloses under its senior deed of trust, thus foreclosing out its own junior deed of trust, it has been held that the creditor cannot then sue on the junior note as a sold-out junior. That issue is discussed in detail in §§4.44 and 5.12. See *Simon v Superior Court* (1992) 4 CA4th 63, 77, 5 CR2d 428 (CCP §580d precludes any recovery on junior debt, even if deeds of trust do not include dragnet clauses). But see *Evans v California Trailer Court, Inc.* (1994) 28 CA4th 540, 552 n6, 33 CR2d 646 (questioning whether same rule would apply if there were other liens intervening between creditor's senior and junior deeds of trust).
- If, instead, the creditor first forecloses under its junior deed of trust and acquires the property at the sale, it will become the fee owner of the same property encumbered by its own senior deed of trust. This might result in a merger of its senior deed of trust into the fee. See *Stockton Sav. & Loan Soc'y v Harrold* (1900) 127 C 612, 621, 60 P 165; *Romo v Stewart Title* (1995) 35 CA4th 1609, 1617 n8, 42 CR2d 414. But see *Kolodge v Boyd* (2001) 88 CA4th 349, 361, 105 CR2d 749. See also discussion of merger in context of deeds in lieu of foreclosure in §7.17. Even if it does occur, however, merger of the senior deed of trust into the fee title may not mean that the obligation secured by the senior deed of trust is extinguished. See §§9.30-9.31.

On both of these foreclosure alternatives, see Andrew, *Enforcement Issues for a Creditor Holding Multiple Deeds of Trust on the Same Property,* 27 Cal Real Prop J 33 (No. 1, 2009).

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3. Foreclosure of Junior Deed of Trust

§9.30 a. California Cases

The effect that foreclosing the creditor's junior deed of trust has on the obligation secured by the creditor's senior deed of trust has not been definitively addressed in a California case.

In *Romo v Stewart Title* (1995) 35 CA4th 1609, 42 CR2d 414, a creditor who held second- and third-priority deeds of trust foreclosed under the third and acquired title with a full credit bid. The court held that this full credit bid under the *third* deed of trust precluded any recovery arising out of the obligation secured by the *second* deed of trust, on the following analysis:

- Under *Cornelison v Kornbluth* (1975) 15 C3d 590, 606, 125 CR 557 (see §§2.86, 2.120), a full credit bid conclusively establishes the value of the property as being equal to the indebtedness. *Romo,* 35 CA4th at 1614.
- In this context, the junior's full credit bid is presumed to establish the value of the *total* indebtedness, *i.e.,* under the first, second, and third deeds of trust, because the foreclosure purchaser under the third takes subject to the first and second. 35 CA4th at 1617.
- The creditor was not obligated to make a full credit bid. If, instead, the creditor had reduced its bid under the third deed of trust by the amount owing under the second deed of trust, it would not have been precluded from thereafter recovering that amount. 35 CA4th at 1617 (recovery of this amount in *Romo* was sought as element of damages against escrow agent in transaction on basis of fraud, negligence, and other theories).

EXAMPLE: *C* holds a senior deed of trust securing $12,000 and a junior deed of trust securing $18,000. *Romo* holds that, if the creditor makes a full credit bid of $18,000 at a foreclosure sale under the junior deed of trust, both obligations are deemed satisfied. But if the creditor made a credit bid of only $6000, *i.e.,* $18,000 minus the $12,000 owing on the senior obligation, *Romo* states in dicta that recovery of the $12,000 owing on the senior obligation would not be precluded (at least, as in that case, as an element of damages against a third party).

The court in *Romo* observed in passing that the creditor's senior deed of trust merged into the fee acquired at the junior sale. 35 CA4th at 1617 n8. But the court based its holding not on merger of estates but rather on its analysis of the impact of the full credit bid. Compare *Romo* with *Kolodge v Boyd* (2001) 88 CA4th 349, 361, 105 CR2d 749, in which the court viewed *Romo* as having been implicitly based on merger of title and suggested that merger of title would extinguish both the senior encumbrance and the senior debt. The court declined to find that merger of title had occurred, absent explicit evidence of actual intent that it do so.

NOTE: The bidding approach suggested in *Romo* in dicta is obviously of limited use if the creditor's senior debt is *larger* than its junior debt. In that situation, the creditor cannot simply reduce the amount of its bid on the junior debt by the amount of the senior debt. In some circumstances, a judicial foreclosure under both deeds of trust together may be the advisable course. See 1 Nelson & Whitman, Real Estate Finance Law §6.16 (5th ed 2007).

Romo is to be distinguished from *Evans v California Trailer Court, Inc.* (1994) 28 CA4th 540, 33 CR2d 646. In *Evans*, the creditor holding senior and junior liens foreclosed under the *senior* lien and credit-bid the full amount of the *senior* debt only. This was held not to bar a potential recovery of amounts due on the *junior* debt as one element of damages in an action for waste, fraud, and other liability.

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§9.31 b. Doctrine of Extinguishment (Merger of Rights)

Some authorities identify a doctrine of "extinguishment" or "merger of *rights*" (as distinguished from merger of *estates;* see §9.28) as applying in the situation in which a senior acquires fee at a junior sale (see, *e.g., Mid Kansas Fed. Sav. & Loan Ass'n v Dynamic Dev. Corp.* (Ariz 1991) 804 P2d 1310, 1318). Under this doctrine, when the purchaser takes title subject to a senior deed of trust, the property becomes the primary fund for satisfaction of that senior debt, and because that property is held by the senior creditor itself, the obligor's liability on that debt is extinguished. Some authorities focus on whether unjust enrichment would result if recovery on the senior debt were permitted on the basis of the actual value of the property. See *Mid Kansas Fed. Sav. & Loan Ass'n v Dynamic Dev. Corp.* (Ariz 1991) 804 P2d 1310, 1319; 1 Nelson & Whitman, Real Estate Finance Law §6.16 (5th ed 2007); Restatement (Third) of Property: Mortgages §8.5, Comment c(2) (1997).

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§9.32 B. One Creditor, Multiple Notes, One Deed of Trust

One creditor might hold multiple notes secured by the same deed of trust if the creditor made one loan that was segmented into multiple notes all secured by the same deed of trust. A creditor might also make a loan secured by a deed of trust and later make another loan in which the note specifies that it is secured by the existing deed of trust or is swept into that deed of trust by a dragnet clause.

Questions raised by this multi-note situation include the following:

- If the loans were made at different times, are they in fact all secured by the deed of trust (*i.e.,* do future-advance or dragnet provisions of the deed of trust accomplish that result)? See §§9.59-9.73.
- If the loans were made at different times, do all of the obligations have the same priority with respect to junior encumbrances? See §§9.42-9.87.
- If some but not all of the notes are in default and there is no cross-default provision, how should enforcement proceed? (This situation is essentially the same as that of a single note payable in installments when a default has occurred but there is no acceleration provision.) See §§3.48, 8.3.

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§9.33 C. Multiple Creditors, Multiple Notes, One Deed of Trust

A single deed of trust might secure multiple notes in the hands of multiple creditors in various situations:

- A debtor might execute several notes or bonds issued to different holders, all secured by the same mortgage or deed of trust. See, *e.g., Mercantile Trust Co. v Sunset Rd. Oil Co.* (1917) 176 C 461, 168 P 1037.
- Multiple notes secured by one deed of trust might be initially issued in favor of one creditor (see §9.32), who later transfers them to multiple holders. See, *e.g., Wilson v McLaughlin* (1937) 20 CA2d 608, 67 P2d 710.
- Interests of multiple lenders who participate in a loan might be evidenced by multiple notes, or there might be a single note in which the lenders hold participation interests, in each case secured by one deed of trust. See, *e.g., Jefferson Sav. & Loan Ass'n v Lifetime Sav. & Loan Ass'n* (9th Cir 1968) 396 F2d 21.

NOTE: In some circumstances, notes or interests in notes may constitute securities within state or federal securities laws. See *Leyva v Superior Court* (1985) 164 CA3d 462, 470, 210 CR 545 ("California 'risk capital' test generally defines a superficial loan transaction as a security if investors are dependent on the promoter's success for a return on the investment.… 'The touchstone [of the federal test] is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.'"); *People v Schock* (1984) 152 CA3d 379, 199 CR 327.

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§9.34 1. Priority of Rights in Security

When a single deed of trust secures multiple notes in the hands of multiple holders, absent contrary agreement, each holder is entitled to share pro rata in the security. *Phelan v Olney* (1856) 6 C 478. In *Phelan*, this was true even though the original payee of two notes, who assigned them separately, expressly assigned the mortgage to only the second transferee. The court based its conclusion on the rule that the security follows the note even without a formal assignment of the security. See §1.25.

Other jurisdictions, at least in older cases, have applied different priority rules in this situation, including priority based on the order in which multiple holders received their notes or interests in a note or the order of maturity dates of multiple notes or interests. See 1 Nelson & Whitman, Real Estate Finance Law §5.35 (5th ed 2007) (criticizing such approaches as impractical and irrational and unlikely to be followed by modern courts).

Even in California, however, the rule of prorata priority may be altered by agreement, and agreement might be inferred from the circumstances in which assignments were made. In *Grattan v Wiggins* (1863) 23 C 16, the original payee of multiple notes assigned them separately, at different times, each time with an assignment of the mortgage. The court found that there was a special priority agreement in favor of the first transferee, a conclusion that appears to have been based only on the fact that that transfer was accompanied by an assignment of the mortgage. 23 C at 31.

In modern participation transactions, the relative rights and priorities of the participants are normally spelled out in explicit detail in the agreements. See 1 Nelson & Whitman, Real Estate Finance Law §5.35 (5th ed 2007).

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§9.35 2. Foreclosure

California cases have recognized the validity of nonjudicial and judicial foreclosures commenced by fewer than all holders of notes secured by a single deed of trust. See *Hohn v Riverside County Flood Control & Water Conserv. Dist.* (1964) 228 CA2d 605, 39 CR 647 (nonjudicial); *Redman v Purrington* (1884) 65 C 271, 3 P 883 (judicial). In *Hohn*, the court concluded that the nonjudicial sale passed the entire title to the foreclosure sale purchaser.

The other holders nonetheless have their rights, pro rata or otherwise (see §9.34), in the foreclosure sale proceeds. In *Hohn*, the court suggested that if sale proceeds were not applied properly, the aggrieved parties might have a claim against the trustee, although the purchaser's title would not be affected. See also *Mercantile Trust Co. v Sunset Rd. Oil Co.* (1917) 176 C 461, 476, 168 P 1037 (holder of some but not all jointly secured bonds agreed to subordinate to junior interest on property; other bondholders were not bound by this and it was proper for them to foreclose, but "if there be any foreclosure, it must be a foreclosure for the benefit of all outstanding bonds entitled to share in the security").

In *Jefferson Sav. & Loan Ass'n v Lifetime Sav. & Loan Ass'n* (9th Cir 1968) 396 F2d 21, when participating interests in a note had been sold, the originating lender foreclosed and acquired title in its own name. The court held that the participant had proportional rights in the property "as a cotenant" and the foreclosing lender held the property "as trustee" for the participant. 396 F2d at 24. (The foreclosing noteholder in *Hohn v Riverside County Flood Control & Water Conserv. Dist., supra,* was also the purchaser, but there the court did not comment on rights that the other noteholder might have had in the property.)

The difficulties involved in a foreclosure in which not all noteholders participate was illustrated in *Baumann v Bedford* (1941) 18 C2d 366, 115 P2d 437. The plaintiffs in a judicial foreclosure had acquired the property at the sale, but a deed could not be issued because the identities of all the other noteholders were not known. The foreclosing plaintiffs thus brought this separate action for partition, naming the other noteholders as defendants, including under fictitious names when the identities were unknown. The action requested that the property be sold and the proceeds divided pro rata. The court approved the appointment of a receiver of the property in the action.

Other issues may arise if some but not all of the notes are due and there is no cross-default provision. This situation is conceptually similar to that involving a single promissory note that is due in installments, one of which is in default, when the note contains no acceleration clause. See §§3.48, 8.3. See also CCP §728; *Stockton Sav. & Loan Soc'y v Harrold* (1900) 127 C 612, 620, 60 P 165; *McDougal v Downey* (1872) 45 C 165. The same solutions might not all be appropriate in the multiple-holder context, however, because they might undermine the multiple holders' rights to share in the entirety of the security. See *Mercantile Trust Co. v Sunset Rd. Oil Co.* (1917) 176 C 461, 476, 168 P 1037.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.36 D. Wraparound Loan

§9.36 D. Wraparound Loan

When a wraparound ("all-inclusive," "overriding," or "hold-harmless") note and deed of trust are used, the face amount of the obligation includes some other "underlying" or "wrapped" obligation, which the holder of the wraparound note will pay off while being paid by the maker of the wraparound note.

EXAMPLE: *C* gives *B* a promissory note for $50,000, which "wraps around" an existing $40,000 note *B* had given to *A;* that is, *C* must pay *B* $50,000, but *B* has agreed to pay *A* $40,000. Thus, the $50,000 note wraps around the $40,000 note, which *B* will continue to pay with funds received from *C* on the wraparound note.

Wraparound notes and deeds of trust are often used as substitutes for second deeds of trust.

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1. Advantages

§9.37 a. Interest Rates

One reason for using a wraparound loan is to capitalize on the lower interest rate of an existing senior loan. The wraparound lender receives the benefit of (1) the interest "spread" on the underlying loan if the wraparound rate is higher as well as (2) the interest on the entire wraparound amount.

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§9.38 b. Tax Considerations

The interest paid by the maker of a wraparound note is currently deductible, nondeductible, or deductible on a deferred basis, depending on the purpose of the financing (*e.g.,* principal residence, raw land, improved rental property). See IRC §163.

The interest received by the holder of the wraparound note is ordinary interest income. IRC §61(a)(4).

The interest that the holder of the wraparound note pays to the underlying senior noteholder is generally "investment interest expense," which is deductible for federal income taxes under rules provided by IRC §163. The prior characterization of the interest expense related to the senior (underlying) note that accrued during the installment seller's ownership of the property is not relevant to the characterization after the sale and creation of the wraparound note. For example, the underlying property may have been the seller's principal residence, in which case it is generally deductible as an itemized deduction on the individual's tax return. IRC §163(d). After the sale, however, the mortgage interest characterization no longer applies.

California income tax law generally conforms to federal law on the above points.

The federal income tax principle—that a seller recognizes income to the extent that any existing deeds of trust assumed (or taken subject to) exceed the seller's basis in the property—does not apply to an existing deed of trust that remains on the property and is wrapped inside another deed of trust. Thus, a seller who takes back a new deed of trust subject to an existing deed of trust on the property may defer recognition of income from the discharge of the underlying deed of trust by having the new deed of trust wrap around it. *Professional Equities, Inc.* (1987) 89 TC 165, acq 1998-2 Cum Bull 1.

Installment sale treatment (IRC §453), on which this premise is based, permits an election out of the installment sale treatment. A wraparound noteholder can elect on the tax return to recognize the gain even if the holder is entitled to defer it. The holder of a wraparound loan may have other deferred tax losses (*e.g.,* capital losses or passive activities losses (IRC §469)) against which sale income can be offset.

WARNING: A thorough analysis of a wraparound noteholder's tax picture must be evaluated before simply going with deferral by default. This chapter does not provide complete and in-depth coverage of the tax consequences of a wraparound loan. Counsel should confer with qualified tax counselors or attorneys for assistance in determining the tax impact of a wraparound loan on their clients.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.39 c. Alters Payment Schedules

§9.39 c. Alters Payment Schedules

Debtors may use wraparound financing as a way to alter the payment schedules on existing loans rather than as a source of new money. Thus, a debtor subject to high loan payments combined with a low interest rate may find a wraparound lender to make the higher underlying payments while accepting smaller monthly payments from the owner, in effect making a second loan to the owner each month of the difference between the two payments as a kind of future-advance loan. On seller financing, see California Real Property Sales Transactions, chap 9 (4th ed Cal CEB 2007).

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2. Disadvantages

§9.40 a. Usury Risks

Whether wraparound financing can generate usurious interest is an issue that remains unresolved. The total interest the borrower pays may fall within the legal limits, but the effective interest received by the wraparound lender on the amount actually advanced may exceed that limit. Having the wraparound lender be personally liable on the senior indebtedness may constitute a defense to that charge. See discussion and authorities cited in California Real Property Sales Transactions §9.7 (4th ed Cal CEB 2007). When the seller is the party taking a wraparound note and deed of trust, the transaction should be exempt from usury limits under the time-price differential doctrine, which distinguishes a credit sale of property from a loan or forbearance, freeing the credit sale from the restrictions of Cal Const art XV, §1. *Boerner v Colwell Co.* (1978) 21 C3d 37, 145 CR 380; *Verbeck v Clymer* (1927) 202 C 557, 261 P 1017. Changes in the usury law since 1979 have generally reduced anxiety over these questions. See Hyman, *Proposition 2 and the California Usury Law,* 3 CEB Real Prop L Rep 25 (Mar. 1980); Brown, *The Current Status of the Time-Price Differential Doctrine in California,* 2 CEB Real Prop L Rep 93 (Aug. 1979) and 3 CEB Real Prop L Rep 109 (Oct. 1979).

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§9.41 b. Foreclosure

The question of how much is owed on a wraparound loan currently in default is not fully resolved. Two cases have stated that the amount due on foreclosure of a wraparound loan includes the amount of the underlying loan as well as the wraparound lender's own "equity" in the loan. *FPCI RE-HAB 01 v E&G Invs., Ltd.* (1989) 207 CA3d 1018, 255 CR 157 (wraparound beneficiary's credit bid, which included amounts due on both loans, was proper and did not chill bidding); *Armsey v Channel Assocs.* (1986) 184 CA3d 833, 229 CR 509 (wraparound beneficiary's bid of only its own equity did not constitute full credit bid and left it entitled to fire insurance proceeds). Permitting the wraparound beneficiary to include in its credit bid the amount owed to the underlying lender gives it a significant advantage over outside bidders and leaves unresolved how the overbid amount is to be paid to the underlying lender.

It is unknown whether the parties can provide in their loan documents that the amount due in wraparound foreclosure cases excludes the underlying loan amount (thus treating the wraparound loan for foreclosure purposes the same as an ordinary second deed of trust) or whether an order of payment could be prescribed. See *J.M. Realty Inv. Corp. v Stern* (Fla App 1974) 296 So2d 588 (cited by *Armsey v Channel Assocs., supra*). Limiting the debt would accordingly limit the amount the wraparound beneficiary could credit-bid. However, if an outsider were to outbid the wraparound lender and take title to the property subject to the underlying loan, this would have a presently unknown effect on the potential personal liability of the wraparound lender. This problem, too, might be avoided by language in the wraparound instrument limiting the beneficiary's duty to service the underlying loan to apply only when the borrower was not in default on the wraparound loan.

In general, parties using wraparound financing should be sure to coordinate the provisions of the wraparound loan with those of the underlying loan so as to eliminate inconsistencies in insurance, late charges, impounds, and prepayment rights.

PRACTICE TIP: It is often useful to provide in the wraparound note for appointment of a collection agent to receive the wraparound payments and to disburse the payments on the senior obligation.

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IV. PRIORITIES

§9.42 A. Significance of Lien Priority

California law provides two fundamental rules for determining the priority of multiple liens on the same real property: (1) a first-in-time rule (see §9.43) and (2) a race-notice recordation system (see §9.44). The consequences of one lien having priority over another is that the foreclosure of a senior lien eliminates the junior liens (*R-Ranch Markets #2, Inc. v Old Stone Bank* (1993) 16 CA4th 1323, 1328, 21 CR2d 21; *Pacific Trust Co. TTEE v Fidelity Fed. Sav. & Loan Ass'n* (1986) 184 CA3d 817, 825, 229 CR 269), but on foreclosure of a junior lien, senior liens remain intact. The lien foreclosure purchaser takes title with the same priority as the lien had. *R-Ranch Markets #2*, 16 CA4th at 1327.

The priority of multiple liens is of critical importance even if the value of the property is greater than the amounts secured by the liens. This is so because, in the largest percentage of foreclosure sales, there are no bids by third party bidders but only credit bids by the foreclosing creditor. There is no obligation to bid the full value of the property. See *Dreyfuss v Union Bank* (2000) 24 C4th 400, 409, 101 CR2d 29. As a result, junior liens may be wiped out, with no sale proceeds going to the junior lienholders even if the property's value exceeds the amount of the senior lien. If a junior lienor believes that there is value in the property in excess of the senior lien, it must take affirmative steps to protect that value, *e.g.,* by bidding at the senior sale to acquire the property (see §2.83) or by paying the senior debt in full or keeping it current (see §2.104).

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B. Basic Determinants of Priority

§9.43 1. First-in-Time Rule

Civil Code §2897 provides:

> Other things being equal, different liens upon the same property have priority according to the time of their creation.

This "first-in-time" rule ranks liens according to the time of their creation. *Thaler v Household Fin. Corp.* (2000) 80 CA4th 1093, 95 CR2d 779. Under this standard, a deed of trust executed and delivered on January 1 has priority over one executed and delivered on February 1. *Boye v Boerner* (1940) 38 CA2d 567, 569, 101 P2d 757. See *20th Century Plumbing Co. v Sfregola* (1981) 126 CA3d 851, 853, 179 CR 144 (presumption that deed of trust delivered on date of execution). Different events may trigger the creation of involuntary or special liens, such as mechanics' liens or vendor's liens (see §§9.53-9.54), but Civil Code §2897 relates solely to consensual liens, *i.e.,* mortgages and deeds of trust.

The priority result under the common law priority system is modified, however, by the race-notice recordation statute (see §9.44) because the first-in-time rule does not account for the fact that the February lender may be unaware of the January lien if it was not recorded. In that event, the January deed of trust is a "secret" lien and should not have priority over a subsequent, innocent bona fide lender or purchaser. Generally, a recordation statute modifies first-in-time priority.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.44 2. Race-Notice Recordation Statute

§9.44 2. Race-Notice Recordation Statute

Civil Code §1214 provides:

> Every conveyance of real property or an estate for years therein, other than a lease for a term not exceeding one year, is void as against any subsequent purchaser or mortgagee of the same property, or any part thereof, in good faith and for a valuable consideration, whose conveyance is first duly recorded, and as against any judgment affecting the title, unless the conveyance shall have been duly recorded prior to the record of notice of action.

This section creates a "race-notice" system, permitting a later-created lien to take priority over an earlier created one if all of the following circumstances apply:

- The earlier lien was not recorded;
- The later lienholder was without notice of the earlier lien;
- The later lienholder gave value for the lien; and
- The later lien was recorded first.

If any of these features is missing, the earlier lien has priority.

See *Citizens for Covenant Compliance v Anderson* (1995) 12 C4th 345, 47 CR2d 898; *First Fid. Thrift & Loan Ass'n v Alliance Bank* (1998) 60 CA4th 1433, 71 CR2d 295; *In re Pavich* (Bankr ED Cal 1996) 191 BR 838.

EXAMPLE 1:

(1) *O* deed of trust to *A*; recorded.

(2) *O* deed of trust to *B*; recorded.

A's deed of trust, first created and first recorded, has first priority. *A*'s recordation imparts constructive notice to all subsequent takers (CC §1213) and thus appropriately gives *A* priority.

But if *A* fails to record, the recordation statute protects subsequent takers who do not otherwise have notice of *A*'s deed of trust:

EXAMPLE 2:

(1) *O* deed of trust to *A*; not recorded.

(2) *O* deed of trust to *B*; recorded.

Even though *A*'s deed of trust was created first in time, *B*'s deed of trust has priority unless *B* had notice of *A*'s deed of trust or did not give value for *B*'s deed of trust. (*B* would also lose by failing to record before *A*.) See *Schelling v Thomas* (1929) 96 CA 682, 274 P 755.

The statute thus protect parties' reliance on the real property records. In addition, by requiring that the later lienholder also record first, the statute provides additional incentive for recordation.

Although recordation is essential to protect a lien against competing liens and other interests, a lien is nonetheless valid between the immediate parties to it even if it is unrecorded, *e.g.,* a deed of trust is valid among trustor, trustee, and beneficiary whether or not it is recorded. CC §§1214, 1217. See *Swiss Bank Corp. v Van Ness Assocs. (In re Van Ness Assocs.)* (Bankr ND Cal 1994) 173 BR 661. Lack of recordation affects only the priority of the lien with respect to other liens or interests in the real property.

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3. Other Requirements for Priority by Recordation

§9.45 a. Instrument Properly Recorded

A lien may be deemed unrecorded for purposes of the recordation act even when the creating instrument has been given to the recorder, copied into the official records, and entered into the appropriate indexes. This occurs in three primary circumstances: when the lien is (1) outside the chain of title, (2) improperly indexed, or (3) not properly recordable.

EXAMPLE:

(1) *O* deed to *A*; not recorded.

(2) *A* deed of trust to *B*; recorded.

(3) *O* deed of trust to *C*; recorded.

The deed of trust from *A* to *B*, even though recorded, is outside the record chain of title to the property—it is a so-called "wild" instrument—because the prior deed in the chain, from *O* to *A*, was not recorded. A search of the real property records, which are grantor-grantee indexed, would show *O* as the owner, not *A*. Neither the deed from *O* to *A* (because it is unrecorded) nor the deed of trust from *A* to *B* (because it is outside the chain of title) gives constructive notice to subsequent takers. As a result, *C*'s deed of trust will have priority over *B*'s (absent knowledge by *C*). The deed of trust from *A* to *B* is treated effectively as unrecorded. See, *e.g., Far W. Sav. & Loan Ass'n v McLaughlin* (1988) 201 CA3d 67, 246 CR 872.

Deeds that are indexed incorrectly by the recorder are also deemed unrecorded because they cannot be discovered by a search of the records. *Hochstein v Romero* (1990) 219 CA3d 447, 268 CR 202.

Title insurers maintain property records by parcels and will likely list an instrument affecting title to the property as an exception to title on the preliminary report regardless of when it was recorded, thus imparting actual notice even if the recorder did not properly index it. But the principles of constructive notice are premised on the grantor-grantee index maintained by the recorder. See §9.46 on importance of notice.

Instruments that are not properly recordable, such as those that lack acknowledgment or statutory authorization for recordation, are nonetheless sometimes recorded. These documents are generally treated as not giving constructive notice, but they may be regarded as creating enough of a cloud on title to give rise to liability for slander of title. See, *e.g., Seeley v Seymour* (1987) 190 CA3d 844, 237 CR 282. On indexing errors and wild deeds, see California Title Insurance Practice, chap 4 (2d ed Cal CEB 1997). On slander of title, see California Real Property Remedies and Damages, chap 9 (2d ed Cal CEB 2002).

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§9.46 b. Without Notice of Other Interest

A party with actual knowledge of a prior lien cannot claim priority over it even if it was not recorded. CC §1217. The statutory requirement of good faith requires the absence of actual or constructive notice of the prior interest. *Gribble v Mauerhan* (1961) 188 CA2d 221, 227, 10 CR 296 (notice precludes good faith). Even without actual knowledge, suspicious circumstances (*e.g.,* a reference in a recorded instrument to an unrecorded instrument or the presence of persons on the property whose possession is inconsistent with record title) may impose an obligation to make inquiries, which, if undertaken, would lead to knowledge of the prior lien. *Randall v Allen* (1919) 180 C 298, 180 P 941 (constructive notice); *Slaker v McCormick-Saeltzer Co.* (1918) 179 C 387, 388, 177 P 155 (actual notice); *Gates Rubber Co. v Ulman* (1989) 214 CA3d 356, 262 CR 630 (constructive notice).

Even a party without actual or inquiry notice may lose its status as a bona fide encumbrancer without notice based on the imputation of constructive knowledge of an agent. *Zeller v Klein* (Apr. 16, 2004, A102248; not certified for publication) 2004 Cal App Unpub Lexis 3728, 2004 WL 823489 (knowledge of mortgage broker who was aware of unrecorded reconveyance imputed to client and assignee of note, who was otherwise innocent and without knowledge). On constructive notice, see California Title Insurance Practice, chap 4 (2d ed Cal CEB 1997).

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§9.47 c. Value

A party who does not give value is not injured by losing priority to a prior unrecorded claim, because there is no substantial reliance to protect. But when value has been given, complying with the recordation act protects that investment. *Oakdale Village Group v Fong* (1996) 43 CA4th 539, 547, 50 CR2d 810. More than nominal value is required, but the amount need not equal the full market value of the property in the case of a sale.

EXAMPLE:

(1) *O* deed of trust to *A*; unrecorded.

(2) *O* sells the property worth $500,000 to *B* for $100,000; *B*, without notice of *A*'s lien, records the deed.

B takes title free of *A*'s lien even though the property is worth $500,000 because the amount paid was not nominal.

When only part of the agreed value has been transferred at the time of discovery of the earlier lien (as with progress payments under a construction loan or on an installment purchase), protection may be given to the payments made before discovery and denied to those made after notice. *Davis v Ward* (1895) 109 C 186, 41 P 1010.

The value requirement means that a recorded judgment lien will generally not prevail over a prior unrecorded lien, because the judgment creditor usually paid no value in reliance on the records when obtaining the judgment. *20th Century Plumbing Co. v Sfregola* (1981) 126 CA3d 851, 853, 179 CR 144; *Hansen v G&G Trucking Co.* (1965) 236 CA2d 481, 486, 46 CR 186. The same is true for attachment lienholders. *Bumb v Bennett* (1958) 51 C2d 294, 302, 333 P2d 23; *Bank of Ukiah v Petaluma Sav. Bank* (1893) 100 C 590, 591, 35 P 170; *Wells Fargo Bank v PAL Investments, Inc.* (1979) 96 CA3d 431, 157 CR 818.

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§9.48 4. Purchase Money Mortgage Priority

Civil Code §2898(a) states:

> A mortgage or deed of trust given for the price of real property, at the time of its conveyance, has priority over all other liens created against a purchaser, subject to the operation of the recording laws.

This section gives purchase money loans priority over certain other preexisting liens. *Mercantile Collection Bureau v Roach* (1961) 195 CA2d 355, 15 CR 710. A loan is purchase money whether a third party advances funds to permit the borrower to acquire property or a seller extends credit to the purchaser. *Van Loben Sels v Bunnell* (1898) 120 C 680, 683, 53 P 266. (The definition of "purchase money" for purposes of CC §2898 is broader than the meaning of "purchase money" under CCP §580b (the purchase money antideficiency statute). Under §580b, third party loans, as opposed to seller financing, are considered purchase money only if the third party loan is made to assist in purchasing one-to-four-unit owner-occupied dwellings.) The section has limited application, however, because it is subject to the operation of the recordation laws and because it gives priority only over liens against the purchaser (see discussion and examples in §§9.43-9.47).

The purchase money priority rule of CC §2898 also breaks ties between parties whose interests attach simultaneously at close of escrow or on any similar occasion when multiple interests arise at the same instant, making ordinary rules for establishing priority—especially "first-in-time" and the recordation acts—unavailable. See *DMC, Inc. v Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 120 CR2d 761 (owner who lost property in trustee sale subsequently obtained new loan to finance repurchase of property; holding that new loan was purchase money loan under §2898, court held that new loan has priority over preexisting lien that might equitably reattach to property at moment of "redemption"; see §3.97).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.49 a. Subject to Operation of Recordation Laws

§9.49 a. Subject to Operation of Recordation Laws

An unrecorded purchase money lien fails as against a subsequent lien that was taken without notice, given for value, and first recorded. In that event, the recordation act, CC §1214, prevails over any purchase money priority the first lien might otherwise have had under CC §2898(a).

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§9.50 b. Liens Against Purchaser

Purchase money liens do not take priority over preexisting liens against the property itself; they take priority only over preexisting liens against the purchaser personally. In this sense, CC §2898(a) is designed, in effect, to break ties in priority that occur at closure of a transaction when a purchase money interest is created and when preexisting judgment liens attach at the moment title is conveyed.

EXAMPLE 1: *O* conveys property to *A*, who finances the acquisition with a recorded purchase money deed of trust. The purchase money deed of trust has priority over any preexisting judgment lienholders against *A*, even though those judgments were recorded before recordation of the deed of trust.

EXAMPLE 2: *A* has a recorded deed of trust on *O*'s property. *O* sells the property to *B*, who obtains a recorded purchase money deed of trust (from *O* or from a third party). Despite its purchase money status, the new lien is inferior to *A*'s deed of trust lien because it was a lien against the property, not against the purchaser.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/ 5. Fixtures/§9.51 a. Priority Rules

5. Fixtures

§9.51 a. Priority Rules

Fixtures are goods that have become so related to particular real property that an interest in them arises under real property law. Com C §9102(a)(41). Civil Code §660 specifies when a thing is deemed to be affixed to land and is thus a real estate fixture. Whether a particular item constitutes a fixture is not always clear and turns in part on the intentions of the parties. See, *e.g., Crocker Nat'l Bank v City and County of San Francisco* (1989) 49 C3d 881, 885, 264 CR 139.

A security interest in fixtures (other than ordinary building materials incorporated into an improvement on land) can be created under Commercial Code Division 9. Com C §§9109(a)(1), (d)(11)(B), 9334(a). A security interest in fixtures can also be created under real property law, such as by a deed of trust encumbering the real property to which they are affixed. See Com C §9334(b).

Different sets of rules govern priority disputes between competing security (and other) interests in fixtures, depending on the law under which the interests arose:

- Priority between competing interests all created under real property law are simply governed by the priority rules of real property law.
- Priority between competing security interests all created under Commercial Code Division 9 are governed by the normal Division 9 priority rules for personal property security interests. See Com C §9322; Secured Transactions in California Commercial Law Practice, chap 4 (2d ed Cal CEB 2001).
- Priority between competing interests, some of which were created under real property law and some of which are security interests created under Division 9, are governed by a special set of Division 9 priority rules, Com C §9334(c)-(g).

Commercial Code §9334(c) establishes a general rule that a Division 9 security interest in fixtures is subordinate to a conflicting interest of an encumbrancer or owner of the real property other than the debtor. Commercial Code §9334(d)-(h) then specifies the following exceptions to this general rule, under which the Division 9 security interest will have priority over the real estate claimant:

- The Division 9 security interest is a purchase money security interest, the interest of the real property claimant arose before the goods became fixtures, the security interest was perfected by a fixture filing (see Note below) before the goods become fixtures or within 20 days thereafter, and the debtor has an interest of record in or is in possession of the real property. Com C §9334(d). However, this priority normally does not apply if the competing real property law interest is a prior recorded construction mortgage. Com C §9334(h).
- The debtor has an interest of record in the real property or is in possession of the real property, and both of the following conditions are satisfied: (1) The Division 9 security interest is perfected by a fixture filing before the interest of the real estate claimant is recorded, and (2) the Division 9 security interest has priority over any conflicting interest of a predecessor in title of the real property claimant. Com C §9334(e)(1).
- The goods are readily removable factory or office machines or readily removable replacements of domestic appliances that are consumer goods. Com C §9334(e)(2).
- The conflicting interest is a judicial lien on the real property obtained after the Division 9 security interest in fixtures was perfected by any means (*i.e.,* a fixture filing is not required). Com C §9334(e)(3).
- The Division 9 security interest is in a manufactured home, in certain circumstances. Com C §9334(e)(4).
- The holder of the real property interest consented to the Division 9 security interest in the fixtures or disclaimed an interest in the goods as fixtures, or the debtor has a right to remove the goods as against the real property encumbrancer or owner. Com C §9334(f).

NOTE: A fixture filing—which is required by several (but not all) of the foregoing rules as a condition of priority—is a Commercial Code Division 9 financing statement that includes additional required information. Com C

§§9102(a)(40), 9502(a)-(b). It is normally filed in the county recorder's office where the related real estate is located. See Com C §9501(a)(1)(B). For detailed discussion of perfection of security interests in fixtures by fixture filing, see California Real Estate Finance Practice: Strategies and Forms §§7.38-7.41A (Cal CEB 2000). For detailed discussion of perfection of security interests in personal property, including fixtures, by other means in real property transactions, see Real Estate Finance §§7.23-7.37.

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§9.52 b. Right to Remove Fixtures

If a Division 9 security interest in fixtures has priority over competing interests in the fixtures arising under real property law (see §9.51), does the holder of the security interest have the right to remove the fixtures in order to exercise its remedies on a default in the secured obligation? Before the revision of Commercial Code Division 9 effective July 1, 2001, former Com C §9313(8) answered that question explicitly: The holder of the security interest could remove the fixtures but was required to reimburse any real property encumbrancer or owner other than the debtor for the cost of repair of any physical injury to the property, but not for diminution in value caused by the absence of the goods removed or the necessity of replacing them. This California provision essentially followed the uniform version of UCC §9-313(8).

When UCC Article 9 was revised effective 2001, the fixture-removal provisions of former UCC §9-313(8) were carried over into revised UCC §9-604 subsections (b)-(d) and further elaborated. But when California adopted revised UCC Article 9 as Com C Division 9, revised UCC §9-604 subsections (b)-(d) were entirely omitted. As a result, the current version of Division 9 is silent on the right of removal.

It appears virtually certain that this omission was inadvertent. It likely occurred because the uniform version of revised UCC §9-604(a), dealing with mixed collateral, was replaced with the extensive nonuniform mixed-collateral rules of Com C §9604(a), discussed in §§9.12-9.23. The entirely separate fixture-removal topic covered by UCC §9-604(b)-(d) appears to have been overlooked in this process. The fact that fixture-removal rights are included in the Commercial Code in the analogous context of *leased* fixtures (see Com C §10309(g)) and in other similar contexts (see Com C §§9335(e)-(f) (removal of accessions), 10310(e) (removal of leased accessions)) clearly suggests that there was no policy decision to omit removal rights in the context of a security interest in fixtures.

Although at present there is no Commercial Code provision dealing explicitly with the right of the holder of a Division 9 security interest to remove fixtures, it seems likely that a court would nonetheless hold that such a right exists. Without such a right, the statute's explicit provisions—conferring priority on the Division 9 security interest in specified circumstances (Com C §9334(d)-(f)) and authorizing the holder of a security interest to exercise remedies upon default (Com C §9601), including taking possession of the collateral (Com C §9609(a)(1))—could be rendered largely ineffective in this context.

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C. Special Lien Priorities

§9.53 1. Vendor's Liens

The law gives a vendor's lien to a seller who is otherwise unsecured with regard to the unpaid balance of the purchase price. CC §3048. This lien is not recorded, because it arises only when no express security instrument is created. *Machado v Bank of Italy* (1924) 67 CA 769, 776, 228 P 369. Furthermore, attempts to place it in the records are generally unsuccessful. *Brown v Johnson* (1979) 98 CA3d 844, 159 CR 675. Consequently, it is junior to recorded liens that qualify under CC §1214. *Brock v First S. Sav. Ass'n* (1992) 8 CA4th 661, 10 CR2d 700 (vendor's lien is inferior even when subsequent beneficiary of deed of trust has actual knowledge, because it is merely equitable interest and gives way before legal interest created by recorded deed of trust). See also *DMC, Inc. v Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 120 CR2d 761, cited in §§3.97, 9.48. The court in *DMC* employed essentially the same analysis as in *Brock* to accord priority to a contractual purchase money lien (that essentially replaced the original senior lien) over a preexisting lien that had been wiped out in a nonjudicial foreclosure but that may have equitably reattached to the property on the obligor's subsequent repurchase of the property.

PRACTICE TIP: Vendor's liens are, at best, a safety net for the improvident seller. In light of their vulnerability from a priority standpoint, the practitioner should never rely on an undocumented or unrecorded purchase money lien at the transactional stage.

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§9.54 2. Mechanics' Liens

Civil Code §3134 provides that mechanics' liens are

> preferred to any lien, mortgage, deed of trust, or other encumbrance upon the work of improvement and the site, which attaches subsequent to the commencement of the work of improvement, and also to any lien, mortgage, deed of trust, or other encumbrance of which the claimant had no notice and which was unrecorded at the time of commencement of the work of improvement.

Thus, mechanics' lien priority depends on the date work begins on a property, not on the date the lien is recorded. On proper recordation of mechanics' liens, see California Mechanics' Liens and Related Construction Remedies §§3.45-3.46 (3d ed Cal CEB 1998).

Under this relation-back theory, mechanics' liens may take priority over purchase money liens and vendor's liens created after work commenced even though recorded before recordation of mechanics' liens. *Schut v Doyle* (1959) 168 CA2d 698, 336 P2d 567. This special priority rule requires a construction lender to inspect the property visually before funding to assure itself that no construction has started, lest any mechanics' liens prevail over the deed of trust despite the order of recordation. Title insurers issue special endorsements to cover this risk. On mechanics' lien endorsements in title insurance, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997).

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§9.55 3. Tax and Assessment Liens

Revenue and Taxation Code §2192.1 provides:

> Every tax declared in this chapter to be a lien on real property, and every public improvement assessment declared by law to be a lien on real property, have priority over all other liens on the property, regardless of the time of their creation. Any tax or assessment described in the preceding sentence shall be given priority over matters including, but not limited to, any recognizance, deed, judgment, debt, obligation, or responsibility with respect to which the subject real property may become charged or liable.

Thus, property tax liens have leapfrog priority over all previous liens, even those of record.

The legislature has police power to give its own liens priority over preexisting private liens. *German Sav. & Loan Soc'y v Ramish* (1902) 138 C 120, 70 P 1067. The priority of a tax lien depends entirely on legislative intent, as expressed in the particular statutory provision that creates the lien. For detailed discussion of relative priorities of various tax and assessment liens, see Miller & Starr, California Real Estate §§11.93-11.175 (3d ed 2000). Federal, not state, law sets the priority of federal tax liens. *U.S. v R.F. Ball Constr. Co.* (1958) 355 US 587, 593, 2 L Ed 2d 510, 78 S Ct 442.

NOTE: Many cities attempt to gain superpriority for water charges by recharacterizing them as a special assessment, despite the unhelpful language of Pub Util C §16469.

On priorities between common interest development association (private) assessment liens and mortgage liens, see Advising California Common Interest Communities, chap 5 (Cal CEB 2003).

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§9.56 D. Priorities in Bankruptcy

In general, bankruptcy law defers to state law on property interests, including security interests in real and personal property. See *Butner v U.S.* (1979) 440 US 48, 55, 59 L Ed 2d 136, 141, 99 S Ct 914 ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."). Thus, because the Bankruptcy Code for the most part does not provide otherwise, bankruptcy law ordinarily does not affect the state-law priority of a mortgage or deed of trust.

NOTE: In limited circumstances, the lien of a mortgage or deed of trust could be subordinated to administrative borrowings in the bankruptcy case, if the lien is adequately protected. 11 USC §364(d). See §11.63.

As discussed in detail in chap 11, a mortgage or deed of trust is subject to possible avoidance, *e.g.,* if it is unrecorded or otherwise invalid as against a bona fide purchaser (11 USC §544) or was a preference (11 USC §547) or a fraudulent transfer (11 USC §548). See §§11.77-11.88. When that occurs, the formerly secured creditor becomes unsecured. However, the avoided lien is preserved for the benefit of the bankruptcy estate (11 USC §551), and the estate thus succeeds to the state-law priority of the avoided interest. Junior-priority interests thus do not benefit from the avoidance. The state-law priorities remain intact.

EXAMPLE: *D* granted a deed of trust to *C1,* which *C1* failed to record. Later *D* granted a deed of trust to *C2*, which *C2* recorded, but *C2* had actual knowledge of *C1*'s prior, unrecorded deed of trust. Under California state law, *C1*'s deed of trust would not be good as against a bona fide purchaser (see §§9.43, 9.56) but would have priority over *C2*'s deed of trust because of *C2*'s actual knowledge (see §9.46).

The results in a bankruptcy of *D* are the following:

- *C1*'s deed of trust is avoidable because the trustee has the status of a bona fide purchaser (11 USC §544(a)(3)), leaving *C1* with only an unsecured claim.
- The avoided lien of *C1*'s deed of trust is nonetheless preserved for the benefit of the bankruptcy estate. 11 USC §551.

Because the estate thus stands in *C1*'s shoes, *C2*'s deed of trust does not step up in priority. The estate will have the right to the first dollars in value of the property, just as *C1* would have had.

If the example were changed so that *C2* did not have knowledge of *C1*'s prior deed of trust, *C2* would have state-law priority over *C1*, and avoidance of *C1*'s deed of trust in bankruptcy would not affect that priority.

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§9.57 E. Junior Rights to Reinstate, Redeem, and Foreclose

Junior lienholders have the same rights as a trustor to reinstate or redeem from senior liens in default because a senior foreclosure will eliminate a junior lien. The converse is generally not true, because the senior has no need to protect its lien from a junior foreclosure. Language in a senior deed of trust may declare that any junior default is also a default of the senior lien, but that would permit senior foreclosure, not senior reinstatement of the junior lien.

Because junior sales are subject to senior liens, a junior whose lien is due may elect to institute an action immediately, regardless of whether the senior lien is in default or whether the senior lender is motivated to wait rather than act. Tactical considerations, such as the availability of funds, may be paramount. A junior bidding at its own sale may credit-bid what it is owed but may not credit-bid at a senior sale. At a senior sale, the junior, like any other bidder, will have to bid in cash. If the senior credit-bids the entire senior debt, the junior will have to overbid that amount in cash, and any other cash overbids, if it wishes to acquire the property.

PRACTICE TIP: Representing junior deed of trust creditors in the face of a threatened senior foreclosure requires careful orchestration of the foreclosure and antideficiency rules. It may not be wise for the junior to rush to its own trustee sale, even if it can "beat" the senior deed of trust in terms of time, unless there is a clear plan in place to redeem, reinstate, or implement a workout with the senior creditor. It is a terrible outcome for the junior to foreclose first at its own trustee sale, incur a categorical deficiency bar under CCP §580d, and then lose the property at a senior sale later. It may be preferable for the non-purchase money junior simply to allow the senior sale to wipe out its lien and then sue on the sold-out note. For an example of a successful implementation of this strategy, in which the junior postponed its sale to allow the senior to foreclosure first, see *Bank of America v Graves* (1996) 51 CA4th 607, 59 CR2d 288. If the junior intends to bid at the senior sale, it must give special attention to the fair value and 3-month limitation provisions of CCP §580a. See *Bank of Hemet v U.S.* (9th Cir 1981) 643 F2d 661; *Citrus State Bank v McKendrick* (1989) 215 CA3d 941, 263 CR 781; *Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 221 CR 425.

For further discussion, see §§2.5, 2.51-2.61, 2.72-2.73, 2.83, 6.63.

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§9.58 F. Priority of Liens Versus Other Real Property Interests

Although this book discusses the relative priority of two liens, a lien can be involved in a priority dispute with another interest that is not itself a lien. In the following examples, the phrase "to prevail under the recording act" means that the interest was timely recorded and met the requirements discussed in §§9.45-9.47.

EXAMPLE 1:

(1) *O* deed of trust to *A*; not recorded.

(2) *O* grants deed to *B*; recorded.

If *B* prevails over *A* under the recordation act, *B* holds title free of *A*'s deed of trust. If *A* prevails, *B* holds title subject to *A*'s deed of trust.

EXAMPLE 2:

(1) *O* grants deed to *A*; not recorded.

(2) *O* deed of trust to *B*; recorded.

If *B* prevails over *A* under the recordation acts, *B* holds a deed of trust on *A*'s property even though *A* never suffered one to be created. If *A* prevails, the property is not subject to any lien in favor of *B*.

EXAMPLE 3:

(1) *O* lease to *A*; not recorded.

(2) *O* deed of trust to *B*; recorded.

If *B* prevails over *A* under the recordation acts, *B*'s deed of trust encumbers the entire fee, and *B* may terminate the interests of both *O* (reversion) and *B* (tenancy) by foreclosing. If *A* prevails over *B*, then *B*'s deed of trust encumbers only *O*'s reversion, and a foreclosure has no effect on *A*'s tenancy.

EXAMPLE 4:

(1) *O* deed of trust to *A*; not recorded.

(2) *O* lease to *B*; recorded.

If *B* prevails over *A* under the recordation acts, a foreclosure of the deed of trust does not terminate *B*'s tenancy, because the deed burdens only *O*'s reversion. If *A* prevails, the deed of trust burdens the entire estate, and *B*'s tenancy will end on *A*'s foreclosure.

EXAMPLE 5:

(1) *O* grants easement to *A*; not recorded.

(2) *O* deed of trust to *B*; recorded.

If *B* prevails over *A* under the recordation acts, *B*'s deed of trust encumbers the dominant as well as the servient estates, *i.e.,* both the burdened property and the easement over it. If *A* prevails over *B*, then *A*'s easement is not subject to *B*'s deed of trust and will burden the estate of anyone who purchases at *B*'s foreclosure sale.

For further discussion of priority issues among leases and deeds of trust, see chap 6.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.59 G. Future-Advance and Dragnet Clauses

§9.59 G. Future-Advance and Dragnet Clauses

Standard title company deed of trust forms typically state:

> Trustor agrees to (1) pay the principal and interest on the note of even date herewith; (2) perform each agreement in this deed of trust; and *(3) pay such further sums as the then recorded owner of the property may hereafter borrow from Beneficiary, when evidenced by another note (or notes) reciting it is so secured*.

There is no legal requirement that a security instrument come into existence simultaneously with the creation of the underlying obligation. Whenever a debtor gives a deed of trust to secure an already existing loan, there is a time lag between the date of the original note and the date of the deed of trust. Consider the following two examples, neither of which is very different from giving a deed of trust to secure an existing loan:

EXAMPLE 1: A bank holds a $100,000 unsecured note from its debtor and is prepared to grant an additional loan of $150,000 if the debtor provides real property security worth $250,000 to secure both loans.

EXAMPLE 2: A debtor requests a total loan of $250,000 and is prepared to furnish at least $250,000 worth of security, but debtor currently needs only $100,000 of the borrowed funds and wants to delay having to pay interest on the balance until the funds are actually drawn.

In each example, separate notes (of $100,000 and $150,000) secured by separate deeds of trust on the same property would be possible. The alternative of using a single note for $250,000 is cumbersome if the two loans have, *e.g.,* different interest rates, payment schedules, or maturity dates. Consequently, lenders often prefer to use two notes and only one deed of trust. In Example 1, the deed of trust would recite that it secured an earlier note for $100,000 and a contemporaneous note for $150,000. In Example 2, the deed of trust would refer to a current loan of $100,000 and a future loan or advance of $150,000. See CC §2884; *London & San Francisco Bank v Bandmann* (1898) 120 C 220, 52 P 583.

No problem would arise in either transaction if the deeds of trust were written as indicated, but commercial lenders seldom want to have to tailor deeds of trust for each individual situation when a standard form can fit many cases. In fact, lenders in the past attempted to extend the wording to cover every other conceivable obligation that either existed or might someday exist in favor of the lender. For example, the clause at issue in *Wong v Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 292, 128 CR 338, states:

> FOR THE PURPOSE OF SECURING: (1) Payment of the sum of $28,000.00 with interest thereon according to the terms of a promissory note or notes of even date herewith, made by Trustor, payable to the order of the Beneficiary, and extensions or renewals thereof; (2) payment of such additional amounts as may be hereafter loaned by Beneficiary or its successor to the Trustor or any of them, or any successor in interest of the Trustor, with interest thereon, *and any other indebtedness or obligation of the Trustor, or any of them, and any present or future demands of any kind or nature which the Beneficiary or its successor may have against the Trustor, or any of them, whether created directly, or acquired by assignment, whether absolute or contingent, whether due or not, whether otherwise secured or not, or whether existing at the time of the execution of this instrument, or arising thereafter;* (3) performance of each agreement of Trustor herein contained; and (4) payment of all sums to be made by Trustor pursuant to the terms hereof. [Italics added.]

The foregoing clause appeared in a 1963 deed of trust. The comparable provision in italics in the standard title company form deed of trust (at the beginning of this section) is more modest because of cases and comments warning lenders of the dangers of overly broad language. The title company form brings other obligations under the security of the deed of trust only if the notes involved so specify. A true dragnet clause (as appears in *Wong*) extends the deed of trust to cover every conceivable past, present, or future obligation between debtor and creditor, whether or not it is related to the present loan. This is why such clauses are called "dragnet": they sweep into the deed of trust far more debts than the parties generally intended. These clauses are also often referred to as "anaconda" or "debt accrual" clauses. *Berger v Fuller* (Ark 1929) 21 SW2d 419. See *Capocasa v First Nat'l Bank* (Wis 1967) 154 NW2d 271, 275.

A dragnet clause in a trust deed is typically an adhesion contract that should be narrowly construed against the

lender; therefore, many California courts consistently construed such clauses more on the basis of the actual expectations of the parties than on the literal wording of the boilerplate. Thus, in *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1447, 1 CR3d 162, when the bank argued that its deed of trust dragnet clause cross-collateralized the borrower's two contemporaneous loans with personal and business property, the court found that the "patently overinclusive language of the dragnet clause suggested that it was not within the actual expectations of the parties" and denied summary judgment. For further discussion of *Fischer,* see comment in 26 CEB Real Prop L Rep 188 (Sept. 2003). See also §§9.60, 12.34.

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§9.60 1. Validity

The existence of a lien does not entitle the lienholder to anything other than satisfaction of the original obligation secured by the lien. CC §2891. See *De Leonis v Walsh* (1903) 140 C 175, 73 P 813; *Mahoney v Bostwick* (1892) 96 C 53, 30 P 1020. But this rule does not prohibit parties from agreeing that a lien will secure more than one obligation as long as the dragnet clause is clearly worded and consistent with the note and other loan documents. See *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162, cited in §§9.59, 12.34; *Ricketson v Richardson* (1861) 19 C 330; *Hocker v Reas* (1861) 18 C 650. The deed of trust could specify with precision all obligations or future advances that it secures and will secure (as suggested by the court in *Fischer v First Int'l Bank, supra*), but the drawback of such precision for the creditor is that advances that are not described or that exceed the amount stated are entirely or partly unsecured (see *Keese v Beardsley* (1923) 190 C 465, 213 P 500). But see *London & San Francisco Bank v Bandmann* (1898) 120 C 220, 52 P 583. Because the courts have long held that a future-advance clause is valid even though it does not state the upper limit of future advances (*Tapia v Demartini* (1888) 77 C 383, 19 P 641; *Oaks v Weingartner* (1951) 105 CA2d 598, 234 P2d 194), creditors naturally prefer to use more generic future-advance clauses and to avoid wording that might hinder them later. Indeed, courts early on approved broad terminology as the best way for parties to agree that everything lent would be covered. *Sather Banking Co. v Arthur R. Briggs Co.* (1903) 138 C 724, 72 P 352.

An earlier version of the future-advance clause took the form of having the deed of trust overstate the debt by the amount that the beneficiary might later lend. These provisions were dropped because of fears that courts might treat them as a fraud on creditors. See *Tully v Harloe* (1868) 35 C 302.

Between the debtor and the creditor, there is no need for a written dragnet clause at all. A parol agreement that the deed of trust will cover an additional loan is valid. *Anglo-Californian Bank, Ltd. v Cerf* (1905) 147 C 384, 81 P 1077; *Banta v Wise* (1901) 135 C 277, 67 P 129. But see *American Sav. Bank v Kemp* (1913) 21 CA 571, 132 P 617. In fact, no agreement is necessary if the additional amount advanced is necessary to protect the security. CC §2876; *Churchill v Woodworth* (1906) 148 C 669, 84 P 155. See §§8.69, 8.71-8.73. It is generally safer, however, to refer to other loans in the deed of trust because third parties may be able to attack unwritten understandings. See *Langerman v Puritan Dining Room Co.* (1913) 21 CA 637, 132 P 617. See also §§9.68-9.73.

Dragnet clauses may also present problems under the Truth in Lending Act (TILA) (15 USC §§1601-1667f) and Regulation Z (12 CFR §§226.1-226.36). The statutory rights of rescission may apply when, *e.g.,* a deed of trust with such a clause encumbers the borrower's principal residence and a later loan is made, even though otherwise unrelated. 12 CFR pt 226, Supp 1, Comment 7 to §226.23(f).

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§9.61 2. Disputes Over Security

When a security instrument contains a dragnet clause and more than one obligation exists between debtor and creditor, a variety of disputes may arise. If only the debtor and the creditor are involved, disagreement may occur when the debtor tenders sufficient funds to pay off the original debt but the creditor refuses to release the security unless other claims are also paid. A similar dispute may arise if the creditor forecloses on its security because of the debtor's failure to satisfy the primary obligation and claims the right to have the surplus from that foreclosure sale applied toward satisfaction of its other claims rather than going to the debtor. The parties' contentions may be reversed if a foreclosure generates funds sufficient to cover only the primary claim. Then the creditor seeks independent legal redress for nonsatisfaction of its other claims, while the debtor contends that the deed of trust secures the other claims, making foreclosure the creditor's only remedy (under CCP §726(a); see §§4.6-4.10) or barring further recovery after a private foreclosure sale (CCP §580d; see §§2.118, 5.8). See *Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549. See also *Kesling v Bank of America (In re Kesling)* (9th Cir 1971) 449 F2d 770.

More complicated disputes arise when third parties enter, either junior creditors or unrelated purchasers of the asset given as security.

EXAMPLE:

(1) *A* lends *O* $100,000 and takes back a deed of trust with a dragnet clause.

(2) *B* lends *O* $150,000 and takes back a second deed of trust on the same property.

(3) *A* advances (lends) an additional $200,000 to *O*.

(4) *O* pays no one.

(5) Foreclosure and sale produces $250,000.

It is clear that the first $100,000 of the sale proceeds should go to *A*, but who gets the next $150,000? *A* contends that its second loan of $200,000 was a proper future advance secured by its dragnet clause and shares priority with its first loan. *B* asserts that *A*'s $200,000 loan is a third lien, subordinate to *B*'s second lien for $150,000. Answers to disputes such as these are not entirely certain.

See §§9.62-9.67.

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§9.62 a. Preexisting Debts

If the deed of trust does not contain a clause covering preexisting debts, neither party can assert that a debtor's earlier, unsecured obligations to the creditor became secured when a deed of trust with such a clause was later executed. Conversely, the clause quoted in §9.59 (from *Wong v Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 128 CR 338) appears to make any earlier obligations automatically secured by the words "any other indebtedness or obligation of the Trustor, or any of them." See *Kesling v Bank of America (In re Kesling)* (9th Cir 1971) 449 F2d 770.

The decision in *Gates v Crocker-Anglo Nat'l Bank* (1968) 257 CA2d 857, 65 CR 536, eliminates the danger that all of the debtor's existing obligations to the beneficiary automatically become secured when the debtor executes a deed of trust containing a dragnet clause. In *Gates*, several cotenants executed a deed of trust to secure their contemporaneous joint obligation. The court held that this deed of trust did not also secure the preexisting debt of one cotenant. Despite the fact that the language of the dragnet clause, like the wording of the clause in *Wong,* specifically covered obligations of any of the trustors, the court ruled that preexisting debts of one trustor were not secured by the other trustors' interests in the property unless the others had expressly consented or acquiesced. The basic rule of the decision—that dragnet clauses will not be read to include debts the trustor did not intend—extends beyond the cotenancy situation and includes existing obligations of the same trustor that are either not specifically enumerated in the deed of trust or not explicitly called to the trustor's attention. Compare *Wong v Beneficial Sav. & Loan Ass'n, supra,* with *Lomanto v Bank of America* (1972) 22 CA3d 663, 99 CR 442.

Because it is easy to include specific existing obligations when that is the parties' intent, failure to do so permits the court to infer that no such intent existed or that, if it did, it was a secret intent harbored by the creditor and not shared with the debtor. See, *e.g., National Bank v Blankenship* (ED Ark 1959) 177 F Supp 667, aff'd sub nom *National Bank v General Mills, Inc.* (8th Cir 1960) 283 F2d 574; *First v Byrne* (Iowa 1947) 28 NW2d 509; *Farmers Nat'l Bank v De Fever* (Okla 1936) 61 P2d 245; *Iser v Herbert Mark Bldg. Corp.* (NY Ct App 1930) 171 NE 757. But see *Kesling v Bank of America (In re Kesling)* (9th Cir 1971) 449 F2d 770 (literal language followed). Parol evidence is admissible to show what the security covers (see *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162; *Shaver v Bear River & Auburn Water & Mining Co.* (1858) 10 C 396). The burden is on the proponent to show that both parties intended to include the preexisting loan (see *Wong v Beneficial Sav. & Loan Ass'n, supra; Anglo-Californian Bank, Ltd. v Cerf* (1905) 147 C 384, 81 P 1077; *Payne v Morey* (1904) 144 C 130, 77 P 831).

For discussion of endorsements available to lenders for advances, see California Title Insurance Practice (2d ed Cal CEB 1997).

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§9.63 b. Future Advances

Civil Code §2884 permits creation of a present lien to secure a future obligation. See Com C §9204. This rule can be reconciled with CC §2872 (making a lien an accessory to an obligation) if the deed of trust provides that the lien secures the debtor's present promise to repay to the creditor all credit later extended. 2 Nelson & Whitman, Real Estate Finance Law §12.7 (5th ed 2007). Thus, a deed of trust containing a future-advance clause is valid even if no debt exists at its inception (*Moss v Odell* (1901) 134 C 464, 66 P 581) or if the debt has been temporarily reduced to zero (*Frank H. Buck Co. v Buck* (1912) 162 C 300, 122 P 466). But see *Fickling v Jackman* (1928) 203 C 657, 265 P 810.

A future-advance clause is not necessarily distinct from a dragnet clause. The dragnet clause in *Wong v Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 128 CR 338 (quoted in §9.59), contains a future-advance clause by its reference to "amounts as may be hereafter loaned." If the dragnet clause omitted all mention of existing obligations, it would then be only a future-advance clause. When the disputed second obligation is a future advance, creditors tend to refer to the clause as a future-advance clause because courts frequently have upheld such clauses. Debtors prefer to refer to such clauses as "dragnet" clauses in order to capitalize on the negative implications of that word. Problems of the validity, construction, and scope of these clauses, and the priority created by them, however, have nothing to do with the label.

The typical clause in the title company form illustrated in §9.59 confines future loans covered by the deed of trust to those in which the promissory note expressly recites that it is secured by the deed of trust. The clause in *Wong,* however, purported to secure future notes whether or not they referred to the existing deed of trust and would sweep under the deed of trust such items as a trustor's subsequent checking account overdraft or a missed payment on an automobile loan, if the same bank handled either item.

California courts have consistently preferred a construction of dragnet clauses that purports to be more faithful to the parties' actual expectations rather than to the literal wording of the clause. As early as 1889, the California Supreme Court held that even an expansive dragnet clause did not permit the creditor to buy up an obligation owed by the debtor to a third party and include it under the creditor's mortgage. *Moran v Gardemeyer* (1889) 82 C 96, 23 P 6. The *Moran* case actually extends beyond its rule because it involved a debtor who obtained a second loan from a secured creditor by endorsing over a note that the debtor was holding from a third party; it was this note that the supreme court held to be unsecured. The court of appeal announced the same rule 16 years later in *Provident Mut. Bldg. & Loan Ass'n v Shaffer* (1905) 2 CA 216, 83 P 274, again in a situation more favorable to the creditor than the rule made it appear. In *Provident,* the secured creditor advanced $300 above the original loan to pay a materialman for goods supplied to benefit the real property secured by the mortgage, but the creditor was not allowed to add the $300 to the mortgage. The Ninth Circuit, however, does not seem to agree. See *Kesling v Bank of America (In re Kesling)* (9th Cir 1971) 449 F2d 770 (following literal language of instrument).

Some dragnet clauses attempt to enlarge their scope by adding "payable to or otherwise acquired by beneficiary," but it is doubtful whether this will help. The loans held unsecured in *Moran* and *Provident* fit literally into the future-advance clauses of those mortgages. Their exclusion from the security was based more on the perceived inequity of permitting a creditor to subject its debtor to such claims than on any inadequacies in the language of the clause.

Even when a secondary obligation was originally created solely between the debtor and the creditor, it does not necessarily become a dragnet clause. In *Moran v Gardemeyer* (1889) 82 C 102, 23 P 8 (companion case to *Moran* decision cited above), a note recited that it was secured by a crop mortgage and did not refer to the existing real property mortgage under which the creditor wanted to secure the note. The supreme court held that, if the note had said nothing about security, it could have come under the real property mortgage, but because it expressly referred to other security it was not secured by the real property mortgage (see §9.65).

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§9.64 (1) Relationship Between Loans

The relationship between two loans may establish whether a court will hold that the parties intended to secure both by the same deed of trust. For example, if the first loan enabled the borrower to erect improvements on the real property and the second loan financed more improvements on the same real property, a court is likely to find that one deed of trust secured both loans. See *Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549. But see *National Enters., Inc. v Woods* (2001) 94 CA4th 1217, 115 CR2d 37, in which *Wendland*'s precedential value was questioned and in which the court held that, absent a very broad dragnet clause, no merger occurred even when the same lender made the second loan to cover delinquent amounts on the original loan.

If there is little connection between the loans, a court may find that the parties did not intend (either when executing the security instrument or when making the second loan) the original deed of trust to secure the second loan. *Moran v Gardemeyer* (1889) 82 C 96, 23 P 6. Thus, Alabama has refused to let creditors sweep unrelated negligence or rent claims under their mortgages. *Monroe County Bank v Qualls* (Ala 1929) 125 So 615; *Albertville Trading Co. v Critcher* (Ala 1927) 112 So 907. See *McCollum v Braddock Trust Co.* (Pa 1938) 198 A 803. Under the rationale followed in these cases, the courts construe the phrase "all other indebtedness" to mean all other debts similar to the primary debt. See *Beavers v LeSueur* (Ga 1939) 3 SE2d 667.

California courts have applied a similar test. Civil Code §3136 (former CCP §1188.1) gives preference to senior construction loans over mechanics' liens for optional as well as obligatory advances if the funds were used to pay for actual improvements to the property (see §9.71). Section 3136 would be sufficiently narrow to be unimportant were it not for the holding in *Turner v Lytton Sav. & Loan Ass'n* (1966) 242 CA2d 457, 51 CR 552, in which the court extended former CCP §1188.1 to a different dispute over priorities between a junior and a senior lienholder. Considerations of notice and whether the advance was optional or obligatory, which are most important in priority disputes (see §§9.68-9.73), may not control in disputes between debtor and creditor only. It is not hard to argue by analogy, however, that if a junior lienholder is to be further subordinated only to advances that actually relate to the property, the debtor's property should also be subject only to the liens of other advances that relate to either the property or the original loan. See *Fricker v Uddo & Taormina Co.* (1957) 48 C2d 696, 312 P2d 1085; *Hoover v Agriform Chem. Co.* (1969) 268 CA2d 818, 74 CR 325.

Under this test, items such as overdrafts on a checking account or personal unsecured loans, which are different in nature from the original transaction, would not be included within the security unless (1) the parties had specifically described them, stating in the deed of trust that such items were to be secured, or (2) the parties subsequently executed notes or other instruments of indebtedness that specified that such debts were secured by the deed of trust. Once they are so described, the debtor cannot argue that they were not intended to come under the deed of trust. However, if the creditor relies instead on the very general wording of the dragnet clause, it leaves itself open to the charge that the debtor did not know what the clause meant. In light of the past success of debtors' arguments in cases such as *Moran v Gardemeyer, supra; Lomanto v Bank of America* (1972) 22 CA3d 663, 99 CR 442; and *Gates v Crocker-Anglo Nat'l Bank* (1968) 257 CA2d 857, 65 CR 536, creditors will not solve their problems by writing increasingly broad dragnet clauses but by more specifically describing subsequent obligations to be secured.

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§9.65 (2) Reliance on Security

The decision in *Moran v Gardemeyer* (1889) 82 C 102, 23 P 8 (a companion case to *Moran v Gardemeyer* (1889) 82 C 96, 23 P 6, discussed in §9.63), illustrates another kind of test to determine whether the debt comes within the scope of the dragnet clause. In *Moran,* the court held that the real property mortgage did not secure the second loan, because the promissory note recited that a crop mortgage secured the note; thus the creditor could not claim to have relied on the real property security in making the loan. This treats a dragnet clause as a continuing offer by the borrower to secure further loans under the security that the lender may accept or reject when making a second loan, depending on its intent. The lender is not considered to have intended the loan to be secured by original security when it takes different security instead. See *Bloom v First Vt. Bank & Trust Co.* (Vt 1975) 340 A2d 78; *Second Nat'l Bank v Boyle* (Ohio 1951) 99 NE2d 474.

Under this rationale, an automobile loan (with the vehicle as security) should not come under a deed of trust held by the same bank. Even a personal loan from the bank, although not separately secured, might be disqualified if the bank's records and books show that the bank was not relying on its deed of trust when it made the loan. Compare *Hollywood State Bank v Cook* (1950) 99 CA2d 338, 221 P2d 988, with *Langerman v Puritan Dining Room Co.* (1913) 21 CA 637, 132 P 617.

In contrast, *Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549, held that reliance is demonstrated when the second note held by the same creditor is secured by a deed of trust on exactly the same property as that securing the first note. The result is that the first deed of trust secures both notes and the second deed of trust is superfluous, even though that does not appear to have been the parties' actual intention. This holding may make splitting a loan into two notes, secured by separate first and second deeds of trust on the same property, impossible whenever the first deed of trust contains a dragnet clause not expressly drafted to exclude the second note. In that event, a recital in the second note that the second, not the first, deed of trust secures it may be insufficient to create two separate notes. See *Simon v Superior Court* (1992) 4 CA4th 63, 5 CR2d 428.

The dragnet clause in the title company form in §9.59 effectively eliminates an independence reliance requirement by limiting coverage to future notes that actually recite that they are secured. The language of the second note will then establish whether the original deed of trust secures it.

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§9.66 c. Contemporaneous Obligations

The same considerations for determining whether preexisting or subsequent notes between the parties come under the dragnet clause (see §§9.64-9.65) should also control when another note is executed at the same time as the secured note. Assume that the debtor signs two notes and one deed of trust. One note recites that the deed of trust secures it and the other says nothing about the deed of trust. If the deed of trust recites that it secures the first note and contains a dragnet clause reciting that everything else is secured, does it cover the second note?

The logic of cases dealing with preexisting debts (see §9.62) dictates that the second note is unsecured because the parties' failure to specifically secure it by appropriate language in either the note or the deed of trust indicates a lack of intent to secure the second note. See *First v Byrne* (Iowa 1947) 28 NW2d 509; *Farmers Nat'l Bank v De Fever* (Okla 1936) 61 P2d 245; *Iser v Herbert Mark Bldg. Corp.* (NY Ct App 1930) 171 NE 757. But if the note is given for a purpose clearly related to that of the first note (see §9.64), and if the failure to secure the note expressly can be explained, the court may find contrary intent. See *Wong v Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 128 CR 338 (discussed in §9.59), in which a single real property development was divided into eight separate parcels, each serving as separate security under eight individual deeds of trust for eight separate promissory notes (in order to exceed the loan limits that would have been imposed on an undivided project). The debts were held tied together by the dragnet clauses in the instruments and thereby prevented the release of any one parcel without payment of the entire debt.

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§9.67 d. Undesirable Effects of Dragnet Clause

The discussion in §§9.61-9.66 assumes that it is the creditor who asserts that another debt is secured, but this is not always the case. A bank with a dragnet clause in its deed of trust may decide to ignore the clause and contend that the other loan is unsecured, for any of the considerations that may motivate the bank to prefer unsecured over secured loans. The moment a loan becomes secured, hindrances as well as benefits attach to it, such as the following:

- Personal collection actions are barred by CCP §726(a). *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873.
- The lender's right to attach the security for the second loan may also be lost. CCP §487.020; *Western Bd. of Adjusters v Covina Publ'g* (1970) 9 CA3d 659, 88 CR 293.
- If the deed of trust is foreclosed by trustee sale, CCP §580d bars any later personal action on the second note, making it entirely uncollectible. *Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549. See §5.12.

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§9.68 3. Lender Disputes Over Priorities

A junior creditor can take advantage of the same arguments available to a debtor (see §§9.61-9.67) concerning whether an obligation is secured by a senior deed of trust. Even if an obligation is secured, the junior can often also assert that, to the extent that the obligation was for funds later advanced, the junior deed of trust has priority.

EXAMPLE: *A* lends *O* $100,000 and takes back a deed of trust that also secures future advances; *B* then lends *O* $150,000, taking back a second deed of trust and giving *A* actual notice of this fact. Then, despite the notice, *A* voluntarily advances $200,000 more to *O* for a note reciting that the original deed of trust secures it. In this case, there is no doubt that *A*'s deed of trust secures $300,000 in loans to *O* and that *A* may take this much out of sale proceeds after a foreclosure. But there also is no doubt that *A* cannot take out its second $200,000 until after *B* has been paid, because *B*'*s* lien for $150,000 is prior to *A*'s lien for $200,000, even though *B*'s lien is junior to *A*'s lien for $100,000. *Garcia v Atmajian* (1980) 113 CA3d 516, 169 CR 845; *Reidy v Collins* (1933) 134 CA 713, 26 P2d 712.

Two facts in this example entitle *B* to leapfrog *A* for partial priority: (1) *A*'s second loan was optional (see §9.69), and (2) *A* had actual notice of *B*'s lien before it made the second loan (see §9.73). If either factor had been absent, *B* would not have achieved this priority.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.69 a. Optional Versus Obligatory Advances

§9.69 a. Optional Versus Obligatory Advances

In the example in §9.68, if *A* had originally bound itself to make a second, later loan to *O* of the $200,000, *A* would have been protected even though it made the second loan after it knew about *B*. Obligatory advances do not lose priority even when made with notice of the second lien. However, when advances are optional rather than obligatory, they retain the priority of the original lien only if they are made without notice of any intervening lien. *Lumber & Builders Supply Co. v Ritz* (1933) 134 CA 607, 25 P2d 1002.

The deed of trust, which is the only recorded document relating to the original transaction between *A* and *O,* rarely states whether future advances are optional or obligatory, and there is no requirement that it do so. In fact, *A* may offer evidence of a parol commitment to lend more to *O* later on. Proof of this oral agreement may be all that is needed to defeat a junior lienholder who claims priority based on having given notice before the second advance was made. *Lumber & Builders Supply Co. v Ritz, supra* (criticized in Note, *Mortgages & Trust Deeds: Future Advances: Priority Over Intervening Liens,* 22 Cal L Rev 705 (1934)); *Machado v Bank of Italy* (1924) 67 CA 769, 228 P 369. But see *Langerman v Puritan Dining Room Co.* (1913) 21 CA 637, 132 P 617.

Because of this rule, to protect itself, the junior creditor must do the following:

- Check the state of record title (which will lead to discovery of the senior deed of trust);
- Make an inquiry about the balance due on the senior deed of trust;
- Obtain warranties and representations from the borrower about the balance due under the senior trust deed;
- Obtain a beneficiary statement from the senior indicating the state of the account on the senior encumbrance, as permitted by CC §2943;
- Record its own deed of trust; and
- Give notice to the senior of the existence of this new lien.

Although CC §2943 does not specifically mention future advances, a senior lender would have difficulty claiming priority for later advances that it asserts are obligatory if they were not mentioned to the junior in the beneficiary statement. A person requesting a beneficiary statement is entitled to rely on its contents in accordance with its terms. CC §2943(d)(1). The junior can also request an estoppel certificate from the beneficiary with respect to future advances.

A lender considering making an additional advance must also confirm that the borrower has not filed a bankruptcy that could interfere with the lender's priority on the additional advance. See *Beeler v Jewell (In re Stanton)* (9th Cir 2002) 285 F3d 888 (optional advance made following bankruptcy by lender with knowledge of bankruptcy was secured but subordinate to trustee's interest).

There are legal as well as evidentiary problems concerning future advances. Advances may appear obligatory in form when in substance they are not, or a creditor may be under a real, though not contractual, compulsion to advance more funds to protect the security (see §§8.76, 8.78-8.80). If the loan agreement both states that the lender is compelled to make future advances and contains exculpatory clauses excusing it from doing so (as when the debtor is not otherwise in default or the project has not achieved sufficient build-out), subsequent advances may be optional rather than obligatory if circumstances permitted the lender to decline. *Midlantic Nat'l Bank v Commonwealth Gen., Ltd.* (Fla App 1980) 386 So2d 31, 33. Indeed, a lender may be justified in refusing to make obligatory advances under the doctrine of prospective failure of consideration. See California Law of Contracts §11.52 (Cal CEB 2007). Such discretion, however, may be overruled by good faith lender-liability requirements. See, *e.g., K.M.C. Co. v Irving Trust Co.* (6th Cir 1985) 757 F2d 752, 759.

NOTE: Modern deeds of trust typically provide that when a lender advances funds to avoid a tax foreclosure sale or to purchase property insurance, these advances are conclusively deemed to be mandatory; however, junior lienholders may not be bound by this provision. See, *e.g., Pike v Tuttle* (1971) 18 CA3d 746, 751, 96 CR 403; *Imhoff v Title Ins. & Trust Co.* (1952) 113 CA2d 139, 247 P2d 851. For discussion and enforcement strategies, see §8.80. See also California Real Estate Finance Practice: Strategies and Forms, chap 4 (Cal CEB 2000).

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§9.70 b. Revolving Line of Credit Problems

One of the more difficult priority problems faced by real property practitioners is ascertaining the priority of a revolving credit obligation. These obligations may arise from complex commercial lines of credit secured by real property or from a personal line of credit that a single-family residence secures. The basics are the same for both types of lines of credit: The debtor may borrow, repay, and reborrow funds over a specific time period, subject to specific conditions, and secured by a lien on real property.

Although no recent cases have considered the priority of advances under revolving credit loans, the principles involved should be the same as those discussed in §§9.68-9.69. If the advances are truly obligatory and are subject only to satisfaction of certain objective conditions, they should be entitled to priority relating back to the date on which the deed of trust or mortgage was recorded, regardless of the lender's actual notice of any subsequent junior encumbrances. If the advances appear discretionary but the lender is held subject to a good faith and fair dealing or commercial reasonableness requirement, they may be treated as obligatory despite their appearance. See discussion of covenant of good faith and fair dealing in §§12.18-12.22.

Lenders can purchase title insurance coverage to protect the priority of later advances, but this coverage typically exempts from coverage liens, encumbrances, or other matters after the policy date that are actually known to the insured before the date of such advances. Lenders can also obtain a broader endorsement omitting the exemption when the lender's advances are obligatory, but it will not cover any advances the lender makes after a known and uncured default by the borrower. Lenders often obtain protection, before making an advance that could be construed as being optional, by procuring an endorsement to their title policy from the California Land Title Association (CLTA) 122 series, ensuring that the additional advance will have the same priority as the original loan. See California Title Insurance Practice §§8.61-8.62 (2d ed Cal CEB 1997).

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§9.71 c. Construction Loan Problems

Construction loans frequently involve issues of obligatory versus optional advances. Often, the construction loan funds are transferred in a lump sum ("assigned") into a special account from which the funds are paid to the borrower or the contractor as progress payments for work completed. Such a transfer permits the borrower to avoid paying interest on unused money and allows the lender to monitor construction to ensure that the job conforms to the plans. Typically, a borrower makes interest payments only on the funds actually disbursed until the entire loan has been disbursed, and then the loan converts to a fully amortized loan repayment schedule. If the borrower defaults on repayment before the construction lender fully disburses the loan funds but after junior lienholders (including mechanics or materialmen) record their liens and notify the lender, the construction lender faces real risks that if it uses the remaining funds to complete the project, those newly advanced funds may lack the priority of the previously disbursed funds. See *A-1 Door & Materials Co. v Fresno Guar. Sav. & Loan Ass'n* (1964) 61 C2d 728, 40 CR 85 (stop notice has priority over assignment of construction loan funds under CC §3166). See also *Miller v Mountain View Sav. & Loan Ass'n* (1965) 238 CA2d 644, 48 CR 278. Stop notice claimants may also have priority over portions of the loan proceeds allocated to loan fees and interest actually paid during the construction period. *Familian Corp. v Imperial Bank* (1989) 213 CA3d 681, 262 CR 101.

The construction lender may argue that there were no future advances, because the entire loan was made when the money was put into the special account. Compare *Valley Lumber Co. v Wright* (1905) 2 CA 288, 84 P 58, with *Lanz v First Mortgage Corp.* (1932) 121 CA 587, 9 P2d 316. See 2 Nelson & Whitman, Real Estate Finance Law, chap 12 (5th ed 2007). The junior lienholder can argue, however, that the obligation was specious because the construction loan agreement undoubtedly permitted the lender to withhold further disbursements once a default occurred, so that all payments made thereafter were optional rather than obligatory. Compare *Fickling v Jackman* (1928) 203 C 657, 265 P 810, with *Citizens' Sav. Bank v Mack* (1919) 180 C 246, 180 P 618. The senior may respond that, even if the later payments were optional, they were nevertheless necessary to protect the security. The lender should not be denied priority, because a half-finished project is a liability and the remaining payments actually improved the property, benefiting juniors as well. See CC §3136; *Turner v Lytton Sav. & Loan Ass'n* (1966) 242 CA2d 457, 51 CR 552. See also CC §2876; *Savings & Loan Soc'y v Burnett* (1895) 106 C 514, 39 P 922; *Machado v Bank of Italy* (1924) 67 CA 769, 228 P 369.

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§9.72 d. Wraparound Loan Problems

A wraparound note (see §§9.36-9.41) generally provides that the noteholder will make the payments on the senior debt wrapped inside it, usually from the payments that the debtor is obligated to make to the wraparound lender. The wraparound noteholder's obligation to service the senior debt may be absolute, but it is usually made conditional on the debtor's not being in default to the wraparound lender. If the obligation is unconditional, payments to the senior lender by the wraparound lender may arguably be obligatory advances, with priority over even known inferior liens (see §9.69). In contrast, when the lender's obligation to service the senior loan is conditional, a junior lender may claim that the payments are merely optional and not entitled to priority. However, because such payments protect the security of both junior lienholders, the payments have priority. CC §2876. For discussion of payments on senior liens, see §§8.78-8.80. The wraparound lender may also claim that it is subrogated to the security position of the senior lienholder. See *Caito v United Cal. Bank* (1978) 20 C3d 694, 144 CR 751.

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§9.73 e. Actual Versus Constructive Notice

A junior lender records both a deed of trust and a request for notice of default on the senior deeds of trust under CC §2924b (see §2.6). Neither recordation deprives the holder of the first deed of trust of priority for optional future advances made after such recordation. Recordation of the second deed of trust gives constructive notice of its contents to all who come after, but it does not constitute notice to senior lienholders already of record. *Savings & Loan Soc'y v Burnett* (1895) 106 C 514, 39 P 922; *Lanz v First Mortgage Corp.* (1932) 121 CA 587, 9 P2d 316. Similarly, recordation of a request for notice of default does not impart notice of any interest in the property. CC §2924b(f). A junior who seeks full protection against future advances taking priority over it must see that the senior has actual knowledge of the junior lien. See *Tapia v Demartini* (1888) 77 C 383, 19 P 641; *Atkinson v Foote* (1919) 44 CA 149, 186 P 831.

Sensible policy considerations underlie this requirement. All lenders intending to take real property as security for their loans examine the state of title to the property in order to learn whether the debtor even owns the property and whether there are prior liens against the title. A junior with notice of the existence of an already recorded deed of trust is charged with notice of its contents, making it appropriate for the junior to read the provisions of any senior deed of trust and giving the junior a chance to discover the existence of any future-advance clause in it. A prudent junior then writes the senior, asking whether any agreements exist with regard to obligatory future advances. Civil Code §2943 may provide a vehicle for obtaining this information, although it does not specifically mention future advances (see §9.69). (A junior may also attempt to obtain an estoppel certificate or statement of condition from the senior that sets forth the provisions on future advances.) As part of the same inquiry, the junior should inform the senior of the junior's existence and status in order to gain protection against later optional advances by the senior.

If mere recordation of the junior deed of trust were considered sufficient notice to the senior, senior lenders would be compelled to run new title checks before each advance or progress payment, a burden that would be cumbersome, unnecessary, and destructive of continuing lines of credit and open-account financing.

Although the constructive notice imparted by recordation is not adequate to protect the junior, the senior's actual knowledge of facts sufficient to create a duty of inquiry may do so. For example, if the junior is a contractor, subcontractor, or material supplier, the senior may be charged with notice of the junior lien if it had actual knowledge that work had begun or materials had been delivered to the property, even without actual notice that a contractor or supplier has a claim. *W.P. Fuller & Co. v McClure* (1920) 48 CA 185, 192, 191 P 1027.

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H. Subordination and Release Provisions

§9.74 1. Definitions

Most common form deeds of trust contain provisions authorizing the beneficiary to subordinate the lien of the security to another lien and to release portions of the security ("reconvey all or any part") under appropriate circumstances.

"Subordination" refers to one party's agreement to accept a priority status below that of a subsequent party. In the deed of trust context, it can indicate one beneficiary's consent to be junior to another beneficiary or to a lease, or to a tenant's willingness to subject the lease to a later deed of trust. See, *e.g.,* §§6.85-6.96. Subordination is often referred to as a "subordination clause" when it appears as part of a buyer's offer to purchase and as a "subordination agreement" when it is included in an agreement creating or dealing with an existing security interest. On subordination, see California Real Estate Finance Practice: Strategies and Forms, chap 3 (Cal CEB 2000); California Real Property Sales Transactions §§9.66-9.99 (4th ed Cal CEB 2007).

Partial release provisions permit the trustor to remove from the coverage of a blanket deed of trust some but not all of the real property serving as security for a loan. Without a release provision, the entire property will secure the debt until it is entirely paid. CC §2912. See §9.87. For discussion of release provisions, see Real Property Sales §§9.100-9.110. Although the issues raised by release provisions do not generally involve priority questions, these matters are covered in §§9.76-9.87 because of the close similarity of analysis in subordination and release cases.

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2. Creating Subordination and Release

§9.75 a. Recordation Versus Express Contract; Automatic Subordination

Although subordination usually occurs as the result of an express agreement (with the subordinating lender often being a third party beneficiary of that agreement; see §9.77), subordination can also occur by less explicit means. "Automatic subordination" is the term often used by courts to describe situations in which, without any express executory agreement, parties acquiring interests in land provide (usually by way of escrow instructions) that instruments are to be recorded in a particular order. This phenomenon was described in *Brown v Boren* (1999) 74 CA4th 1303, 88 CR2d 758.

Automatic subordination can be confusing because it uses order of recordation as an indication of priority in circumstances when the recordation acts have no formal impact, because all parties know about each other and none can therefore qualify as a bona fide purchaser or encumbrancer. Automatic subordination is best understood as a situation in which order of recordation determines priority based either on an express or implied contract or an estoppel.

The term "automatic subordination" is sometimes also used to describe what occurs automatically by contract, such as when a lease clause provides that the lease "is now and at all times hereafter shall be subordinate" to any loan secured by (or any ground lease on) the property. In this situation, no further execution of a document will be needed to effect the subordination of a later executed mortgage or lease. See §6.92.

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§9.76 b. Role of Subordination and Release Provisions in Land Development

Developers assembling raw land for subdivision and construction frequently use subordination and release. A developer-purchaser who requires the seller to take back a deed of trust for part of the purchase price must ascertain in advance if the seller will accept a deed of trust that will subsequently become inferior to a deed of trust given to a lender to secure a construction loan. On subordination as element of seller financing, see California Real Property Sales Transactions §§9.66-9.99 (4th ed Cal CEB 2007). Similarly, if a purchaser intends to develop and sell acreage as individual lots over time, it is essential that the lender (seller or bank) agree in advance to release parcels from the blanket deed of trust as they are sold.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.77 c. Express Subordination and Release Clauses in Purchase Contract

§9.77 c. Express Subordination and Release Clauses in Purchase Contract

In a land-development subordination situation, the purchaser's offer to buy will include the stipulation, "Subject to the seller's accepting a deed of trust, which shall be subordinate to…." The deed of trust taken by the seller includes a provision reciting that the instrument is inferior in priority to some other lien (see §9.79); alternatively, the parties will direct the escrow agent to record only after the subordinating lien has been recorded (see §9.75).

In a release situation, the offer to buy will provide, "Subject to inclusion in the deed of trust of a provision for release of specified land from the deed of trust as follows…." Individual releases or reconveyances of parcels from the deed of trust will be recorded as the terms of the release are met.

Without such clauses, neither subordination nor release can be forced on the lender. See *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 92 CR 851. See also §9.87. However, subordination may be created later by agreement or by equitable decree. See §§9.84-9.85.

NOTE: A subordination agreement must comply with the large-print requirements of CC §§2953.1-2953.4, unless either the subordinating loan or the loan to be subordinated exceeds $25,000. CC §2953.5.

A release clause usually also requires that a subdivision map be recorded before the first parcel is released. Otherwise, it might constitute an illegal lot split. Govt C §66499.30; see California Subdivision Map Act and the Development Process §2.6 (2d ed Cal CEB 2001).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.78 d. Timing Concerns

§9.78 d. Timing Concerns

The time for working out satisfactory subordination or release arrangements is when the seller and purchaser first enter into negotiations for sale of the real property. California courts often refuse to grant specific performance against a seller who refuses to sell when the terms of subordination or release have not been drawn with sufficient specificity to minimize the seller's risk. See California Real Property Sales Transactions §§9.66-9.99 (4th ed Cal CEB 2007); California Real Property Remedies and Damages, chap 5 (2d ed Cal CEB 2002). To be enforceable, the subordination or release provision must be both specific and fair. A purchase and sale agreement that merely calls for execution of a subordination or release clause, without setting forth its essential terms, is unenforceable. *Handy v Gordon* (1967) 65 C2d 578, 55 CR 769 (subordination); *White Point Co. v Herrington* (1968) 268 CA2d 458, 73 CR 885 (release).

Regarding subordination, courts first held that the details of all provisions of the subordinating loan—including use of its proceeds, its maximum amount, interest rate, maturity, points, prepayment, and acceleration provisions—must be set forth in the purchase and sale agreement. *Magna Dev. Co. v Reed* (1964) 228 CA2d 230, 39 CR 284. Later decisions have eroded this strict rule somewhat by holding sellers liable for damages for refusing to honor contracts containing release clauses even though they would have been too ambiguous to support specific performance. See *Larwin-Southern Cal., Inc. v JGB Inv. Co.* (1979) 101 CA3d 626, 162 CR 52; *Yackey v Pacifica Dev. Co.* (1979) 99 CA3d 776, 160 CR 430. A subordination clause may be for the buyer's benefit, so that the buyer can waive it and obtain specific performance against a reluctant seller, as seen in *Reeder v Longo* (1982) 131 CA3d 291, 182 CR 287 (directly contradicting decision in *Magna Dev. Co. v Reed, supra*).

For a partial release clause to be enforceable, it may be necessary to draft a complete release plan, including the release price per parcel and all restrictions on releases, such as maximum or minimum size, contiguity, and avoidance of "landlocking," plus provisions for the relationship between regular installment loan payments and partial releases. *White Point Co. v Herrington, supra*. A release map of the property is helpful. However, so much specificity is often difficult to obtain early in the project planning. At the very least, the clause should specify maximum and minimum lot sizes for release. It must adequately protect the releasing party (the lender) with respect to adjacent parcels, access, and utilities, and the like in order for the developer to obtain specific performance of it. *Eldridge v Burns* (1978) 76 CA3d 396, 142 CR 845.

PRACTICE TIP: From the lender's point of view, a well-drafted release clause will preclude "cherry-picking" the most valuable portions of the security and will improve rather than degrade the lender's margin of security with each release.

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§9.79 e. Collateral Agreement for Subordination and Release in Security Instrument

In addition to incorporating complete terms for subordination or release into their purchase and sale agreement (see §9.77), the parties should include those terms in the deed of trust securing the loan. They may include enforceable subordination or release provisions in the security instrument even if their purchase contract omitted them. The former potential unenforceability of the contract (for lack of certainty) is immaterial if the parties eliminate that uncertainty by inserting appropriate language in the deed of trust. Even if the subordination or release clause is still not completely adequate, the further the transaction has progressed, the less willing courts become to undo it for uncertainty.

A subordination agreement in the original purchase contract is performed by either (1) later including a clause in the deed of trust that recites that the instrument is to be subordinated to some other instrument (executory subordination) or (2) not having the seller's security instrument recorded until after the developer records its other loan instrument, so that the time of recordation establishes the priorities (executed subordination). CC §2897. On distinctions between executory and executed agreements, see California Real Property Sales Transactions §§9.66-9.99 (4th ed Cal CEB 2007).

A release agreement is first implemented by including the provisions for release of individual parcels in the blanket deed of trust. Final performance occurs only when release or reconveyance documents for undeveloped lots are ultimately executed and recorded.

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§9.80 3. Enforcing Subordination Clauses

The primary concern of a subordinated seller-lender is that the developer properly use all proceeds from the senior loan on the property itself in order to increase the security value of the property correspondingly and thus protect the subordinated security interest. For instance, if a seller conveys raw land worth $500,000 to a developer for $100,000 cash and a note and deed of trust for $400,000 to be subordinated to a construction loan deed of trust for $1 million, the arrangement makes sense only if the completed product (land and buildings) has a value of at least $1,400,000. In the ordinary situation, this makes it necessary that the developer actually expend all construction funds on the property. If some senior funds are misspent, thus impairing the seller's security, the seller may seek appropriate relief from numerous parties (see §§9.81-9.82).

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§9.81 a. Relief Against Subordinating Lender

A subordinated seller may seek a total or partial reversal of priorities, or comparable monetary relief, against the subordinating lender whose failure to execute appropriate control over the construction funds has endangered the subordinated seller's security. *Middlebrook-Anderson Co. v Southwest Sav. & Loan Ass'n* (1971) 18 CA3d 1023, 96 CR 338. See *Gluskin v Atlantic Sav. & Loan Ass'n* (1973) 32 CA3d 307, 108 CR 318; *Miller v Citizens Sav. & Loan Ass'n* (1967) 248 CA2d 655, 56 CR 844; *Brown v Boren* (1999) 74 CA4th 1303, 88 CR2d 758. But see *Gill v Mission Sav. & Loan Ass'n* (1965) 236 CA2d 753, 46 CR 456; *Campbell v Scripps Bank* (2000) 78 CA4th 1328, 93 CR2d 635 (prior determination that priority not lost despite failure to adhere to subordination agreement was basis for collateral estoppel).

Middlebrook rejected construction lenders' contentions that they owed no supervisorial duties to subordinated sellers when the subordination occurred by virtue of delayed recordation rather than under a subordination clause in the seller's deed of trust, because they gained their priority by virtue of the recordation laws rather than by the seller's consent. The court held that regardless of how the subordination was accomplished, the seller is a third party beneficiary of the construction loan provision that the lender will oversee disbursements.

The *Middlebrook* doctrine was later extended in *Protective Equity Trust v Bybee* (1991) 2 CA4th 139, 2 CR2d 864, to apply even when the loan documents did not require the construction lender to oversee disbursement of the loan proceeds, as long as the lender knew of the subordination. The doctrine was extended even further in *Plastino v Eureka Fed. Sav. & Loan Ass'n (In re Sunset Bay Assocs.)* (9th Cir 1991) 944 F2d 1503, which held that the construction lender gains priority over the seller's subordinated loan only if its own loan complies with the terms of the subordination agreement, whether or not the lender actually knows those terms.

The doctrine was restricted in *Swiss Prop. Mgmt. v Southern Cal. IBEW-NECA Pension Plan* (1997) 60 CA4th 839, 70 CR2d 587, which held that a specific, unconditional subordination by the seller can free the lender from supervisory duties. The parties in *Swiss Property* used the standard CLTA subordination form, which requires the subordinating seller to acknowledge the following:

- The named lender would not make the subordinating loan without the specific subordination;
- Prior agreements are superseded;
- The lender has no obligation to oversee disbursement of the loan proceeds; and
- The buyer's misuse of loan proceeds will not defeat the subordination.

The conflict between judicially imposed "good faith" duties and contractually created disclaimers of them is not yet fully resolved.

There is no need for the same special judicial protections when the subordinating loan is for acquisition rather than construction, because its funds go to the seller directly. See *Schneider v Ampliflo Corp.* (1983) 148 CA3d 637, 196 CR 172; *Thomas v Fox* (1982) 128 CA3d 361, 180 CR 253.

PRACTICE TIP: When representing a putatively subordinated seller or other party seeking to upset an apparent subordination, be sure to assert real property, contract, and equitable theories for reversing priority in addition to fraud and other more widely known tort theories. One litigant, which probably had good grounds to reverse a subordination, was unsuccessful because it relied strictly on fraud and conspiracy theories and did not assert "contract theories" of priority in a timely fashion. *Brown v Boren* (1999) 74 CA4th 1303, 88 CR2d 758.

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§9.82 b. Relief Against Other Parties

Monetary relief may also be obtained against the purchaser-developer for failing to spend the funds properly. *Joanaco Projects, Inc. v Nixon & Tierney Constr. Co.* (1967) 248 CA2d 821, 57 CR 48. Misuse may be a breach of contract or type of fraud, and recovery for it may escape the antideficiency rules, depending on how it is pleaded. See §§4.48-4.53, 5.54-5.59.

A seller may also have damage claims against other parties for their failure to properly protect the seller. *Starr v Mooslin* (1971) 14 CA3d 988, 92 CR 583 (attorney); *Timmsen v Forest E. Olson, Inc.* (1970) 6 CA3d 860, 86 CR 359 (broker); *Ruth v Lytton Sav. & Loan Ass'n* (1968) 266 CA2d 831, 72 CR 521 (escrow).

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§9.83 4. Effect of Loan Modifications on Priority

Material modifications to a secured loan can result in a full or partial loss of priority to unconsenting junior interests, depending on the circumstances. See §§10.23-10.27. See also Giesen, *"Routine" Mortgage Modifications: Lenders Beware,* 17 Real Est LJ 221, 224 (1989); Bernhardt, *Solomonic Priority,* 20 CEB Real Prop L Rep 164 (July 1997).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.84 5. Subsequent Subordination Agreement

§9.84 5. Subsequent Subordination Agreement

Subordination can be accomplished without enabling language in the deed of trust if both trustor and beneficiary agree and no third parties with valid grounds object. A trustor and beneficiary can agree at any time to subordinate the lien of their instrument to some other lien; they need only execute a separate subordination agreement to accomplish this purpose. *International Mortgage Bank v Eaton* (1918) 39 CA 39, 177 P 880. When the trustor is entirely unaffected, the beneficiary can probably subordinate its lien unilaterally, without the trustor's or rival lienholder's consent. The trustor's consent is undoubtedly needed if it would suffer, as might occur if the beneficiary subordinated its non-purchase money lien to a previously junior purchase money lien, thus increasing exposure to liability for a deficiency. See *Lomanto v Bank of America* (1972) 22 CA3d 663, 99 CR 442.

The parties can also accomplish a form of de facto subordination by having the subordinated lender agree to delay recordation of its deed of trust until after the subordinating lender (usually a construction lender) has recorded its instrument. See California Real Property Sales Transactions §§9.66-9.99 (4th ed Cal CEB 2007).

PRACTICE TIP: Automatic subordination is an unreliable mechanism and can raise a host of litigation issues, as reflected in *Middlebrook-Anderson Co. v Southwest Sav. & Loan Ass'n* (1971) 18 CA3d 1023, 96 CR 338; *Plastino v Eureka Fed. Sav. & Loan Ass'n (In re Sunset Bay Assocs.)* (9th Cir 1991) 944 F2d 1503; *Protective Equity Trust v Bybee* (1991) 2 CA4th 139, 2 CR2d 864; and *Brown v Boren* (1999) 74 CA4th 1303, 88 CR2d 758. Prudent counsel for the subordinating lender should demand a specific and express contractual subordination, as in *Swiss Prop. Mgmt. v Southern Cal. IBEW-NECA Pension Plan* (1997) 60 CA4th 839, 70 CR2d 587.

A subordination agreement between some but not all of the lienholders can create difficulty regarding distribution of foreclosure or other sales proceeds. An incomplete or partial subordination only affects parties participating in the agreement and consequently creates a circuity of liens for other lienholders. See, *e.g., Bratcher v Buckner* (2001) 90 CA4th 1177, 109 CR2d 534, and analysis in Bernhardt, *The Editor's Take,* 24 CEB Real Prop L Rep 256 (Oct. 2001). In that situation, the borrower cannot take advantage of the failure of the lienholders to make clear the relative priority of the liens. The court will determine the distribution of the proceeds in an interpleader action. See, *e.g., Wells Fargo Bank v Neilsen* (2009) 178 CA4th 602, ___ CR3d ___.

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§9.85 6. Equitable Subrogation

Another form of subordination can occur through judicial application of the doctrine of equitable subrogation. See *Smith v State Sav. & Loan Ass'n* (1985) 175 CA3d 1092, 223 CR 298. Under this doctrine, a lender who refinances a senior lien without actual knowledge of existing junior liens is subrogated to the priority position of the senior lien, and junior liens remain in their subordinated position even though they are prior in time to the new, subrogated lien. The relief, however, is often limited to cases in which the refinancing lender has no notice of the intervening liens. *Lawyers Title Ins. Corp. v Feldsher* (1996) 42 CA4th 41, 49 CR2d 542. Regarding whether actual or constructive notice is controlling, see Bernhardt, *Paying the Wrong Debt,* 19 CEB Real Prop L Rep 212 (Oct. 1996).

Under CC §2904, a lender with an existing lien that pays off a senior lien in order to protect its security is subrogated to the benefits of the paid-off lien and appears to have priority over any intervening liens, even though it may have notice of them.

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§9.86 7. Enforcing Release Clauses

The primary concern of the parties under a blanket deed of trust with a release provision is that the provision be clear enough to bind both parties when the debtor seeks the release of individual lots. See *Eldridge v Burns* (1978) 76 CA3d 396, 142 CR 845; *Lawrence v Shutt* (1969) 269 CA2d 749, 75 CR 533. Additionally, the parties need to protect themselves against the claims of either junior creditors or purchasers of other lots that releases were improperly made (see §9.87). Even when the deed of trust clearly specifies the order of release, however, the buyer must be careful that the selection of release parcels does not appear to be inequitable. See *Eldridge v Burns* (1982) 136 CA3d 907, 186 CR 784.

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§9.87 8. Release Without Express Release Clause; Marshaling

When there is no release clause, the trustor has no right to demand partial releases of the property from the lien of the deed of trust as the debt is reduced. CC §2912. See *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 92 CR 851; *Miller v Federal Land Bank* (9th Cir 1978) 587 F2d 415.

EXAMPLE: If a deed of trust secures a debt of $1 million on 100 acres, the trustor must pay the entire $1 million before the beneficiary frees a single acre from the deed of trust. The trustor cannot demand that the beneficiary release an acre for each $10,000 paid.

The absence of a release clause in the original documents does not bar the trustor and beneficiary from subsequently agreeing that some part of the property will be released from the blanket deed of trust. Such a release should be enforceable between the parties, but it may be objectionable from the viewpoint of third parties. Under CC §§2899 and 3433, junior creditors and transferees have the right to "marshal" assets. A junior creditor who has a lien on only part of the property subject to the senior blanket deed of trust may insist that the senior foreclose and first sell off the part of the property that is not subject to the junior lien in order to improve the chances of recovery by the junior. This is known as the "two-fund rule." This rule may prohibit the senior beneficiary and the trustor from agreeing to release parcels that are not subject to the junior lien without first obtaining the junior's consent.

The junior needs this protection to ensure that lots subject only to the senior lien not be released for less than their share of the property's value. Otherwise, the remaining lots will bear a disproportionately large share of the balance and reduce the junior's prospects of being paid out of the surplus.

EXAMPLE: Assume that the senior holds a blanket deed of trust on 100 lots securing a loan of $1 million, that each lot has a value of $15,000 (for a total value of $1.5 million), and that a junior lienholder holds a second deed of trust on lots 1-10. Because the lots together are worth more than the senior lien, the junior can expect to be paid out of the surplus value as the senior either sells or forecloses on the lots. But if the senior releases lots 11-100 for only $800,000, that leaves the remaining 10 lots securing a balance of $200,000, or $20,000 per lot. The releases thus deprive the junior of any chance for a surplus on foreclosure.

See *Woodward v Brown* (1897) 119 C 283, 51 P 542.

Business and Professions Code §11013.1 prohibits a subdivider from selling lots subject to a blanket deed of trust unless it includes an enforceable release clause. See Forming California Common Interest Developments §3.37 (Cal CEB 2004).

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§9.88 V. MULTIPLE PARTIES

The sections that follow discuss the liability and defenses of parties other than the original trustor or borrower who may also be liable, directly or indirectly, for payment of an obligation secured by real property. Such parties include the following:

- Guarantors and sureties (see §§9.88A-9.90B);
- Negotiable instrument accommodation parties and endorsers (see §§9.118-9.121);
- Letter of credit issuers (see §§9.113-9.117); and
- Subsequent owners of the real property security (see §§9.122-9.136).

Multiple-party issues can also arise when a transaction simply involves more than one borrower. See §4.30 (application of CCP §726 to codebtors), §9.88F (ostensible principal obligor deemed to be surety), and §9.118 (accommodation makers).

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A. Guarantors and Sureties

§9.88A 1. Definitions and Terminology

Since 1939, CC §2787 has defined the terms "surety" and "guarantor" the same: "one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor." (Regarding the pre-1939 distinction, see §9.88C.) Section 2787 provides that "[t]he terms and their derivatives, wherever used in this code or in any other statute or law of this state now in force or hereafter enacted, shall have the same meaning as defined in this section." "Surety" is the more frequently used term throughout the Civil Code's "Suretyship" title, CC §§2787-2856, but must be read to include "guarantor." The statute uses the terms "guarantor" and "guaranty" in the context of guaranties of collection (CC §§2800-2802; see §9.89Y) and continuing guaranties (CC §§2814-2815; see §9.89Z), but CC §2787 specifies that these are simply "forms of suretyship obligations" and, except as otherwise specifically provided, are subject to all of the general suretyship provisions.

NOTE: Although CC §2787 defines "surety" and "guarantor" identically and abolished the prior distinction between them, CC §2856 refers to a "guarantor or other surety" (and to a "guaranty or other type of suretyship obligation"), intimating that the terms are not exact equivalents, "guarantor" being a type of "surety." In practice, "guarantor" is most commonly used when referring specifically to a party who has executed an explicit "guaranty" agreement (see §9.88E), but such a party is also clearly a "surety" (and the guaranty is a "suretyship obligation") under the Civil Code.

In §§9.88B-9.90B, portions of the discussion focusing on the Civil Code provisions use primarily the term "surety," as does the statute itself; portions of the discussion focusing on one-action, antideficiency, and related case law use primarily the term "guarantor" because most of the cases deal with explicit guaranties. However, the two terms should be regarded as interchangeable in legal effect, except as otherwise expressly indicated.

The party whose debt is the subject of a guaranty or suretyship obligation is referred to throughout the Civil Code's suretyship provisions as the "principal." The principal's debt is referred to variously as the "principal obligation," "principal debt," and "principal contract," and in one instance as the "underlying agreement."

In practice, the principal is often referred to as the "principal obligor," the principal obligation as the "underlying obligation," the guarantor or surety's obligation as a "secondary obligation," and the guarantor or surety as a "secondary obligor." This terminology is used in Restatement (Third) of Suretyship and Guaranty (1996). See Restatement §1(1)(a). See also *Western Sec. Bank v Superior Court* (1997) 15 C4th 232, 62 CR2d 243. The terms "secondary obligor" and "secondary obligation" are also used in Commercial Code Division 9. See, *e.g.,* Com C §9102(a)(71), (77). See also §9.89Q.

In the context of negotiable instruments, as governed by Commercial Code Division 3, an "accommodation party" is a surety. See Com C §3419(a). See also §§9.88F, 9.118-9.121.

PRACTICE TIP: A very useful surety law resource is the combination of Restatement (Third) of Suretyship and Guaranty (1996) and *California Commentary on the Restatement of the Law Third, Suretyship and Guaranty,* 34 Loy LA L Rev 231 (2000), the latter (prepared by the UCC Committee of the State Bar's Business Law Section) detailing how the Restatement compares with and differs from California statutes and case law.

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§9.88B 2. Surety Distinguished From Principal Obligor

The implicit premise of CC §2787's definition of a guarantor or surety as one who promises to "answer for the debt … *of another*" (emphasis added) is that such *other* party is the one who should ultimately be responsible for the debt. Suretyship status "arises where two persons are under obligation to the same obligee, who is entitled to but one performance, as between the two who are bound, and one of them should ultimately bear the burden of the obligation. The obligor ultimately responsible for the debt is the principal and the other is the surety." *Everts v Matteson* (1942) 21 C2d 437, 447, 132 P2d 476. See Restatement (Third) of Suretyship and Guaranty §1(1) (1996).

An obligor who receives the direct benefit of the value given by the obligee—*e.g.,* an obligor who receives the proceeds of a loan made by the obligee—is normally the principal. Other obligors, who do not receive the direct benefit, are normally sureties. See Restatement §1, Comment p; Com C §3419(a) (accommodation parties). See also §§9.88F, 9.118.

By virtue of suretyship status, under the Civil Code a surety acquires rights of recourse against the principal (see §§9.88P-9.88R), rights of contribution from cosureties (see §9.88S), and suretyship rights and defenses as against the creditor (see §§9.88T-9.88X). However, CC §2856(a)(1) provides that all of these are waivable (see §9.89L), and they are often waived.

When a principal obligation is secured by real property, a crucial consequence of suretyship status in California is that even though the principal obligor is protected by the one-action and antideficiency rules (see chaps 4-5), case law has not extended those protections directly to a surety (although some apply indirectly) (see §§9.88Z-9.89G) unless the suretyship obligation is itself secured by real property (see §9.89H). Moreover, to whatever extent one-action and antideficiency rules might apply to the surety in this situation, directly or indirectly, they are waivable under CC §2856(a)(3) (see §9.89N), and they are often waived. Waivers by a principal obligor are prohibited at the outset and limited subsequently. See CC §2953; see also §§4.60-4.66, 5.64-5.70. Thus, to prevent subterfuge, courts carefully scrutinize whether a party that is ostensibly a surety truly has that status. See §§9.89S-9.89X.

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§9.88C 3. Prior Distinction Between Guarantors and Sureties Abolished

Current California law does not distinguish between a guarantor and a surety. See §9.88A. Civil Code §2787, as amended in 1939, abolished the prior distinction.

Before 1939, many of the rights and defenses of the Civil Code's suretyship provisions applied to sureties only, not to guarantors. See Cormack & McCarroll, *The Distinction Between Suretyship and Guaranty in States Having the Field Code Provisions,* 10 S Cal L Rev 371, 383-388 (1937). Under present §2787, that is no longer the case. However, the pre-1939 distinction between guarantors and sureties remains relevant to understanding and assessing the precedential value of case law from that era, which continues to be cited, often without consideration of the intervening statutory change.

In many states, a distinction between sureties and guarantors was established as a matter of common law. The courts identified a variety of supposedly distinguishing characteristics, including most commonly the concept that a surety is bound *with* the principal on the same contract, whereas a guarantor's contract, to perform on the principal's default, is separate. Cormack & McCarroll, 10 S Cal L Rev at 371-374; Radin, *Guaranty and Suretyship,* 18 Cal L Rev 21, 23-25 (1929); see also Restatement (Third) of Suretyship and Guaranty §1, Comment c (1996).

In California and other states adopting the Field Code, however, the guarantor-surety distinction was statutory. California's 1872 Civil Code set out the pre-1939 definitions as follows:

- "A guaranty is a promise to answer for the debt, default, or miscarriage of another person." Former CC §2787 (1872).
- "A surety is one who at the request of another, and for the purpose of securing to him a benefit, becomes responsible for the performance by the latter of some act in favor of a third person, or hypothecates property as security therefor." Former CC §2831 (1872).

These and other contemporary distinctions between guarantors and sureties were examined in two prominent articles (Radin, *Guaranty and Suretyship* (pts 1-2), 17 Cal L Rev 605 (1929), 18 Cal L Rev 21 (1929), and Cormack & McCarroll, *The Distinction Between Suretyship and Guaranty in States Having the Field Code Provisions,* 10 S Cal L Rev 371 (1937)), which found the distinctions futile and of spurious origins and urged that they be abolished. See, *e.g.,* Cormack & McCarroll, 10 S Cal L Rev at 404-405: "Upon dissection, the distinction between suretyship and guaranty is vapid.… A distinction so formidable upon first impression, so difficult of application and so empty in effective content, should not be retained in the law."

Drawn from Cormack & McCarroll, 10 S Cal L Rev at 405-414, the 1939 legislation (Stats 1939, ch 453) amended CC §2787 to define "guarantors" and "sureties" identically (basing the definition primarily on the former definition of "guaranty"), repealed CC §2831's separate definition of sureties, and equalized the treatment of guarantors and sureties by giving to both the broader statutory rights previously held only by sureties. See also Cormack, *Suretyship & Guaranty*, *The Work of the 1939 California Legislature,* 13 S Cal L Rev 48 (1939); *Abolition of the Distinction Between Suretyship Guaranty,* 13 S Cal L Rev 67 (1939).

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§9.88D 4. Examples of Suretyship

The examples in §§9.88E-9.88J, common situations in real property secured transactions, illustrate the application and effect of CC §2787.

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§9.88E a. Explicit Guaranty

EXAMPLE: Able obtains a loan from Lender, executing a promissory note to evidence the debt, secured by a deed of trust. Baker executes a separate "guaranty" of the debt, promising to pay Lender if Able defaults.

This is the archetypal guaranty situation. Able is the principal obligor. Able's debt to Lender is the principal obligation. Baker is a guarantor, and thus a surety, and has rights of recourse against Able and suretyship rights and defenses as against Lender, except to the extent enforceably waived. (Regarding various types of guaranties that might be used in such a transaction, see §§9.89Y-9.90B.)

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§9.88F b. Co-Obligor

EXAMPLE: Able obtains a loan from Lender. Lender requires that Baker co-sign the promissory note with Able rather than execute a separate guaranty. Able and Baker are described in the note as "borrowers," with no distinction made between them.

Because only Able received the loan, and Baker received no direct benefit, Able is the principal obligor and Baker is a surety, even though both are referred to in the note as "borrowers." See §9.88B. The language of the document is not controlling. Under CC §2832, one who is ostensibly a principal, such as Baker, "may show that he is in fact a surety, except as against persons who have acted on the faith of his apparent character of principal," and "[i]t is not necessary for him to show that the creditor accepted him as surety."

If the note is a negotiable instrument, Baker is defined by statute as an "accommodation party," having signed the instrument for the purpose of incurring liability on it "without being a direct beneficiary of the value given for the instrument," and Able is the "accommodated party." Com C §3419(a). An accommodation party is a surety. Regarding accommodation parties and endorsers on negotiable instruments, see §§9.118-9.121. Commercial Code Division 3's provisions governing accommodation parties take precedence over, but do not entirely displace, the suretyship provisions of the Civil Code. See §9.121.

In some circumstances when multiple parties have signed a note or other agreement, a party might be a principal for some portions of the obligation and a surety for other portions, even though the party ostensibly signed in only one capacity. See, *e.g., Chipman v Morrill & Webster* (1862) 20 C 130, in which several parties purchased property and gave their joint note in payment, and by the purchase each became the owner of a separate, undivided interest in the property. "In giving their joint note for the whole amount of the purchase money, each party was principal for the amount of his own interest, and cosurety for the remaining interests." 20 C at 136. See Restatement (Third) of Suretyship and Guaranty §1, Comment o and Illustration 31 (1996).

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§9.88G c. Third Party Security

EXAMPLE: Able obtains a loan from Lender. Baker does not make any promise to "guarantee" or otherwise pay the loan but executes in favor of Lender a deed of trust encumbering Baker's real property, securing Able's note to Lender.

Baker is a surety because CC §2787 includes in its definition one who "hypothecates property as security" for the debt of another. This is true even though Baker has not executed a separate "guaranty" document, suretyship terminology is not used in the deed of trust, and Baker has made no promise to pay the debt. See, *e.g., Mead v Sanwa Bank Cal.* (1998) 61 CA4th 561, 71 CR2d 625 (landlords' execution of tenant-borrower's deed of trust, subjecting their reversionary interest to deed of trust, makes them sureties). Baker has not incurred personal liability for payment of the debt, however, beyond his or her interest in the encumbered real or personal property. See, *e.g., Carson v Reid* (1902) 137 C 253, 70 P 89.

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§9.88H d. Loan Purchase Agreement; Indemnity Agreement

EXAMPLE: Able obtains a loan from Lender. Baker agrees to purchase the loan from Lender on demand, for the amount due, if Able defaults.

This transaction is functionally the same as the standard guaranty situation described in §9.88E. The Restatement (Third) of Suretyship and Guaranty §1(2)(b)(iii) and Illustration 7 (1996) readily classifies Baker as a surety. There are California-law cases, however, in which similar arrangements were found not to create a suretyship relationship. See *United Cal. Bank v Maltzman* (1974) 44 CA3d 41, 118 CR 299 (court of appeal deferred to trial court's factual finding); *United Cal. Bank v THC Fin. Corp.* (9th Cir 1977) 557 F2d 1351. See also *Union Bank v Winnebago Indus., Inc.* (9th Cir 1975) 528 F2d 95. Caution is advisable in relying on these cases to conclude that this will not be treated as a suretyship situation.

In *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 37 CR3d 83, a mortgage broker agreed to "indemnify" a lender for losses in connection with, or to purchase, loans originated by the broker, in the event of early default by the borrowers or fraud in the loan applications. When the lender sought to recover deficiency liability from the broker after nonjudicially foreclosing on defaulted loans, the broker defended on grounds that the agreement was in reality a guaranty, enforcement of which was barred by the estoppel defense of *Union Bank v Gradsk*y (1968) 265 CA2d 40, 71 CR 64 (see §§9.89F-9.89G). The court concluded that the "indemnity" agreement was not a guaranty because it did not reflect a "direct promise" to perform the borrowers' obligations (134 CA4th at 1309) and found that enforcement was not precluded by *Gradsky* or antideficiency rules because the broker was not the alter ego of the borrower.

NOTE: Regarding the several analytical shortcomings of *Trust One Mortgage Corp.,* see Bernhardt, *Foreclosures: Mortgage Broker's Agreement to Indemnify Its Mortgage Banker for Any Loss Following Foreclosure Sale Is Unaffected by Antideficiency Laws,* 29 CEB Real Prop L Rep 249 (March 2006). Again, caution is advisable.

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§9.88I e. Master Lease

EXAMPLE: SmithCo obtains permanent financing from Lender secured by SmithCo's office building. Lender requires that J. Smith, owner of SmithCo, "master lease" the entire building from SmithCo, for "rent" sufficient to pay debt service and other carrying costs on the property, with the "master lease" assigned to Lender as additional collateral. It is not contemplated that J. Smith will occupy the building. As individual space leases are signed with actual tenants, that space will be released from the "master lease" for the duration of the space lease. Alternatively, space tenants might sublease from J. Smith, or J. Smith might sublease back to SmithCo to sub-sublease to tenants.

A "master lease" to a principal or affiliate of the borrower who does not occupy the building is typically intended for no purpose other than to support the debt. There is a strong likelihood that a court would treat such a "master lease" as a guaranty. See Snyder, *Master Leases in Financing Transactions,* RPPT eReport (Dec. 2006) (www.abanet.org/rppt/publications/ereport/2006/2/home.shtml).

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§9.88J f. Unreleased Seller of Encumbered Property

EXAMPLE: Seller owns property encumbered by a deed of trust in favor of Lender, securing Seller's obligation to repay a loan. Buyer purchases the property, and the loan remains outstanding with the deed of trust still in place. Lender does not release Seller from liability on the loan.

Whether Buyer assumes the loan or merely takes subject to it, Seller has become a surety. If Buyer assumes, Buyer becomes the principal obligor, but if Buyer merely takes subject to the encumbrance, the property itself is effectively the principal obligor (or Buyer might be characterized as the principal obligor, with liability limited to Buyer's interest in the property). See *Braun v Crew* (1920) 183 C 728, 192 P 531; *Hopkins v Warner* (1895) 109 C 133, 136, 41 P 868; *Vincent v Garland* (1936) 14 CA2d 725, 58 P2d 1320; *Brichetto v Raney* (1926) 76 CA 232, 245 P 235; Restatement (Third) of Suretyship and Guaranty §1, Illustrations 29-30 (1996). See also *Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476.

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§9.88K g. Caution: Substance Controls Over Form or Language

Of the examples in §§9.88E-9.88J, only the first involves explicit "guaranty" language, yet all of the examples implicate suretyship law. In transactions that do not fit the simple model of §9.88E, creditors and their counsel often fail to consider suretyship issues and as a result do not obtain waivers of suretyship, one-action, and antideficiency rights and defenses. This can cause substantial prejudice to the creditor if enforcement becomes necessary.

PRACTICE TIP: In both transactional and litigation contexts, counsel should consider suretyship law issues when analyzing any contractual arrangement, regardless of structure or nomenclature, in which multiple parties bear the economic burden of an obligation, directly or indirectly. "The determination that a contract establishing the secondary obligation gives rise to suretyship status is based on substance, not form." Restatement (Third) of Suretyship and Guaranty §1, Comment h. See also Restatement §1(3).

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5. Suretyship Formation Issues

§9.88L a. Consideration

Under CC §2792, there is no requirement of separate consideration for a suretyship obligation if it is "entered into at the same time with the original obligation, or with the acceptance of the latter by the creditor, and forms with that obligation a part of the consideration to him." The consideration supporting the underlying obligation also supports the suretyship obligation, even if the surety receives no benefit.

This rule is satisfied if, for example, a guaranty is executed some time after, but pursuant to, the original loan agreement between a lender and the principal obligor. The guaranty, "being in pursuance of the original agreement, relates back to and takes effect the same as if it had been coincident with the execution by the principal debtors." *Stroud v Thomas* (1903) 139 C 274, 275, 72 P 1008. See also *Beverly Hills Nat'l Bank v Glynn* (1968) 267 CA2d 859, 73 CR 808.

Otherwise, for a subsequent guaranty, CC §2792 requires "consideration distinct from that of the original obligation." See, *e.g., Rusk v Johnston* (1937) 18 CA2d 408, 63 P2d 1167 (guaranty unenforceable when it was not requested nor given until after note was executed and consideration for note passed). Compare CC §2792 with Com C §3419(b) (consideration not required for accommodation parties on negotiable instruments). See §9.121.

If the creditor agrees to modify the underlying obligation, or to forbear from enforcement, that will constitute consideration for a guaranty then obtained. See, *e.g., California Bank v Kenoyer* (1934) 2 CA2d 367, 37 P2d 836. Similarly, making a new loan is consideration that will support a guaranty of prior debt. See, *e.g., Oakland Bank of Commerce v Washington* (1970) 6 CA3d 793, 86 CR 276; *Beverly Hills Nat'l Bank v Glynn* (1968) 267 CA2d 859, 73 CR 808. See generally CC §1605 (consideration for contractual promises).

NOTE: It is important to distinguish between *consideration*, which is relevant to contract-law enforceability of a suretyship obligation, and *value*, which is relevant to fraudulent-transfer law. As the foregoing discussion reflects, a suretyship obligation may be supported by consideration, and thus be enforceable under contract law, even though the surety received no benefit from the transaction. However, if the surety did not receive reasonably equivalent value, directly or indirectly, for incurring the suretyship obligation and was insolvent or was rendered insolvent (or certain other financial-condition criteria apply), that obligation might be avoidable as a fraudulent transfer under state law (see CC §§3439.05, 3439.03) or in a bankruptcy of the guarantor (see 11 USC §548(a)(1)(B), (d)(2)(A)). See Carl, *Fraudulent Transfer Attacks on Guaranties in Bankruptcy,* 60 Am Bankr LJ 109 (1986); Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware,* 125 U Pa L Rev 235 (1976). Regarding fraudulent transfers generally, see §11.86.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.88M b. Statute of Frauds

§9.88M b. Statute of Frauds

Civil Code §2793 requires that a suretyship obligation be in writing and signed by the surety. See also CC §1624(a)(2). But CC §2794 establishes several exceptions to that rule, identifying circumstances in which the promise to answer for the debt of another is "deemed an original obligation of the promisor." These include a situation "[w]here the promise is upon a consideration beneficial to the promisor, whether moving from either party to the antecedent obligation, or from another person." CC §2794(4). See *Merritt v J. A. Stafford Co.* (1968) 68 C2d 619, 68 CR 447; *Farr & Stone Ins. Brokers, Inc. v Lopez* (1976) 61 CA3d 618, 132 CR 641.

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§9.88N c. Notice of Acceptance; Knowledge of Principal

Under CC §2795, an offer to become a surety may be accepted by acting on it, unless notice of acceptance is expressly required. An absolute suretyship obligation also binds the surety without notice of acceptance.

A suretyship obligation can be created without the knowledge or consent of the principal. CC §2788. The Civil Code's suretyship rights and defenses apply whether or not the principal was aware of the suretyship obligation.

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§9.88O 6. Rights and Defenses Arising From Suretyship Status

Suretyship status gives rise to three sets of rights in favor of the surety under the Civil Code's suretyship provisions:
(1) Rights of recourse against the principal (see §§9.88P-9.88R);
(2) Rights of contribution against cosureties (see §9.88S); and
(3) Rights and defenses against the creditor (see §§9.88T-9.88W).

Under CC §2856(a)(1), all of these rights and defenses are waivable by a surety (see §9.89L; but see §9.89R). Extensive waivers are standard in explicit guaranty documents, but suretyship rights and defenses can be of great significance in transactions in which suretyship status was not recognized (see, *e.g.,* §§9.88F-9.88K) and waivers thus were not obtained.

Sureties also have an important nonstatutory defense arising from a creditor's duty of disclosure (see §9.88X), likely not waivable (see §9.89Q).

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a. Recourse Against Principal

§9.88P (1) Equity of Exoneration; Reimbursement and Subrogation

The fundamental premise of suretyship status is that, as between the principal obligor and the surety, the principal "should ultimately bear the burden of the obligation." *Everts v Matteson* (1942) 21 C2d 437, 447, 132 P2d 476. See §9.88B. To implement that result, statutory law provides the following:

- Civil Code §2846 gives a surety the right to "compel his principal to perform the obligation when due," a right sometimes referred to as the right of (or the equity of) exoneration. See also CCP §1050. An action for *quia timet* has also been recognized in this context, which may allow the surety to prevent the principal from dissipating funds from which the principal obligation could be paid. See *Escrow Agents' Fid. Corp. v Superior Court* (1992) 4 CA4th 491, 5 CR2d 698; Restatement (Third) of Suretyship and Guaranty §21, Comments j-*l* and Reporter's Note to Comment j (1996).
- If the surety satisfies any part of the principal obligation, CC §2847 gives the surety a right of reimbursement from the principal for amounts disbursed, including necessary costs and expenses. See §9.88Q.
- If the surety satisfies the principal obligation entirely, CC §2848 subrogates the surety to the position of the creditor, entitling the surety "to enforce every remedy which the creditor then has against the principal to the extent of reimbursing what he has expended." See §9.88R.
- Under CC §2849 the surety is "entitled to the benefit of every security for the performance of the principal obligation held by the creditor," even if the surety was unaware of the security.

NOTE: The surety's rights against the principal arise as a matter of law and do not depend on any agreement between the principal and the surety. In some transactions, however, the principal executes an agreement in favor of the surety explicitly setting out rights of indemnity and reimbursement. Sometimes the principal provides security to the surety. If so, under CC §2854 the creditor is also entitled to the benefit of that security.

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§9.88Q (2) Scope of Reimbursement Right

There are circumstances in which a creditor can recover against a surety even though the creditor could not recover against the principal. In California these include claims for which the statute of limitations has run on the principal obligation (see §9.88T) and claims that are precluded by one-action or antideficiency rules as against the principal but not as against the surety (see §§9.88Z-9.89A, 9.89N). Such situations raise the question whether the surety, after paying the creditor's claim, can recover reimbursement from the principal. See Restatement (Third) of Suretyship and Guaranty §§24, 26 (1996).

Regarding the running of the statute of limitations on the principal obligation, the rule in California is that the surety's reimbursement claim is not affected, because it is a new cause of action, arising when the surety pays the creditor. See *Regents of Univ. of Cal. v Hartford Acc. & Indem. Co.* (1978) 21 C3d 624, 147 CR 486; *Loewenthal v Coonan* (1902) 135 C 381, 67 P 324. Not all states follow this rule. See Restatement §43.

Regarding the one-action and antideficiency defenses, at least two courts of appeal have stated that a guarantor cannot recover reimbursement from the principal obligor, because this would subject the principal indirectly to the very liability that the one-action and antideficiency rules were intended to preclude. See *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64 (applying CCP §580d); *Heckes v Sapp* (1964) 229 CA2d 549, 40 CR 485 (applying CCP §580b). See also Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes,* 17 UCLA L Rev 245, 276 and n99, 279 and n106 (1969); Hetland, *Deficiency Judgment Limitations in California—A New Judicial Approach,* 51 Cal L Rev 1, 25-26 (1963). However, in *Western Sec. Bank v Superior Court* (1997) 15 C4th 232, 249, 62 CR2d 243, the supreme court specifically criticized statements to this effect in *Gradsky* as "unnecessary" and "suggesting a much broader rule than its holding and analysis warranted." See §§9.89F-9.89G. The significance of that criticism is uncertain. *Western Sec. Bank* itself involved a letter of credit, not a guaranty. See CCP §580.5(b) (reimbursement of letter of credit issuer does not violate one-action or antideficiency rules). See also §9.116.

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§9.88R (3) Scope of Subrogation Right

Despite the seemingly clear language of CC §2848, allowing the surety who pays the debt "to enforce every remedy which the creditor then has against the principal," some California cases significantly limit rights of subrogation, while others do not.

In *Regents of Univ. of Cal. v Hartford Acc. & Indem. Co.* (1978) 21 C3d 624, 637, 147 CR 486, the supreme court summarized California case law as holding that "a surety who pays the principal debt extinguishes that obligation and thus cannot sue the debtor as subrogee of the original debt.… Subrogation in California suretyship law thus is not the surety's primary remedy for recourse against the principal; it refers instead to a variety of rights which the surety may assert against third parties, cosureties, and property." The court noted, however, that the surety may be subrogated to the creditor's rights to priorities or "securities," *i.e.,* collateral, citing CC §2849. 21 C3d at 638 n6. See also CC §1473 (full performance by obligor or another, if accepted by creditor, extinguishes obligation); *Yule v Bishop* (1901) 133 C 574, 65 P 1094 (full payment and performance by surety extinguishes primary obligation). But see *Collection Control Bureau v Weiss* (1975) 50 CA3d 865, 123 CR 625 (purporting to limit *Yule* to situations in which note is marked "paid"); *Berrington v Williams* (1966) 244 CA2d 130, 52 CR 772 (distinguishing purchase of debt from payment of debt).

In *Flojo Int'l, Inc. v Lassleben* (1992) 4 CA4th 713, 6 CR2d 99, without mentioning *Regents*, the court cited CC §2848 and held that subrogation puts the surety in place of the creditor and gives the surety all the creditor's collection rights against the principal. See also *Sanders v Magill* (1937) 9 C2d 145, 70 P2d 159 (by right of subrogation, or as owner of note by assignment from bank, surety could proceed against all persons liable for payment of balance due; surety's acquisition of obligation does not extinguish it); *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64. This broader view of subrogation is reflected in Restatement (Third) of Suretyship and Guaranty §28 (1996) (see also Restatement (Third) §28, Reporter's Note to Comment b) and is the rule for accommodation parties to negotiable instruments (Com C §3419(e); see §§9.118, 9.120-9.121).

See Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes,* 17 UCLA L Rev 245, 281-285 (1969).

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§9.88S b. Contribution Right Against Cosureties

In some transactions there are multiple sureties under the same document or separate documents. Civil Code §2848 entitles a surety who satisfies the principal obligation "to require all his co-sureties to contribute thereto, without regard to the order of time in which they became such," but does not elaborate on how the contributive share is to be determined. Regarding that issue, see CC §1432 (general rule of "proportionate contribution"); *Williams v Riehl* (1899) 127 C 365, 59 P 762; Bernhardt, *Inequitable Noncontribution,* 30 CEB Real Prop L Rep 179 (Nov. 2007); Restatement (Third) of Suretyship and Guaranty §57 (1996). Sureties have also been held to have a right of subrogation as against cosureties. See *Pond v Dougherty* (1907) 6 CA 686, 92 P 1035.

NOTE: In some circumstances, a surety may have the right to recover not just a contribution but the entire amount from another surety. See *Continental Cas. Co. v Hartford Acc. & Indem. Co.* (1966) 243 CA2d 565, 52 CR 533. See also Restatement (Third) of Suretyship and Guaranty §53 (1996) (distinguishing "cosuretyship" from "subsuretyship").

Civil Code §2849 also entitles each surety to the benefit of any security given for the performance of the principal obligation to a cosurety.

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c. Rights and Defenses Against Creditor

§9.88T (1) Defenses of Principal

To some extent, CC §§2809 and 2810 allow a surety to assert, as against the creditor, defenses that the principal obligor has to the underlying obligation.

Under CC §2809, the surety's obligation must be "neither larger in amount nor in other respects more burdensome than that of the principal; and if in its terms it exceeds it, it is reducible in proportion to the principal obligation." In *Bloom v Bender* (1957) 48 C2d 793, 802, 313 P2d 568, the supreme court suggested that CC §2809 looks to "the time of the contracting of the surety's obligations" and indicates that the surety "cannot agree to perform higher and greater obligations than those then imposed on the principal debtor." The court held, though, that §2809 does not prevent the surety from agreeing that "upon the occurrence of some specified event his liability would remain the same even though the obligation of the principal is thereby decreased." 48 C2d at 803. (The court enforced the guarantor's liability after the creditor's release of the principal in an assignment for the benefit of creditors.)

Civil Code §2810 provides that a surety is not liable if the principal is not liable at the time the contract is executed or if the principal's liability thereafter ceases, "unless the surety has assumed liability with knowledge of the existence of the defense." However, the surety is not exonerated by "personal disability" of the principal (*e.g.,* lack of capacity), even if it makes the contract void against the principal. See also §9.88U (effect of discharge of principal by operation of law).

Although CC §§2809 and 2810 thus enable a surety to assert at least some defenses of the principal obligor, California case law limits their reach:

- One-action and antideficiency defenses have been excluded from CC §§2809 and 2810 (see §9.89E).
- The running of the statute of limitations on the principal obligation ordinarily does not exonerate a surety. *Regents of Univ. of Cal. v Hartford Acc. & Indem. Co.* (1978) 21 C3d 624, 147 CR 486; *Bloom v Bender* (1957) 48 C2d 793, 313 P2d 568. However, some statutes of limitations expressly limit claims against sureties to the same time period applicable to the underlying claim:
- The specific statute of limitations at issue in *Regents,* for latent construction deficiency liability, did not at that time mention sureties but was later amended to do so. CCP §337.15. This obviated the specific holding of *Regents* (see *Lantzy v Centex Homes* (2003) 31 C4th 363, 381 n14, 2 CR3d 655) but did not undermine the broader proposition of *Regents* and *Bloom* that a surety is not ordinarily exonerated in California by expiration of the statute of limitations against the principal. Not all states follow this rule. See Restatement (Third) of Suretyship and Guaranty §43 (1996).
- Code of Civil Procedure §359.5, also adopted after *Regents*, provides that expiration of the statute of limitations on the principal's obligation bars action on a "surety bond" that is "conditioned upon performance of the principal" unless the bond provides otherwise. "Surety bond" is not defined. Regarding this term generally, see Restatement §1 Comment d, §3 Comment b, and §24 Comment b. On whether CCP §359.5 may be limited to performance bonds, see *Department of Indus. Relations, Div. of Labor Standards Enforcement v Seaboard Surety Co.* (1996) 50 CA4th 1501, 58 CR2d 532 (dicta).

Regarding a surety's assertion of defenses or offsets of the principal, see Restatement §§34-35. Regarding a usury defense, see §9.89Q.

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§9.88U (2) Effect of Discharge of Principal

Under CC §2825, a surety is not exonerated by discharge of the principal by operation of law "without the intervention or omission of the creditor." Thus, a surety remains liable if the obligation of the principal is discharged in bankruptcy. See *Bloom v Bender* (1957) 48 C2d 793, 313 P2d 568. See also 11 USC 524(e).

If the creditor receives a dividend on its bankruptcy claim in the form of securities, however, it must make an election at that time: (1) retain the securities and sue the surety for the balance due, or (2) recover the full claim from the surety and subrogate the surety to the securities. The creditor cannot hold the securities, speculating on their value, and later change its election. *Durgin v Kaplan* (1968) 68 C2d 81, 65 CR 158; *Zellner v Lasky* (1970) 13 CA3d 787, 91 CR 810.

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§9.88V (3) Alteration of Principal Obligation or Impairment of Remedies

Under CC §2819, except to the extent that the surety is indemnified by the principal (see CC §2824; *Texaco Ref. & Mktg., Inc. v Aetna Cas. & Sur. Co.* (9th Cir 1990) 895 F2d 637), the surety is exonerated if by any act of the creditor without the surety's consent

- "the original obligation of the principal is altered in any respect"; or
- "the remedies or rights of the creditor against the principal, in respect thereto, [are] in any way impaired or suspended."

NOTE: Related to the impairment defense is CC §2849, which entitles the surety to the benefit of all security held by the creditor. See, *e.g., Massachusetts Bonding & Ins. Co. v Osborne* (1965) 233 CA2d 648, 43 CR 761 (release of collateral exonerates surety). Regarding failure to perfect a security interest in collateral, see *American Sec. Bank v Clarno* (1984) 151 CA3d 874, 880, 199 CR 127. In the context of accommodation parties to negotiable instruments, see Com C §3605(g). See also §9.120.

Under CC §2820, the fact that a promise by the creditor is void or voidable does not prevent it from altering the obligation or impairing the remedies within the ambit of CC §2819. But see *Wise v Clapper* (1968) 257 CA2d 770, 774, 65 CR 231. Similarly, under CC §2821, rescission of an agreement altering the obligation or impairing remedies does not restore the surety's liability. However, under CC §2822(b), if the creditor agrees to accept from the principal a reduced amount, "without the prior consent of the surety and without any other change to the underlying agreement between the creditor and principal debtor," that will not exonerate the surety for the reduced amount.

When an obligation is modified, in California it is the materiality of the modification, not whether it is prejudicial to the surety, that triggers exoneration under CC §2819. See, *e.g., Braun v Crew* (1920) 183 C 728, 192 P 531 (extension of time); *Driscoll v Winters* (1898) 122 C 65, 54 P 387 (reduction of principal's purchase obligation); *Wise v Clapper* (1968) 257 CA2d 770, 65 CR 231 (extension of time must be for definite period to be material alteration exonerating surety); *Hill & Morton, Inc. v Coughlan* (1963) 214 CA2d 545, 29 CR 550 (method of payment). Compare CC §2819 with Com C §3605(c)-(d), applicable to accommodation parties on negotiable instruments, which limits exoneration to the loss caused by the modification (see §§9.120-9.121).

Civil Code §2819 provides that a modification exonerates the surety only if done without the surety's consent. The courts have held that "such consent may be given in advance of the alteration of the principal's obligation as well as at or after the time of such act." *Bloom v Bender* (1957) 48 C2d 793, 801, 313 P2d 568. See, *e.g., Stevenson v Oceanic Bank* (1990) 223 CA3d 306, 272 CR 757 (no exoneration when guaranty expressly consented to modifications without notice or consent); *Krueger v Bank of America* (1983) 145 CA3d 204, 193 CR 322. See also *Central Bldg., LLC v Cooper* (2005) 127 CA4th 1053, 26 CR3d 212 (continuing guaranty is deemed modified with modifications in underlying obligation). Advance consent in the guaranty has also been recognized in the context of §2819's impairment-of-remedies defense. See, *e.g., American Sec. Bank v Clarno* (1984) 151 CA3d 874, 199 CR 127.

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§9.88W (4) First Pursuit of Principal and Principal's Collateral

Under CC §2845, a surety may require the creditor "to proceed against the principal, or to pursue any other remedy in the creditor's power which the surety cannot pursue, and which would lighten the surety's burden," and the creditor's failure to do so exonerates the surety "to the extent to which the surety is thereby prejudiced." See, *e.g., Moffett v Miller* (1953) 119 CA2d 712, 260 P2d 215. But see *Glickman v Collins* (1975) 13 C3d 852, 120 CR 76 (no exoneration allowed when pursuit of principal would be futile).

NOTE: Under CC §2823, a creditor's "mere delay" to proceed against the principal or to enforce any other remedy does not exonerate a surety.

Section 2845 is often linked in the case law with two other sections:

- Civil Code §2849, which entitles the surety to the benefit of all security held by the creditor; and
- Civil Code §2850, which provides that if the principal and surety have both given security, the surety is also entitled to have the principal's property "first applied to the discharge of the obligation."

When not waived, these provisions are relied on to establish that the surety can require the creditor to pursue the principal's collateral before proceeding against the surety. See, *e.g., Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476 (citing CC §§2845 and 2850 for proposition that pre-1939 surety could require creditor to first resort to principal's trust deed or mortgage security; sections 2845 and 2850, then applicable only to sureties, currently apply to guarantors and sureties alike); *Adams v Wallace* (1897) 119 C 67, 51 P 14 (citing CC §§2849-2950); *Krueger v Bank of America* (1983) 145 CA3d 204, 193 CR 322 (citing CC §2845); *Wiener v Van Winkle* (1969) 273 CA2d 774, 78 CR 761 (citing CC §§2845 and 2849); *Engelman v Bookasta* (1968) 264 CA2d 915, 71 CR 120 (same); and *American Guar. Corp. v Stoody* (1964) 230 CA2d 390, 41 CR 69 (same); *Union Bank v Ross* (1976) 54 CA3d 290, 126 CR 646 (citing CC §§2819 and 2845). See also cases cited in §9.89B.

NOTE: That CC §2845 requires the creditor to pursue the principal's collateral is especially clear when that collateral is real property. Because the principal is protected in that event by CCP §726, the creditor can proceed against the principal only by first proceeding against the collateral. See Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes,* 17 UCLA L Rev 245, 264 n62 (1969); Hetland, *Deficiency Judgment Limitations in California—A New Judicial Approach,* 51 Cal L Rev 1, 24 n107 (1963).

To trigger CC §2845, the surety must make demand on the creditor. See, *e.g., Sukut-Coulson, Inc. v Allied Canon Co.* (1978) 85 CA3d 648, 149 CR 711 (implicit in such demand is recognition by surety of its obligation under bond and, in effect, its admission of liability to creditor). See also *United Cal. Bank v Maltzman* (1974) 44 CA3d 41, 118 CR 299.

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§9.88X (5) Defense Based on Duty to Disclose

In addition to defenses arising from the Civil Code's suretyship provisions (see §§9.88T-9.88X), case law imposes a duty of disclosure on a creditor that, when breached, can exonerate a surety. In *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 90, 73 CR 564, the supreme court adopted the rule of the Restatement of Security (now found in substantively similar form in Restatement (Third) of Suretyship and Guaranty §12(3) (1996)):

> "Where before the surety has undertaken his obligation the creditor knows facts unknown to the surety that materially increase the risk beyond that which the creditor has reason to believe the surety intends to assume, and the creditor also has reason to believe that these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety, failure of the creditor to notify the surety of such facts is a defense to the surety." The rule of the Restatement recognizes that whether a creditor owes a duty to volunteer disclosure to a surety depends upon the nature of the risk guaranteed and the relationship of the parties involved.

The court based this duty on a creditor's duty of continuous good faith and fair dealing to a surety. 70 C2d at 90.

In the context of a continuing guaranty (see §9.89Z), the court held that the creditor's duty of disclosure arises "prior to every new extension of credit" because "[e]ach extension of credit creates a new suretyship contract." 70 C2d at 92. See Restatement (Third) of Suretyship and Guaranty §12(6) (1996).

Regarding waivability of this defense, see §9.89Q.

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§9.88Y 7. Applying One-Action and Antideficiency Rules: Overview

A recurring issue in California case law has been how the one-action and antideficiency rules (see chaps 4-5) and the suretyship rights and defenses (see §§9.88O-9.88X) apply and interact when a transaction involves both a guarantor and real property collateral. The two primary questions are as follows:

- To what extent is a guarantor protected by the one-action and antideficiency rules, directly or indirectly?
- To what extent, and in what manner, can a guarantor enforceably waive any such protections that do apply?

After 1996, the broad statutory authorization of waivers in CC §2856 largely answers the second question and, when waivers are obtained, moots the first. Section 2856 permits a "guarantor or other surety" to waive, in addition to the Civil Code's suretyship rights and defenses, any rights or defenses that arise because the principal obligation is secured by real property, including any that are based directly or indirectly on the one-action or antideficiency rules. The statute also provides optional safe-harbor waiver language. Waivers are discussed in §§9.89J-9.89R.

The sections that follow examine the question of how the one-action and antideficiency rules have been applied, absent waiver, in the following transactional contexts:

- The principal obligor encumbers its real property to secure the principal obligation, which is also guaranteed by a third party (see §§9.88Z-9.89G);
- A third party executes a guaranty of the principal obligation and encumbers its real property to secure the guaranty (see §9.89H); and
- A third party encumbers its real property to secure the principal obligation directly, making that third party a guarantor or surety under CC §2787 (see §9.89I).

NOTE: This discussion assumes throughout that the third party in question is truly a guarantor or other surety, not a disguised principal obligor. See §§9.89S-9.89X.

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8. One-Action and Antideficiency Rules When Principal's Real Property Secures Principal Obligation

a. No Direct Protection of Guarantors

§9.88Z (1) Case Law

With the exception of the depublished court of appeal case noted in §9.89A, reported California case law has uniformly taken the view—whether in holding or in dicta—that the one-action and antideficiency rules do not directly protect the guarantor of an obligation secured by the principal obligor's real property (unless the guaranty is itself secured by real property; see §9.89H):

- **CCP §726, one-action and security-first rules, judicial foreclosure.** See, *e.g., Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476; *Loeb v Christie* (1936) 6 C2d 416, 57 P2d 1303; *Union Bank v Gradsky* (1968) 265 CA2d 40, 43 n3, 71 CR 64. On the indirect effect of CCP §726 on guarantors as a result of CC §2845, see §9.88W.
- **CCP §580d, prohibiting deficiency after nonjudicial foreclosure.** See, *e.g., Gradsky*, 265 CA2d at 41; *Consolidated Capital Income Trust v Khaloghli* (1986) 183 CA3d 107, 227 CR 879; *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238; *Bauman v Castle* (1971) 15 CA3d 990, 93 CR 565. But see *Union Bank v Dorn* (1967) 254 CA2d 157, 159, 61 CR 893 ("a point not entirely free from doubt"). On indirect application of §580d to guarantors, see §§9.89F-9.89G.
- **CCP §580a, fair-value rule limiting deficiency after nonjudicial foreclosure.** See, *e.g., Everts v Matteson, supra; Bank of America v Hunter* (1937) 8 C2d 592, 67 P2d 99; *Talbott v Hustwit* (2008) 164 CA4th 148, 78 CR3d 703; *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238; *Security-First Nat'l Bank v Chapman* (1940) 41 CA2d 219, 106 P2d 431.
- **CCP §580b, prohibiting deficiency on purchase money obligations.** See, *e.g., Gottschalk v Draper Cos.* (1972) 23 CA3d 828, 100 CR 434; *Bauman v Castle, supra*; *Roberts v Graves* (1969) 269 CA2d 410, 75 CR 130; *Heckes v Sapp* (1964) 229 CA2d 549, 40 CR 485; *Katz v Haskell* (1961) 196 CA2d 144, 155, 16 CR 453; *Paradise Land & Cattle Co. v McWilliams Enters.* (9th Cir 1992) 959 F2d 1463, 1466.

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§9.89 (2) Rationales in Case Law

The stated rationale for the holdings in many of the cases cited in §9.88Z is that the guarantor's obligation is separate and independent from the principal's obligation. See, *e.g., Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476; *Loeb v Christie* (1936) 6 C2d 416, 57 P2d 1303; *Talbott v Hustwit* (2008) 164 CA4th 148, 151, 78 CR3d 703.

Another frequently expressed rationale is that a guaranty is a form of additional security for the underlying obligation, and just as the antideficiency rules are interpreted not to limit recovery against additional property security (see §§9.7-9.8), they should likewise not limit recovery against the personal security of a guaranty. See, *e.g., Talbott v Hustwit* (2008) 164 CA4th 148, 78 CR3d 703; *Gottschalk v Draper Cos.* (1972) 23 CA3d 828, 100 CR 434; *Heckes v Sapp* (1964) 229 CA2d 549, 40 CR 485; Hetland, *Deficiency Judgment Limitations in California—A New Judicial Approach,* 51 Cal L Rev 1, 25 (1963). See also *Everts v Matteson, supra*.

NOTE: Characterization of guaranties as "additional security" suggests to some that if the creditor pursues judicial foreclosure, a guarantor must be included in the action, by analogy to the one-action rule's requirement that all real property security be included (see §§4.11, 4.23-4.28, 9.6). Inclusion of the guarantor avoids argument over the issue and is common practice. A guarantor is a proper party. *Titus v Woods* (1920) 45 CA 541, 188 P 68.

Regarding the case law rationale for not extending direct one-action and antideficiency protection to guarantors, see Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes,* 17 UCLA L Rev 245, 263-272 (1969).

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§9.89A b. Arguments for Direct Protection of Guarantors

It has long been argued that one-action and antideficiency rules should (or do) apply directly to guarantors. One court of appeal case so held in 1995, applying the fair value rule of CCP §580a to a guarantor, but the opinion was ordered not published by the supreme court. *Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 1472, 46 CR2d 656). The view that §580a should apply to guarantors was also expressed in the concurrence in *Talbott v Hustwit* (2008) 164 CA4th 148, 154, 78 CR3d 703 (concurring opinion of Sills, J), and by the court of appeal in an unpublished case, *Chequers Inv. Assocs., II v Del Heil* (Nov. 29, 2001, G021285; not certified for publication) 2001 Cal App Unpub Lexis 1170, *10, but the courts in both of those cases held that under current law, §580a does not protect a guarantor. The arguments for direct protection of guarantors reflected in these cases are discussed in §§9.89B-9.89C.

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§9.89B (1) Effect of 1939 Statutory Change

The supreme court cases holding one-action or antideficiency rules inapplicable directly to guarantors (see §§9.88Z-9.89) all arose under the law in effect before statutory abolition of the distinction between guarantors and sureties in 1939 (see §9.88C). It has been argued that the 1939 legislation undermined those cases—specifically, their characterization of a guaranty as "independent" of the principal obligation—and that post-1939 cases have failed to take the statutory change adequately into account. See, *e.g., Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 1470 n5, 46 CR2d 656).

The thrust of this argument is that guarantors are, under current law, obligated directly on the underlying secured debt with the principal obligor and consequently are protected directly by the one-action and antideficiency rules. Although California cases have not adopted that view, the Nevada Supreme Court did so in a case involving a California guaranty. The court decided that as a result of the 1939 change in CC §2787, "it is clear that the rule in contracts of 'guaranty' that the obligations of the principal debtor and that of the 'guarantor' were entirely independent obligations was abolished." *Component Sys. Corp. v Eighth Judicial Dist. Court* (Nev 1985) 692 P2d 1296, 1300. From this the court concluded that California guarantors are "co-obligors" with the principal; on that basis the court applied Nevada's one-action rule to a guarantor.

There are at least two difficulties with this argument. First, it would make important consequences turn on such conceptual abstractions as whether guarantors are obligated "with" the principal or separately, an approach very much akin to what the 1939 legislation was intended to reject. See §9.88C. Second, prior to 1939, neither guarantors *nor* sureties were directly protected by the one-action rule in California; the argument thus questionably ascribes to the 1939 legislation an intent to give rights to both that were held previously by neither.

NOTE: Prior to 1939, a surety, unlike a guarantor, could require the creditor to first resort to the principal's collateral, but this was not by direct application of CCP §726. Rather, it was pursuant to the suretyship provisions of CC §§2845, 2849, and 2850. See §9.88W. See *Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476; *Adams v Wallace* (1897) 119 C 67, 51 P 14; *Birkhofer v Krumm* (1935) 4 CA2d 43, 40 P2d 553; *Kelley v Goldschmidt* (1920) 47 CA 38, 190 P 55; *Craiglow v Williams* (1920) 45 CA 514, 188 P 76; *Murphy v Hellman Commercial Trust & Sav. Bank* (1919) 43 CA 579, 185 P 485. See also *Martin v Becker* (1915) 169 C 301, 146 P 665.

Some post-1939 California court of appeal cases have agreed with the proposition that guaranty obligations are no longer "independent." However, they have taken that conclusion to mean simply that guarantors, like sureties, now have the benefit of CC §§2845 and 2849 and all other suretyship rights. See *Wiener v Van Winkle* (1969) 273 CA2d 774, 78 CR 761; *American Guar. Corp. v Stoody* (1964) 230 CA2d 390, 41 CR 69.

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§9.89C (2) Policy Arguments

It has also been argued, most forcefully in regard to CCP §580a's fair value rule, that the public policy reflected in that rule is squarely implicated in the case of guarantors and thus the rule should apply. See, *e.g., Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 1472, 46 CR2d 656); *Chequers Inv. Assocs., II v Del Heil* (Nov. 29, 2001, G021285; not certified for publication) 2001 Cal App Unpub Lexis 1170, *10.

This argument is often made by analogy to the extension of CCP §580a that occurred in *Bank of Hemet v U.S.* (9th Cir 1981) 643 F2d 661 and *Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 221 CR 425. Those cases, finding that the policy of California is "to prevent excess recoveries by secured creditors" (643 F2d at 669), applied §580a beyond its literal language to limit money judgments by junior trust-deed beneficiaries who purchase the encumbered property at the senior's foreclosure sale and then sue the borrower (see §5.23). That same rationale and approach, it can be argued, would support the extension of §580a's fair value rule to limit secured creditors' recoveries from guarantors as well as from additional collateral pledged by the principal obligor.

Regarding additional collateral, however, this argument was rejected by the supreme court in *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29, reaffirming *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 120 P2d 869. The court held that neither CCP §580a nor §580d limits or otherwise applies to recoveries from additional collateral, explaining that "section 580a applies only to shield a borrower from personal liability"; the court noted that the same is true of §580d. 24 C4th at 408. See §9.7. See also §9.8 (discussing §580b).

This view of CCP §580a's purpose, shielding a borrower from personal liability, is considerably narrower than that articulated in *Bank of Hemet* and *Walter E. Heller W.*, "prevent[ing] excess recoveries by secured creditors." In response to the argument that it should "revitalize" and extend the reach of CCP §580a, the *Dreyfuss* court wrote: "Such an undertaking is a matter for legislative, not judicial, action." 24 C4th at 412.

Dreyfuss did not address guarantors. Arguably its analysis did not entirely rule out applying CCP §580a and other antideficiency rules directly to guarantors. As a practical matter, however, *Dreyfuss* greatly diminished the likelihood that courts will take that step absent legislative expansion of the statutes. See, *e.g., Chequers Inv. Assocs., II v Del Heil* (Nov. 29, 2001, G021285; not certified for publication) 2001 Cal App Unpub Lexis 1170, *13 (holding, in light of *Dreyfuss*, that §580a does not apply to guarantors, although the court in *Chequers* believed it should and urged legislative consideration). See also *Talbott v Hustwit* (2008) 164 CA4th 148, 152, 78 CR3d 703.

NOTE: The enactment of CC §2856 in 1996 (see §9.89J), broadly authorizing waivers by a guarantor or surety of one-action and antideficiency protections even if they apply directly, may be thought relevant in two ways. By authorizing waiver of any such protections that a guarantor or surety "*may* have" (CC §2856(a)(3)), the statute leaves open the possibility that, absent waiver, a guarantor or surety *does* have such protections. On the other hand, rights based on strong public policy are normally not waivable at all, so the waiver statute makes it more difficult to argue, as a policy matter, that the one-action and antideficiency rules are legislatively intended to encompass guarantors and sureties.

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§9.89D c. Indirect Protection of Guarantors

In addition to the question whether one-action and antideficiency rules apply directly to a guarantor (see §§9.88Z-9.89C), cases have also considered whether the rules apply indirectly, via suretyship rights and defenses. As discussed in the sections that follow, indirect protection has been rejected in broad form (see §9.89E) but has been applied in one context (see §§9.89F-9.89G).

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§9.89E (1) Civil Code §§2809 and 2810

The suretyship rules that might be thought most likely to provide indirect one-action and antideficiency protection to a guarantor are CC §§2809 and 2810. These sections enable a guarantor to assert defenses of the principal obligor, at least to some extent (see §9.88T).

Nonetheless, California courts have consistently held that §§2809 and 2810 do not enable a guarantor to assert the principal's one-action and antideficiency defenses. The primary rationale is that the one-action and antideficiency rules only affect the *remedy* available against the principal, not the obligation itself. See, *e.g., Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476; *Loeb v Christie* (1936) 6 C2d 416, 57 P2d 1303; *Gottschalk v Draper Cos.* (1972) 23 CA3d 828, 831, 100 CR 434; *Heckes v Sapp* (1964) 229 CA2d 549, 554, 40 CR 485; *Katz v Haskell* (1961) 196 CA2d 144, 16 CR 453. See also *Bloom v Bender* (1957) 48 C2d 793, 801, 313 P2d 568.

For detailed criticism of this position, see Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes,* 17 UCLA L Rev 245 (1969); see also *Talbott v Hustwit* (2008) 164 CA4th 148, 154, 78 CR3d 703 (concurring opinion of Sills, J).

NOTE: A similar argument for indirect application of antideficiency defenses might be made under CC §2822(a), which provides that a creditor's acceptance of anything in partial satisfaction of an obligation reduces a surety's obligation "in the same measure as that of the principal." If the creditor realizes on the principal's collateral and the principal's obligation is thereby reduced (or eliminated) by antideficiency rules, a guarantor might argue under CC §2822(a) that its obligation is likewise reduced (or eliminated). This argument will likely meet the same response, however, as held by the courts in the context of CC §§2809 and 2810, *i.e.,* that one-action and antideficiency rules only limit the *remedy* against the principal, not the obligation itself.

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§9.89F (2) *Union Bank v Gradsky:* Estoppel Defense Exonerates Guarantor

In *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64, the creditor sought to recover a deficiency from the guarantor after first nonjudicially foreclosing on the principal's real property collateral. The court held that CCP §580d does not apply directly to guarantors, so it does not directly protect a guarantor from deficiency liability after nonjudicial foreclosure. But the court held that the guarantor was nonetheless exonerated on the basis of estoppel principles.

The court reasoned that nonjudicial foreclosure renders a guarantor's subrogation rights worthless because

- the collateral, having been foreclosed on, is gone; and
- CCP §580d bars the creditor from recovering any deficiency from the principal obligor; the guarantor, standing in the creditor's shoes by subrogation if it pays the deficiency, is thus also barred from recovering the deficiency from the principal.

If, instead, the creditor had foreclosed judicially or recovered from the guarantor without foreclosing, CCP §580d would not have been triggered. For that reason, the court held that the guarantor was exonerated by the creditor's election of the nonjudicial foreclosure remedy (265 CA2d at 46):

> Upon the Bank's electing to pursue a remedy which destroys both the security and the possibility of the surety's reimbursement from the principal debtor, the creditor is thereafter estopped from pursuing the guarantor for a deficiency following a nonjudicial sale of the security. The result follows not because section 580d of the Code of Civil Procedure prevents recovery of a deficiency judgment against the guarantor, but because the section prevents a deficiency judgment by the guarantor against the debtor.

Although not questioning the result, two later supreme court cases raise uncertainties about *Gradsky*'s analysis that have not been resolved. Compare *Regents of Univ. of Cal. v Hartford Acc. & Indem. Co.* (1978) 21 C3d 624, 640 n11, 147 CR 486 (describing *Gradsky* as having been based on impaired reimbursement rights), with *Western Sec. Bank v Superior Court* (1997) 15 C4th 232, 249, 62 CR2d 243 (criticizing, as "unnecessary," statements in *Gradsky* that reimbursement recovery against principal would be barred by CCP §580d, and describing *Gradsky* as having been based on destroyed subrogation rights). See §§9.88Q-9.88R.

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§9.89G (3) *Union Bank v Gradsky:* Limitations on Estoppel Defense

The court in *Gradsky* stated that a guarantor could "by express contract or by his subsequent actions either waive or be estopped" from raising the estoppel defense described in §9.89F, although waiver was found not to have occurred. *Union Bank v Gradsky* (1968) 265 CA2d 40, 48, 71 CR 64.

Waiver by contract is currently authorized by statute (CC §2856(a)(2); see §§9.89M, 9.89O-9.89P). Regarding the possibility of subsequent waiver by conduct, compare *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238 (creditor's tender of loan to guarantor prior to foreclosure was not accepted; this, together with waiver language in guaranty, waived *Gradsky* defense), with *Consolidated Capital Income Trust v Khaloghli* (1986) 183 CA3d 107, 227 CR 879 (unaccepted tender of loan does not waive *Gradsky* defense as a matter of law, but is fact-dependent).

PRACTICE TIP: In any circumstance where the *Gradsky* defense may not have been waived, it is advisable to tender the loan to the guarantor and demand payment before nonjudicially foreclosing.

Apart from waiver, the *Gradsky* defense has been held not to apply in at least two circumstances:

- The defense bars recovery from a guarantor *after* nonjudicial foreclosure but does not affect recoveries from the guarantor *before* foreclosure. See, *e.g., Krueger v Bank of America* (1983) 145 CA3d 204, 193 CR 322; *Aruba Bonaire Curacao Trust Co. v United Cal. Bank* (1973) 32 CA3d 281, 107 CR 924. See also *Gradsky*, 265 CA2d at 44. In *Krueger*, the court also rejected the argument that *Gradsky* could give rise to an affirmative cause of action by the guarantor against the creditor for nonjudicially foreclosing.
- Because the defense is premised on impairment of the right to recover a deficiency, it does not apply if a deficiency recovery was already precluded for other reasons. See, *e.g., Bauman v Castle* (1971) 15 CA3d 990, 93 CR 565 (no rights of reimbursement or indemnity because debt was within purchase money antideficiency rule of CCP §580b). See also *Consolidated Capital Income Trust v Khaloghli* (1986) 183 CA3d 107, 227 CR 879 (remand for factual determination whether rights of reimbursement and subrogation had been released by guarantor).

The defense also might not apply if the principal is insolvent and no deficiency is recoverable in any event. See Restatement (Third) of Suretyship and Guaranty §44 and Illustration 2 (1996).

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§9.89H 9. One-Action and Antideficiency Rules When Guarantor's Real Property Secures Guaranty

Sections 9.88Z-9.89G address the guarantor's defenses when the principal's obligation is secured by the principal's real property. If, instead, the guaranty is itself secured by real property, there is no doubt that the guarantor is directly protected by the one-action rule, under the plain language of the statute. CCP §726(a) provides that the rule applies to the "recovery of any debt or the enforcement of any right secured by mortgage upon real property." See, *e.g., Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, and *Bayless v Ames* (1929) 207 C 54, 276 P 1011 (both applying §726(a) to guarantors who secured their guaranty with their real property).

Less clear is applicability of the antideficiency rule of CCP §580d and thus whether a deficiency could be recovered against a guarantor after nonjudicial foreclosure on the guarantor's real property. By its terms, §580d applies only to a "note" secured by real property, indicating that other obligations, possibly including guaranties, might be outside its reach. See *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64 (action on guaranty would not constitute action on "note" within §580d; dicta). See also *Freedland v Greco* (1955) 45 C2d 462, 289 P2d 463 (observing that other antideficiency provisions, which refer to debts, obligations, or contracts and not merely to notes, may be broader than §580d; dicta); *Passanisi v Merit-McBride Realtors, Inc.* (1987) 190 CA3d 1496, 236 CR 59 (§580d not applicable to creditor's attorney fee award in prior injunction action brought by trustor); *Willys of Marin County v Pierce* (1956) 140 CA2d 826, 296 P2d 25 (§580d not applicable to lease obligations secured by deed of trust).

If CCP §580d *does* apply to guaranties, then the creditor would not be able to obtain a personal recovery against the guarantor without foreclosing judicially on the guarantor's real property and obtaining a deficiency judgment pursuant to CCP §726. If CCP §580d does *not* apply to guaranties, then a deficiency would be permissible after nonjudicial foreclosure but would be subject to the fair value rule of CCP §580a, which applies to an "obligation," not just a note. Section 580a's 3-month postsale deadline for commencing the action would also apply.

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§9.89I 10. One-Action and Antideficiency Rules When Guarantor's Real Property Secures Principal Obligation

As discussed in §9.88G, if a third party gives a deed of trust to secure the obligation of another, that third party is a guarantor or surety under CC §2787, even though there is no separate guaranty document. When that occurs, the third party has incurred no liability on the debt beyond its interest in the property (see, *e.g., Carson v Reid* (1902) 137 C 253, 70 P 89), and therefore recovery of a deficiency against that party is not legally tenable.

However, this arrangement triggers the one-action and antideficiency rules with respect to the *principal obligor* because the underlying principal obligation has become secured by real property. See, *e.g., Gnarini v Swiss Am. Bank* (1912) 162 C 181, 121 P 726 (CCP §726 was violated by setoff against principal obligor's bank account because principal obligation was secured by third party's mortgage); *Indusco Mgmt. Corp. v Robertson* (1974) 40 CA3d 456, 114 CR 47 (nonjudicial foreclosure under third party deed of trust securing principal obligation would preclude deficiency recovery against principal). See also *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, 268, aff'd (9th Cir 1995) 46 F3d 1143 (unpublished opinion). But see *Murphy v Hellman Commercial Trust & Sav. Bank* (1919) 43 CA 579, 185 P 485 (despite money judgment against principal in prior lawsuit, CCP §726 did not bar subsequent foreclosure against third party mortgagor's real property collateral).

PRACTICE TIP: Rather than obtaining a third party deed of trust to secure the principal obligation, it is often preferable from the creditor's standpoint to obtain a separate guaranty from the third party and secure the guaranty with the deed of trust. The underlying obligation thus remains unsecured, free from the restrictive enforcement rules governing a real property secured obligation. To protect the guarantor from personal liability, if that is the agreement of the parties, the guaranty can simply provide that it is nonrecourse.

Sometimes a creditor obtains both a third party deed of trust securing the principal obligation *and* a separate guaranty of that obligation from the same third party. That was the case in *Indusco Mgmt. Corp. v Robertson* (1974) 40 CA3d 456, 114 CR 47. The court held that, after nonjudicial foreclosure under the deed of trust, the guarantor was exonerated from the guaranty on the basis of *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64, because the creditor's election of the nonjudicial foreclosure remedy destroyed the guarantor's right of recovery from the principal obligor—*i.e.,* the same result as if the principal obligor had itself given the deed of trust (see §9.89F).

NOTE: Creditors often take third party deeds of trust without recognizing that the trustor has suretyship status under CC §2787 and thus fail to obtain waivers of suretyship rights and defenses. When that occurs, conceivably the creditor may face conflicting statutory duties. Pursuant to CC §2845, the third party trustor, as surety, can require that the creditor proceed first against the principal obligor before proceeding against the third party's real property (see §9.88W). But because the principal obligation is secured by that property, CCP §726 seemingly requires that the creditor first proceed against the property. It is unclear how this conflict would be resolved, although arguably a surety implicitly waives CC §2845 by encumbering its property to secure the underlying debt.

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§9.89J 11. Waiver of Rights and Defenses

Waiver of a guarantor or surety's rights and defenses—those arising from suretyship law as well as any that may arise from one-action and antideficiency rules—is the subject of CC §2856. The statute identifies certain types of rights and defenses that may be enforceably waived. See CC §2856(a). See also §§9.89K-9.89N. It also addresses the specificity required for contractual waivers of those rights and defenses, setting out both a general rule (CC §2856(b)) and optional safe-harbor waiver language for some but not all rights and defenses (CC §2856(c)-(d)). See §9.89P.

NOTE: The current version of §2856 was enacted in 1996, effective January 1, 1997. A prior, more limited version of §2856 was enacted in 1994, effective during 1995-1996. Stats 1994, ch 1204, §1 (repealed by Stats 1996, ch 1013, §1). Under CC §2856(f), the validity of waivers executed prior to 1997 is to be determined by application of the law in effect at the time of execution.

Civil Code §3268, in effect since 1872, governs waivers of rights under several Civil Code titles, including the suretyship title. See also CC §3513, an even more general waiver provision. Sections 3268 and 3513 remain in effect, and thus partially overlap CC §2856, but the more recent and specific rules of §2856 should govern whenever applicable.

Certain rights and defenses potentially available to a guarantor or surety are beyond the scope of CC §2856. See §§9.89Q-9.89R.

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§9.89K a. Waivable Rights and Defenses

Civil Code §2856(a), as enacted in 1996 and applicable to waivers executed thereafter (CC §2856(f)), allows a "guarantor or other surety" to enforceably waive any or all of three sets of rights and defenses:

(1) Suretyship rights and defense (see §9.89L);

(2) Election of remedy rights and defenses (see §9.89M); and

(3) One-action and antideficiency rights and defenses arising because the principal's obligation is secured by real property (see §9.89N).

A provision in the bill enacting CC §2856 stated the legislative intent that the types of waivers described in §2856 "do not violate the public policy of this state." Stats 1996, ch 1013, §3.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.89L (1) Suretyship Rights and Defenses

§9.89L (1) Suretyship Rights and Defenses

Under CC §2856(a)(1), a guarantor or other surety may waive "rights of subrogation, reimbursement, indemnification, and contribution and any other rights and defenses that are or may become available to the guarantor or other surety" under CC §§2787-2855. See, *e.g.,* rights and defenses cited in §§9.88O-9.88Y. The referenced sections in §2856(a)(1) encompass the entire balance of the Civil Code's suretyship provisions. (Regarding possible limitations on this scope, see §9.89R.)

This authorization of waivers is consistent with prior case law recognizing the waivability of various suretyship rights and defenses. See, *e.g.,* the following:

- *Bloom v Bender* (1957) 48 C2d 793, 313 P2d 568 (CC §2809);
- *Pearl v General Motors Acceptance Corp.* (1993) 13 CA4th 1023, 16 CR2d 805 (CC §2815);
- *Bloom*, 48 C2d at 801, *Stevenson v Oceanic Bank* (1990) 223 CA3d 306, 272 CR 757, and *Krueger v Bank of America* (1983) 145 CA3d 204, 193 CR 322 (CC §2819, advance consent to modifications); and
- *Guild Wineries & Distilleries v Land Dynamics* (1980) 103 CA3d 966, 163 CR 348, *Brunswick Corp. v Hays* (1971) 16 CA3d 134, 93 CR 635, *Wiener v Van Winkle* (1969) 273 CA2d 774, 78 CR 761, *Engelman v Bookasta* (1968) 264 CA2d 915, 71 CR 120, and *American Guar. Corp. v Stoody* (1964) 230 CA2d 390, 41 CR 69 (CC §§2845, 2849).

See also Restatement (Third) of Suretyship and Guaranty §48 (1996). In addition, CC §3268, enacted in 1872 and still in effect, authorizes waiver of provisions of several titles of the Civil Code, including the suretyship title, "unless such waiver would be against public policy." See, *e.g., Bloom v Bender, supra*.

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§9.89M (2) Election of Remedies Rights and Defenses

Under CC §2856(a)(2), a guarantor or other surety may waive "[a]ny rights or defenses the guarantor or other surety may have in respect of his or her obligations as a guarantor or other surety by reason of any election of remedies by the creditor." The optional safe-harbor waiver language of CC §2856(c)-(d) (see §9.89P) makes clear the intent of CC §2856(a)(2) to preserve a guarantor's liability to the creditor even if the guarantor's reimbursement and subrogation rights against the principal have been destroyed by the creditor's choice of remedy.

This provision authorizes waiver of the estoppel defense of *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64 (see §§9.89F-9.89G), and any other right or defense that might likewise arise as a result of the creditor's election of remedies. This provision, like CC §2856(a)(1), is consistent with prior case law holding that the *Gradsky* defense is waivable, although that case law often found particular contractual language insufficient to accomplish a waiver (see §9.89O).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.89N (3) One-Action and Antideficiency Rights and Defenses

§9.89N (3) One-Action and Antideficiency Rights and Defenses

Under CC §2856(a)(3), a guarantor or other surety may waive "[a]ny rights or defenses the guarantor or other surety may have because the principal's note or other obligation is secured by real property or an estate for years." These "include, but are not limited to, any rights or defenses that are based upon, directly or indirectly," the application of CCP §580a, §580b, §580d, or §726 to the principal's note or other obligation. The optional safe-harbor waiver language of CC §2856(c) (see §9.89P) makes clear the intent of CC §2856(a)(3) to include

- any right of the guarantor to require the creditor to first pursue the principal's real or personal property collateral;
- any protection of the guarantor under fair value rules; and
- any exoneration of the guarantor based on destruction of the guarantor's right to collect from the debtor as a result of the creditor's foreclosure on the real property collateral.

By referring to rights and defenses that the guarantor or surety "may" have under the one-action and antideficiency rules, CC §2856(a)(3) leaves open the question whether such rules do, in fact, benefit a guarantor or surety directly when the principal obligation is secured by real property. See §§9.89A-9.89C. The provision makes clear, though, that to whatever extent those rules do apply in that context to a guarantor or surety, directly or indirectly, they are waivable, unlike the unenforceability of waivers by the principal (CC §2953; see §§4.60-4.66, 5.64-5.70).

NOTE: Prior to enactment of §2856, the only case directly protecting a guarantor with an antideficiency defense, *Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 46 CR2d 656) (CCP §580a), questioned whether waiver would be permissible but found that no waiver had occurred. 39 CA4th at 1476 n8. *Dombrow* was the impetus for legislative expansion of CC §2856 to its current form in 1996.

Civil Code §2856(a)(3) applies to rights or defenses the guarantor or surety may have because "the *principal's* note or other obligation is secured by real property." (Emphasis added.) This must be distinguished from the situation in which the obligation of the guarantor or other surety is itself secured by real property. See §9.89H. In that situation, the guarantor or surety is protected by one-action and antideficiency rules directly, in its own right. Civil Code §2856(a)(3) is by its terms inapplicable, and thus the normal prohibitions on one-action and antideficiency waivers should apply.

Less clear is the situation in which the guarantor's real property secures not a separate guaranty but the principal obligation directly. See §9.89I. This situation is within the literal scope of §2856(a)(3) because "the principal's note or other obligation is secured by real property," which thus appears to authorize waivers of one-action and antideficiency protections by the guarantor as trustor. Waivers by the guarantor are of less significance in this context, however, for two reasons. First, the guarantor normally does not have personal liability in any event, not having promised to pay the debt, so recovery of a deficiency from the guarantor is moot. Second, by virtue of the guarantor's deed of trust, the principal obligor has itself become protected directly by the one-action and antideficiency rules, and CC §2856(a)(3) does not purport to authorize waivers by the principal.

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b. Interpretation of Contractual Waivers

§9.89O (1) Case Law Prior to Civil Code §2856

Pre-CC §2856 California cases dealing with contractual waivers of suretyship rights and defenses generally did not demand a high level of specificity in the contract language. See, *e.g., Bloom v Bender* (1957) 48 C2d 793, 803, 313 P2d 568; *River Bank Am. v Diller* (1995) 38 CA4th 1400, 1413, 45 CR2d 790; *Brunswick Corp. v Hays* (1971) 16 CA3d 134, 138, 93 CR 635; *Wiener v Van Winkle* (1969) 273 CA2d 774, 786-87, 78 CR 761. See also CC §3268 (intent ascertained in usual manner for contracts). See Restatement (Third) of Suretyship and Guaranty §48 and Comment d (1996).

NOTE: In *River Bank Am.,* supporting its conclusion that a waiver was sufficient, the court also considered that the guarantors were sophisticated business persons, with special expertise in real estate development, represented by counsel. 38 CA4th at 1417.

When waiver of the *Gradsky* estoppel defense (see §§9.89F-9.89G) was at issue, courts tended to apply a more rigorous standard. In *Gradsky* itself, the court found that the guaranty did not "specifically waive the guarantor's defense based upon an election of remedies which destroys both the guarantor's subrogation rights and his right to proceed against the principal obligor for reimbursement." Absent that explicit waiver, the court declined to "strain the instrument" to find a waiver by implication. *Union Bank v Gradsky* (1968) 265 CA2d 40, 48, 71 CR 64. See also *Indusco Mgmt. Corp. v Robertson* (1974) 40 CA3d 456, 461, 114 CR 47; *Union Bank v Brummell* (1969) 269 CA2d 836, 839, 75 CR 234. But see *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 236, 99 CR 238.

In *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, the court held that a guaranty was inadequate to waive the *Gradsky* defense because it did not inform the guarantor in highly specific terms of the nature of the defense—"*i.e.,* the legal consequence of the destruction of subrogation rights by nonjudicial foreclosure." 14 CA4th at 1540. The court considered its conclusion "buttressed by the absence of any mention" of CCP §580d in the waiver language. 14 CA4th at 1541. See also *Resolution Trust Corp. v Titan Fin. Corp.* (9th Cir 1994) 22 F3d 923, 924. *Cathay Bank* was the impetus for initial enactment of CC §2856 in 1994.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.89P (2) Civil Code §2856

§9.89P (2) Civil Code §2856

Civil Code §2856(b) provides the following general rule for determining the adequacy of contractual waiver language, which requires little by way of specificity:

> A contractual provision that expresses an intent to waive any or all of the rights and defenses described in subdivision (a) shall be effective to waive these rights and defenses without regard to the inclusion of any particular language or phrases in the contract to waive any rights and defenses or any references to statutory provisions or judicial decisions.

Civil Code §2856(c)-(d) goes on to provide optional safe-harbor waiver language for the waivers authorized in CC §2856(a)(2) (election of remedies) and §2856(a)(3) (one-action and antideficiency rules), "[w]ithout limiting any rights of the creditor or any guarantor or other surety to use any other language to express an intent to waive."

NOTE: The statute provides no safe-harbor language for waiver of the suretyship rights and defenses as authorized in CC §2856(a)(1). Thus, the adequacy of such waivers are determined under the general rule of CC §2856(b).

Under CC §2856(c), the following language is effective to waive all rights and defenses waivable under §2856(a)(2)-(3):

> The guarantor waives all rights and defenses that the guarantor may have because the debtor's debt is secured by real property. This means, among other things:
> (1) The creditor may collect from the guarantor without first foreclosing on any real or personal property collateral pledged by the debtor.
> (2) If the creditor forecloses on any real property collateral pledged by the debtor:
> (A) The amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price.
> (B) The creditor may collect from the guarantor even if the creditor, by foreclosing on the real property collateral, has destroyed any right the guarantor may have to collect from the debtor. This is an unconditional and irrevocable waiver of any rights and defenses the guarantor may have because the debtor's debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based upon Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure.

Under CC §2856(d), the following language is effective to waive all rights and defenses arising by reason of an election of remedies by the creditor:

> The guarantor waives all rights and defenses arising out of an election of remedies by the creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guaranteed obligation, has destroyed the guarantor's rights of subrogation and reimbursement against the principal by the operation of Section 580d of the Code of Civil Procedure or otherwise.

PRACTICE TIP: It is now standard practice—and highly advisable for creditors—to include the foregoing waiver language essentially verbatim in guaranties and other contracts that create suretyship obligations.

Under CC §2856(e), the foregoing provisions dealing with contractual waiver language—*i.e.,* the general rule of CC §2856(b) and the safe-harbor language of §2856(c)-(d)—are inapplicable to a guaranty or surety obligation in respect of a purchase money loan secured by a borrower-occupied dwelling for not more than four families. An accompanying statement of legislative intent indicates that "[n]o inference of any kind should be drawn from the exclusion of these transactions" from CC §2856(b)-(d). Stats 1996, ch 1013, §3. Thus, courts are left to determine the adequacy of waiver language in this context but are not precluded from reaching results similar to those provided in the statute.

NOTE: Civil Code §2856(e) makes the waiver *language* provisions of CC §2856(b)-(d) inapplicable but does not call off the *authorization* of waivers in CC §2856(a).

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c. Limitations on Waiver

§9.89Q (1) Beyond Civil Code §2856

Despite the breadth of CC §2856(a)'s authorization of waivers, some rights and defenses of a guarantor or surety are beyond its scope:

Illegal transactions. In *WRI Opportunity Loans II, LLC v Cooper* (2007) 154 CA4th 525, 65 CR3d 205, the court held that a waiver of suretyship defenses, including CC §§2809 and 2810 (see §9.88T), did not preclude the guarantor from asserting, as a defense to payment under the guaranty, that the underlying obligation was usurious. The court held that "the usury defense rests on the rule against the enforcement of illegal transactions, which is founded on considerations of public policy that are independent of sections 2809 and 2810." 154 CA4th at 545. The court concluded that CC §2856(a)(1) was not intended to abrogate that rule.

Duty to disclose. In *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 85, 73 CR 564, the creditor's duty of disclosure to a surety (see §9.88X) was based by the supreme court on a creditor's "duty of continuous good faith and fair dealing" to a surety, not on the Civil Code's suretyship provisions. A breach of that duty is a form of misrepresentation. 70 C2d at 90; Restatement (Third) of Suretyship and Guaranty §12(3) (1996). The defense arising from such a breach thus is not within CC §2856(a)(1), and it is doubtful whether, as a matter of public policy, a waiver would be enforced. Creditors do, however, frequently obtain (1) representations and warranties that a guarantor has full access to information about the borrower's financial condition and other facts relevant to the risk undertaken and (2) a covenant by the guarantor to stay fully informed.

Rights under Commercial Code Division 9. With respect to a creditor's enforcement of a security interest in personal property collateral, Chapter 6 of Commercial Code Division 9 provides various rights to both debtors and secondary obligors (as defined in Com C §9102(a)(71)), which for the most part cannot be waived at all (Com C §9602), although some can be waived after default (see Com C §9624(a), (c) (right to notice of disposition and right to redeem)). These Commercial Code Division 9 rights are not within any of the categories of waivable rights and defenses under CC §2856(a), and thus Division 9's waiver rules govern. See also §9.120 (same with respect to accommodation parties).

WARNING: The nonwaivable rules of Division 9 can result in reduction or elimination of deficiency liability of a guarantor or surety if the creditor does not comply with its duties in enforcing its security interest in personal property. See Com C §9626.

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§9.89R (2) Within Civil Code §2856

Even within the literal scope of CC §2856(a)(1)'s waiver authorization, the waivability of at least some fundamental suretyship defenses is questionable:

- Civil Code §2839 provides that performance (or an offer of performance) of the principal obligation exonerates a surety, and CC §2822(a) provides that partial satisfaction of an obligation reduces a surety's obligation correspondingly. A waiver of these defenses, if enforceable, could allow the creditor to recover from a surety even after being paid. See *Durgin v Kaplan* (1968) 68 C2d 81, 89 n8, 65 CR 158 (questioning validity of such waiver, as contrary to public policy, prior to enactment of §2856; dicta).
- Civil Code §2856(a)(1) ostensibly authorizes waiver of even formation defenses such as consideration (CC §2792) and the statute of frauds (CC §2793). See §§9.88L-9.88M. If a guaranty or other contract creating a suretyship obligation did not meet the statute's formation requirements, it seems unlikely that a court would bootstrap it into enforceability by means of waivers within it.

Regarding waiver of the right to revoke a continuing guaranty, also questionable, see §9.89Z.

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§9.89S 12. Purported "Guaranty" by Principal Obligor

As discussed in §9.88F, under suretyship law a party may have guarantor or surety status even if the contractual documents purport to designate that party a principal obligor. As §§9.89T-9.89X discuss, the reverse is also true: The fact that a party is nominally a "guarantor" or "surety" in the transaction does not preclude a determination that the party is, in fact, a principal obligor. See, *e.g., Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476.

The question whether a party is a principal obligor or a guarantor has a major impact when the obligation in question is secured by real property. Principal obligors are protected by the one-action and antideficiency rules, unwaivable at the outset, but guarantors are not protected (see §§9.88Z-9.89A, 9.89M-9.89N). For that reason, creditors have substantial incentive to require guarantors in real property secured transactions and to characterize as "guarantors" parties who might otherwise be principal obligors. Transactions must be carefully scrutinized to determine the true nature of each party's liability.

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§9.89T a. "Debt of Another"

A guarantor or surety is "one who promises to answer for the debt, default, or miscarriage *of another*, or hypothecates property as security therefor." (Emphasis added). CC §2787. If a would-be "guarantor" or "surety" already has liability as a principal obligor for the debt in question, that definitional requirement will not be met. The debt is not that "of another"; it is the party's own debt. See, *e.g., Valinda Builders, Inc. v Bissner* (1964) 230 CA2d 106, 40 CR 735.

In the case law, guaranties that satisfy this test are commonly referred to as "true" guaranties, as distinguished from "sham" or "purported" guaranties. See, *e.g., Union Bank v Gradsky* (1968) 265 CA2d 40, 42, 71 CR 64. Only a "true" guarantor will be subject to pursuit by the creditor free of one-action and antideficiency protections, and it is a factual question whether a party is truly a guarantor or merely a disguised principal. See *River Bank Am. v Diller* (1995) 38 CA4th 1400, 1422, 45 CR2d 790.

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§9.89U b. Examples: Sham Guaranties

In the following situations, the courts found a purported "guarantor" to be a principal obligor, protected by one-action or antideficiency rules:

- A purchaser of encumbered property who assumed the secured debt also purported to guarantee it. The purchaser was held to be a principal obligor, not a guarantor, protected by CCP §580a after nonjudicial foreclosure. *Everts v Matteson* (1942) 21 C2d 437, 448, 132 P2d 476 (foreclosure predated enactment of CCP §580d).
- Two individuals entered into a contract to purchase real property, but title was taken by their closely held corporation, which executed the note and deed of trust contemplated by the purchase agreement. The individuals purported to guarantee the obligation. Finding "no evidence that [the corporation] was anything other than an instrumentality used by the individuals or that [the individuals] were ever removed from their status and obligations of purchasers," the court held that the individuals were principals, not guarantors, protected by CCP §580b. *Valinda Builders, Inc. v Bissner* (1964) 230 CA2d 106, 110, 40 CR 735. Compare *Valinda Builders, Inc.,* with *Roberts v Graves* (1969) 269 CA2d 410, 75 CR 130 (when individual's obligation under purchase contract was found to have been modified from personal to corporate by parties' agreement, guaranty was enforceable and CCP §580b did not apply).
- General partners of a partnership purported to guarantee the partnership's real property secured debt. The guaranty was held to add nothing to the partners' joint and several liability under partnership law for debts of the partnership. Thus, the partners were protected by CCP §580b in a purchase money transaction. *Riddle v Lushing* (1962) 203 CA2d 831, 21 CR 902. See *Union Bank v Dorn* (1967) 254 CA2d 157, 61 CR 893 (same, non-purchase money, applying CCP §580d).
- A general partner purported to guarantee the partnership's real property secured obligation. The creditor obtained an attachment on the partner's bank account in an action on the guaranty. The partner was held to be a principal obligor on the basis of his liability as a partner. The attachment thus violated CCP §726, resulting in loss of the real property security. *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1997) 205 BR 427, aff'd (9th Cir 1999) 164 F3d 1214.
- A purchaser of real property caused the seller to convey title to a "dummy," a third party who had no interest in the property, who also executed a note and deed of trust for the purchase price. The true purchaser executed a "guaranty." The true purchaser was held to be protected by CCP §580b. *Coast Fed. Sav. & Loan Ass'n v Crawford (In re Wilton-Maxfield Mgmt. Co.)* (9th Cir 1941) 117 F2d 913.

"True guaranty" cases focus on preventing evasion of one-action and antideficiency rules. "[T]he legislative purpose of the antideficiency law may not be subverted by attempting to separate the primary obligor's interests by making a related entity the debtor while relegating the true principal obligors to the position of guarantors." *Torrey Pines Bank v Hoffman* (1991) 231 CA3d 308, 320, 282 CR 354.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/ c. Issues Raised by Particular Entity Types/§9.89V (1) Partnerships, Corporations, and LLCs

c. Issues Raised by Particular Entity Types

§9.89V (1) Partnerships, Corporations, and LLCs

When the maker of a note or other credit agreement secured by real property is a general or limited partnership, and general partners in that partnership purport to guarantee the obligation, the analysis is straightforward. General partners are already jointly and severally liable on the partnership's debt as a matter of law. Corp C §15904.04(a) (limited partnerships), §16306(a) (general partnerships); but see Corp C §§15904.04(b), 16306(b) (no liability for debts incurred by partnership before person became general partner). Thus, general partners are already principal obligors, their guaranties add nothing to that liability, and they are protected by the one-action and antideficiency rules. See, *e.g., Union Bank v Dorn* (1967) 254 CA2d 157, 61 CR 893; *Riddle v Lushing* (1962) 203 CA2d 831, 21 CR 902; *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1997) 205 BR 427, aff'd (9th Cir 1999) 164 F3d 1214.

NOTE: In *Westinghouse Credit Corp. v Barton* (CD Cal 1992) 789 F Supp 1043, 1046, the court applied the same rule even though the partnership's debt was contractually nonrecourse, characterizing that approach as a "device" to avoid antideficiency statutes.

By contrast, when the maker is a limited partnership, limited liability company (LLC), or corporation and the guarantors are its limited partners, members, or shareholders, they are not, merely by virtue of their status, already liable for their entity's debts. Corp C §15903.03(a) (limited partners), §17101(a) (LLC members), §17158(a) (LLC managers and officers). See *Bing Crosby Minute Maid Corp. v Eaton* (1956) 46 C2d 484, 297 P2d 5 (corporate shareholders). Thus, their status does not by itself undermine the enforceability of their guaranties of the entity's debts. See, *e.g., Heckes v Sapp* (1964) 229 CA2d 549, 40 CR 485. Other factors may change that conclusion, however. For example:

- If, by virtue of the alter ego doctrine, the guarantor is liable for the entity's debts, the guaranty might not be considered "true." See *Valinda Builders, Inc. v Bissner* (1964) 230 CA2d 106, 40 CR 735. But see *Communist Party v 522 Valencia, Inc.* (1995) 35 CA4th 980, 993, 41 CR2d 618 ("persons who themselves control a corporation, who have used the corporate form of doing business for their benefit, who have dealt with and treated the corporation as a separate entity, or who have otherwise by their actions expressly or impliedly recognized its corporate existence, may be estopped to deny the corporation's separate legal existence"). Regarding alter ego doctrine and factors that may cause a court to apply it, see Counseling California Corporations §§3.78-3.85 (3d ed Cal CEB 2008); see also *Associated Vendors, Inc. v Oakland Meat Co.* (1962) 210 CA2d 825, 26 CR 806.
- If a contract to purchase real property is in the name of an individual but title is taken in the name of the individual's business entity, the individual might still be considered to be the actual purchaser and the entity a mere "instrumentality." The individual's "guaranty" of the purchase price may thus be ineffective to defeat antideficiency protection under CCP §580b. Compare *Valinda Builders, Inc. v Bissner* (1964) 230 CA2d 106, 40 CR 735 (CCP §580b applicable), with *Roberts v Graves* (1969) 269 CA2d 410, 75 CR 130 (CCP §580b inapplicable). See §9.89U. See also *Torrey Pines Bank v Hoffman* (1991) 231 CA3d 308, 282 CR 354.
- Active intervention by the creditor in structuring the roles of the ostensible principal and guarantor entities, with the goal of avoiding one-action and antideficiency protections, might defeat "true guarantor" status. See *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790; *Union Bank v Brummell* (1969) 269 CA2d 836, 75 CR 234.

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§9.89W (2) Revocable Trusts

Inter vivos revocable trusts are common in California because of their frequent use as an estate planning device. A settlor creates the trust and places assets into it and often serves as trustee. See Prob C §15200. The settlor is also typically the lifetime beneficiary of the trust, which provides for successor beneficiaries after the settlor's death. See Prob C §15209. Thus, one person (or often a married couple) occupies three roles: settlor, trustee, and primary beneficiary. That person normally retains full power to revoke or modify the trust. See Prob C §§15400-15402. See generally California Estate Planning, chap 6 (Cal CEB 2002).

Three reported cases have examined whether a settlor's guaranty of a loan to the trust is a "true" guaranty when the trust's real property secures the loan, but the question has not been definitively resolved.

The court in *Torrey Pines Bank v Hoffman* (1991) 231 CA3d 308, 282 CR 354, held that such a guaranty was ineffective because under then-applicable trust law, a trustee was personally liable on a contract of the trust unless the contract provided otherwise. Thus, much like a general partner of a partnership, the settlor-trustee was already a principal obligor. The court held that the individual was protected by CCP §580d and that attempted waivers in the guaranty were ineffective.

The court in *Torrey Pines* noted that this rule of trustee liability for trust obligations had been changed by later-enacted Prob C §18000. 231 CA3d at 321 n8. Section 18000 currently provides that a trustee is ordinarily *not* personally liable on contracts entered into in a trust capacity, but it did not apply retroactively to the loan in *Torrey Pines*.

In *Cadle Co. II v Harvey* (2000) 83 CA4th 927, 100 CR2d 150, the court relied on *Torrey Pines* to hold a settlor-trustee's guaranty ineffective, calling *Torrey Pines* "indistinguishable." 83 CA4th at 933. In fact, though, the loan in *Cadle* was made after Prob C §18000 had became effective, and as a result the trustee would not have had liability for the trust's obligations, as in *Torrey Pines*. The court in *Cadle* failed to take account of, or even mention, the statute.

In *Talbott v Hustwit* (2008) 164 CA4th 148, 78 CR3d 703, the court upheld a guaranty executed by individuals who were the settlors of the borrower trust, distinguishing *Torrey Pines* factually because these settlors were not personally the trustees of the trust. Instead, they had used a limited liability company as trustee. The settlors also were not the primary beneficiaries. *Talbott,* like *Cadle,* did not mention Prob C §18000.

NOTE: A more definitive resolution of these issues will require consideration of not only Prob C §18000 but also Prob C §§18200 and 19001(a), which make the property of a revocable trust liable for claims of creditors of the settlor, to the extent of the settlor's right of revocation. If the settlor is the guarantor, Prob C §§18200 and 19001(a) presumably would make the assets of the trust liable for the guaranty obligation. Those are the very assets protected by the one-action and antideficiency rules by virtue of the trust's status as principal obligor. For an illustration of the close legal proximity between the settlor and property in the revocable trust, see *Walgren v Dolan* (1990) 226 CA3d 572, 276 CR 554 (specific performance can be ordered against trust for settlor's contract to sell real property, even though title held by trust).

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§9.89X (3) Spouses

In *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238, a wife executed a promissory note secured by a deed of trust on her separate property. Her husband executed a guaranty of the note. For two reasons, the court concluded that the wife's note and deed of trust imposed no obligations on the husband, and thus the husband's guaranty obligation was "separate and distinct from the primary obligation of his wife" (22 CA3d at 235):

- Under then-applicable family law, community property was not liable for contracts of a wife unless secured by a pledge or mortgage thereof executed by the husband; and
- Separate property of one spouse is not liable for debts of the other.

The court held that the husband was a "true" guarantor, liable for a deficiency after nonjudicial foreclosure.

NOTE: The court did not discuss the property that would be liable for the husband's guaranty obligation. However, the effect of finding the guaranty to be an enforceable obligation of the husband would have been to make it a liability of both his separate property and the community property. Under then-applicable law, community property was liable for a debt of the husband, even though it was not liable for a debt of the wife.

Under current Fam C §910(a), community property is now generally liable for a debt incurred by either spouse, "regardless of which spouse has the management and control of the property and regardless of whether one or both spouses are parties to the debt or to a judgment for the debt." In a situation having the same facts as in *Mariners Sav. & Loan Ass'n,* the wife's separate property *and* the community property would now be liable for her promissory note, subject to one-action and antideficiency protections. This statutory change undermines one of the two elements of the court's rationale for enforcing the husband's guaranty. Caution is advisable in relying on *Mariners Sav. & Loan Ass'n* under current family law, at least to the extent that it would impose liability for the guaranty on community property and not just on the guarantor-spouse's separate property.

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13. Types of Guaranties

§9.89Y a. Guaranties of Payment Versus Guaranties of Collection

Under CC §2807, a "surety who has assumed liability for payment or performance is liable to the creditor immediately upon the default of the principal, and without demand or notice." In a guaranty of payment, liability of the guarantor is fixed by the principal's failure to pay when due. *Pierce v Merrill* (1900) 128 C 464, 61 P 64. See Restatement (Third) of Suretyship and Guaranty §15(a) (1996).

By contrast, under CC §2800, a guaranty "to the effect that an obligation is good, or is collectible, imports that the debtor is solvent, and that the demand is collectible by the usual legal proceedings, if taken with reasonable diligence." See *Menefee v Robert A. Klein & Co.* (1932) 121 CA 294, 9 P2d 219; Restatement (Third) of Suretyship and Guaranty §15(b) (1996). See also CC §§2801-2802.

Most guaranty forms expressly state that the guaranty is of payment and performance, not of collectibility.

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§9.89Z b. Continuing Guaranties

Civil Code §2814 defines a "continuing guaranty" as one "relating to a future liability of the principal, under successive transactions, which either continue his liability or from time to time renew it after it has been satisfied." A continuing guaranty is "a continuing offer which the creditor accepts each time he extends credit to the principal." *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 93, 73 CR 564. A continuing guaranty typically is used to establish the credit of, or a line of credit for, the principal obligor.

Civil Code §2815 provides that a continuing guaranty "may be revoked at any time by the guarantor, in respect to future transactions, unless there is a continuing consideration as to such transactions which he does not renounce."

EXAMPLE: Jones executes a continuing guaranty of the obligations of Brooks to Lender under a line of credit. Lender makes two advances to Brooks under the line. Jones revokes the guaranty. Lender makes a third advance to Brooks.

Jones remains liable to Lender on the guaranty for the first two advances but not the third, unless Lender was contractually obligated to make the third advance prior to Jones's revocation. See Restatement (Third) of Suretyship and Guaranty §16 (1996).

Civil Code §2815, which sets out the guarantor's right to revoke a continuing guaranty, is among the suretyship provisions ostensibly waivable by a guarantor under CC §2856(a)(1). The enforceability of such a waiver seems doubtful because the result could be a perpetual and limitless guaranty of the principal's future obligations to the creditor. Nonetheless, in *Pearl v General Motors Acceptance Corp.* (1993) 13 CA4th 1023, 16 CR2d 805, the court concluded that the right to revoke under CC §2815 is waivable but held that the language of the guaranty was not sufficient to waive it.

NOTE: Regarding the creditor's ability to modify, postrevocation, the principal's prerevocation obligations without exonerating the guarantor, compare *American City Bank v Tourtelot* (1978) 86 CA3d 585, 150 CR 361 (guarantor held not exonerated by renewal, because guaranty language clearly consented to modifications even if made postrevocation), with *Southern Cal. First Nat'l Bank v Olsen* (1974) 41 CA3d 234, 116 CR 4 (guarantor exonerated by renewal).

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§9.90 c. Limited or Partial Guaranties

Some guaranties expressly limit the guarantor's liability by amount, percentage, duration, or otherwise, and as a result the guarantor may not be liable for the full amount of the underlying principal obligation. A guarantor may especially want to cap liability in a continuing guaranty (see §9.89Z) because the guarantor does not know the amount of the principal obligations that potentially could be covered by the guaranty.

Interpretive difficulties can arise if the guaranty does not make very clear how the limitation on liability is affected by payments and other recoveries on the principal obligation. See, *e.g., Carson v Reid* (1902) 137 C 253, 70 P 89; *Brunswick Corp. v Hays* (1971) 16 CA3d 134, 93 CR 635; *Bank of America v Pauley* (1953) 119 CA2d 355, 259 P2d 714. Careful drafting is essential.

NOTE: Civil Code §2822(a) provides that "if the surety is liable upon only a portion of an obligation and the principal provides partial satisfaction of the obligation, the principal may designate the portion of the obligation that is to be satisfied." Regarding application of payments, see CC §1479. See also §8.55.

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§9.90A d. Completion Guaranties

In the context of a construction loan, a lender will often require a "completion guaranty" from principals in the borrower entity. Such a guaranty ostensibly obligates the guarantor to complete the construction project or provide funds for the lender to do so if the borrower defaults on its construction obligations.

Under *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135 CR 802, a completion guaranty may not provide the remedy that many lenders expect. The court held that a completion guaranty is a security device only, not a contract to construct improvements. 66 CA3d at 125. The court rejected the argument that the measure of recovery was the cost to complete. Rather, damages are measured by calculating (66 CA3d at 124)

> the value which the improvements, had they been completed, would have added to the security because that is the contractual benefit of which Glendale [the lender] was deprived. In other words, Glendale was entitled to damages only to the extent noncompletion of the improvements impaired its security interest. If Glendale had been fully secured on the date of foreclosure, it would have suffered no injury by reason of the failure to construct the improvements and would not have been entitled to damages. Or if, despite its failure to complete the improvements, Marina View [the borrower] had repaid the indebtedness, Glendale would have suffered no damage and manifestly could not have successfully prosecuted an action for breach of the completion guarantee agreement.

In addition, the court held that it was appropriate to deduct from this measure of damages the amount of undisbursed loan proceeds. It upheld a finding of no damages, because the trial court "determined that the enhancement in the value of the security had the work been completed as contemplated would not have exceeded the value added to the land by the work actually performed plus the amount of the undisbursed funds which Glendale retained and applied to Marina View's indebtedness." 66 CA3d at 128. See O'Brien, *Completion Guaranties: Misnamed and Misunderstood,* 12 Cal Real Prop J 1 (Fall 1994).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.90B e. Nonrecourse Carve-Out Guaranties

§9.90B e. Nonrecourse Carve-Out Guaranties

Loans secured by commercial real property are frequently made on a "nonrecourse"—or, more accurately, limited-recourse—basis. The loan documents limit the creditor's recourse for collection of the loan to the collateral and preclude personal recovery from the borrower. However, in virtually all such transactions, certain types of borrower liability are "carved out" from the nonrecourse provision, preserving personal liability for such conduct as fraud, misrepresentation, waste, failure to insure, and misappropriation or misapplication of rents, security deposits, or insurance or condemnation proceeds. See §1.15. See also California Real Estate Finance Practice: Strategies and Forms §§3.49-3.51, 3.97 (Cal CEB 2000). Such provisions are commonly referred to in practice as "bad boy" carve-outs.

Commercial real property is often held by a single-purpose limited-liability borrower entity, owning no assets other than the real property and associated personal property. Because all of this property is likely already encumbered by the lender, nonrecourse carve-outs may have little or no value as against the borrower. Thus, it is common for a lender to require a guaranty of the liability that is covered by the carve-out provisions. This form of guaranty is typically referred to as a "nonrecourse carve-out guaranty" or simply "carve-out guaranty."

There is as yet little reported case law dealing with such guaranties, all of it in other jurisdictions. For discussion of the case law and the rights and duties of lenders and guarantors under a carve-out guaranty, see Cardinale, *The Carve-out Guaranty in Non-recourse Commercial Real Estate Loans—Cases That Adjudicate Guarantor Liability and Damages,* 26 Cal Real Prop J 3 (No. 3, 2008).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§§9.91-9.112 [Deleted]

§9.91-9.112 [Deleted]

All of the sections that originally comprised letter A of part V of this chapter, addressing rights and liabilities of guarantors, were rewritten for the update published in January 2010; the rewritten material is in §§9.88A-9.90B.

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B. Letter of Credit Issuers

§9.113 1. Nature of Letter of Credit

Another form of third party credit support for an obligation secured by real property is the standby letter of credit. Issued by a financial institution ("issuer") under Division 5 of the Commercial Code, the issuer promises to pay the lender ("beneficiary") a stated sum following compliance with all conditions precedent (such as presentation of necessary documents). In addition, and by way of a separate contract, the borrower ("customer") promises to pay the issuer for any amounts paid by the issuer to the beneficiary on the letter. Both promises are subject to the "independence principle," *i.e.,* the issuer must pay the beneficiary regardless of any dispute the customer may have over the underlying obligation, and the customer's promise to reimburse the issuer is separate from any suretyship rights of subrogation or reimbursement that a guarantor might have. See Gregora, *Letters of Credit in Real Property Finance Transactions,* 9 Cal Real Prop J 1 (Spring 1991).

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§9.114 2. Conflict Between Real Estate and Commercial Rules

The independence principle of letters of credit inevitably conflicts with the real estate rules protecting borrowers. If the letter of credit issuer may recover against a borrower after being compelled to honor it in situations involving purchase money loans or trustee sales or the failure to meet fair value standards, then these protections can be stripped from a borrower whenever the borrower furnishes a letter of credit as additional security for a loan. On the other hand, if the issuer is not permitted to recover, the commercial principle of independence is defeated.

Although letters of credit are frequently described as a particular form of guaranty (as a source of additional credit support), they are by statute not a form of suretyship. CC §2787. This fact and the independence principle embodied in Com C §5114 have been cited as a basis for denying a claim for equitable contribution and equitable indemnity brought by a borrower against true sureties or guarantors. In *Morgan Creek Residential v Kemp* (2007) 153 CA4th 675, 63 CR3d 232, a borrower caused an issuing bank to provide a letter of credit to the lender. After a default and a draw on the letter of credit, the borrower reimbursed the issuing bank and sought equitable contribution and indemnity from two guarantors of the loan. The court upheld the sustaining of a demurrer to the complaint on the grounds that the guarantors were true sureties with potential suretyship defenses and did not share the same level of liability on the loan as the borrower who had caused the letter of credit to be placed and who was directly and primarily liable to reimburse the issuing bank.

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§9.115 3. Judicial and Statutory Responses

The first California court of appeal decision held in favor of the independence principle was subsequently ordered not published. *Western Sec. Bank, N.A. v Superior Court* (ordered not published April 13, 1994; superseded opinion at 26 CA4th 1441, 25 CR2d 908). The legislature responded by enacting CCP §580.5 as urgency legislation, abrogating *Western Sec. Bank, N.A*. It allowed the issuer of a letter of credit to honor the beneficiary's demand and then to compel reimbursement from the debtor notwithstanding the antideficiency rules. The California Supreme Court granted review and then remanded the case to the court of appeal to consider in light of the new legislation. The court of appeal held that the legislation was prospective only and did not affect the original holding. The supreme court again granted review, reversed the court of appeal, and held that the statute was effectively retroactive. *Western Sec. Bank, N.A. v Superior Court* (1997) 15 C4th 232, 62 CR2d 243.

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§9.116 a. Under CCP §580.5

Under CCP §580.5 (see §9.115), when a letter of credit is given as additional security to accompany a deed of trust on real estate, neither the beneficiary's demand for payment, payment itself, nor the issuer's demand for reimbursement constitutes an action for one-action purposes (CCP §726), a money judgment for deficiency purposes (CCP §§580a-580b, 580d), or a violation of any of those sections. In a comment to this section, the legislature added:

> The fact that a [letter of credit] beneficiary may be precluded by applicable law from seeking a deficiency judgment respecting the underlying obligation does not permit or otherwise justify the issuer's dishonor of the draft or demand for payment under paragraph (b) of subdivision (2) of Section 5114 of the Commercial Code nor does it provide the customer [borrower/letter of credit account party] with a defense to the customer's reimbursement duties under subdivision (3) of Section 5114 of the Commercial Code or under any agreement or otherwise, or provide any rights against the beneficiary as a result of performance of those duties.

As a conforming change, CC §2787 was also amended to distinguish a letter of credit from a suretyship obligation, whether or not it is governed by Division 5 of the Commercial Code. Division 5 was also significantly revised (providing inter alia for the issuer to have subrogation rights against the customer). See Weise, *A Primer on Letters of Credit Under New Division 5,* 18 CEB Cal Bus L Rep 176 (Mar. 1997).

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§9.117 b. Exception for Purchase Money Loans

A narrow exception to independent liability has been carved out for letters of credit issued during workouts on purchase money loans to natural persons that are secured by one-to-four-unit owner-occupied real estate. CCP §580.7.

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C. Negotiable Instrument Endorsers and Accommodation Parties

§9.118 1. Liability of Parties to Negotiable Instruments

The liability of additional parties on an obligation secured by real property sometimes arises under a promissory note that is a negotiable instrument within Division 3 of the Commercial Code, California's adoption of Article 3 of the Uniform Commercial Code. A note is governed by Division 3 if it meets all the criteria of Com C §3104. See Com C §3102(a).

NOTE: The criteria for negotiable-instrument status under Division 3 are technical and specialized. See §1.29. Many promissory notes do not qualify as negotiable instruments. As used in the discussion in §§9.118-9.121, "negotiable note" means a promissory note that is a Division 3 negotiable instrument. However, to some extent, a court may apply Division 3 by analogy to notes that are not within it. See Official Comment 2 to UCC §3-104; see also CC §1459 (transfer by endorsement of nonnegotiable written contracts for payment of money).

Division 3 specifies the liability of parties to a negotiable note as follows:

- **Maker:** A person who signs or is identified in the note as undertaking to pay it. Com C §3103(a)(5). The maker is obliged to pay the note according to its terms at the time it was issued. Com C §3412; see also Com C §3105(a).
- **Endorser:** A person who signs the note other than as maker, for the purpose of negotiating, restricting payment of, or incurring endorser's liability on the note. Com C §3204(a)-(b). An endorser is normally obliged to pay the amount due on the note according to its terms at the time it was endorsed (Com C §3415(a)) unless the endorsement states that it is "without recourse" or otherwise disclaims liability. Com C §3415(b); see also *Gaetani v Goss-Golden W. Sheet Metal Profit Sharing Plan* (2000) 84 CA4th 1118, 101 CR2d 432 (assignment language negated recourse). A signature on an instrument is presumed to be an endorsement unless the instrument unambiguously indicates otherwise. Com C §3204(a). An endorsement is referred to as "anomalous" if made by a person who is not the holder of the note. Com C §3205(d).
- **Accommodation party:** "If an instrument is issued for value given for the benefit of a party to the instrument ('accommodated party') and another party to the instrument ('accommodation party') signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument, the instrument is signed by the accommodation party 'for accommodation.'" Com C §3419(a). Usually an accommodation party signed the note as a comaker or an "anomalous" endorser. See Official Comment 1 to UCC §3-419. Although signing for accommodation, the party is nonetheless obliged to pay the instrument in the capacity in which it signed (Com C §3419(b)) even if the payee knows that the party signed for accommodation. Com C §3419(c).

EXAMPLE: Smith and Baker both sign a negotiable note in which they promise to repay Lender's loan to Smith. Jones also signs the note, in a separate place, perhaps in the margin or on the reverse side. Lender later sells the note, indorsing it in favor of the purchaser. Under Division 3, Smith and Baker are makers, and Jones and Lender are endorsers. Because only Smith received the loan, Baker and Jones are accommodation parties (accommodation maker and accommodation endorser, respectively), and Smith is the accommodated party. Jones's endorsement is "anomalous" (but nonetheless enforceable).

Endorsers and accommodation parties who pay a negotiable note normally have the right to recover from the party primarily liable. Com C §§3412 (maker liable on note to endorser who pays), 3419(e) (accommodation party who pays is entitled to reimbursement from, and to enforce note against, accommodated party).

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§9.119 2. One-Action and Antideficiency Rules

Applicability of the one-action and antideficiency rules to a negotiable note secured by real property depends on the party against whom enforcement is sought:

- **Ordinary makers:** The one-action and antideficiency rules clearly apply to an ordinary maker on a negotiable note. Code of Civil Procedure §§580a-580b, 580d, and 726 make no distinction between obligations evidenced by negotiable instruments and other obligations.
- **Accommodation makers:** When there are multiple comakers of a note, courts have applied the one-action rule to protect all of them, even if not all are trustors on the deed of trust. See *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298; *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1993) 156 BR 263, 268, aff'd (9th Cir 1995) 46 F3d 1143 (unpublished opinion). See also *Kincaid v Gomez* (1969) 274 CA2d 839, 79 CR 539 (interpreting CCP §580b). See §4.30. Although the cases did not discuss accommodation makers, it is likely that the same rule would apply when some of the comakers are accommodation parties. An accommodation party is liable on the instrument in the capacity in which it signed. Com C §3419(b). An accommodation maker is thus still a comaker on a note secured by real property. But see *Craiglow v Williams* (1920) 45 CA 514, 188 P 76.
- **Ordinary endorsers:** Several California cases have held that endorsers are not protected by the one-action and antideficiency rules, because the endorser's liability on a note is separate and distinct from that of the maker. See, *e.g., Lange v Aver* (1966) 241 CA2d 793, 50 CR 847; *Katz v Haskell* (1961) 196 CA2d 144, 16 CR 453; *Stephenson v Lawn* (1957) 155 CA2d 669, 318 P2d 132; *Nuetzel v Mackie* (1927) 80 CA 768, 253 P 166. These cases arose in non-accommodation contexts, when an endorsement was made in connection with transfer of the note.
- **Accommodation endorsers:** At least one California case has applied the same rule to an accommodation endorser, holding antideficiency protections inapplicable. *Engelman v Gordon* (1966) 242 CA2d 510, 51 CR 627. Later-enacted Com C §3305(d) provides that an accommodation party may assert any defense that the accommodated party could assert, except discharge in bankruptcy, infancy, and incompetency. But see Com C §3305(b) (rights of holder in due course). It is not clear whether §3305(d) would permit an accommodation endorser to assert one-action and antideficiency protections. Compare Com C §3305(d) with CC §2809 (surety's obligation must not be larger or more burdensome than principal's), and see *Katz v Haskell*, *supra* (§2809 does not make antideficiency protection available).

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§9.120 3. Division 3 Discharge Defenses of Endorsers and Accommodation Parties

Because endorsers and accommodation parties normally have a right of recourse against the party primarily liable if they pay on a negotiable note (Com C §§3412, 3419(e)), they are given special surety-type defenses by Com C §3605 to protect that right from impairment. These defenses apply to any endorser (whether or not for accommodation) and any accommodation party (of any type) having a right of recourse. Com C §3605(c)-(e). Such an endorser or accommodation party is discharged from liability *to the extent of loss* if, without consent, the party entitled to enforce the note does any of the following:

- Agrees to extend its due date (Com C §3605(c));
- Agrees to a material modification (Com C §3605(d)); or
- Impairs the value of an interest in collateral (Com C §3605(e); see also §3605(g), listing several acts and omissions constituting impairment), including failure to perfect a security interest, release of collateral, and failure to comply with applicable law in disposing of collateral.

Commercial Code §3605 provides additional implementing detail and limitations regarding each of these defenses.

An accommodation party is not discharged under these provisions unless the person entitled to enforce the note knows or is deemed to have notice of the accommodation. Com C §3605(h). If the accommodation is in the form of an "anomalous" endorsement (see §9.118) or is "accompanied by words indicating that the signer is acting as surety or guarantor with respect to the obligation of another party to the instrument," there is notice of accommodation. Com C §3419(c).

The defenses of Com C §3605 do not apply if the endorser or accommodation party consents to the event or conduct in question or if the note or a separate agreement "provides for waiver of discharge under this section either specifically or by general language indicating that parties waive defenses based on suretyship or impairment of collateral." Com C §3605(i).

NOTE: The waiver authorized by §3605(i) applies to discharge "under *this section*," *i.e.,* Com C §3605, including §3605(e)'s discharge relating to impairment of collateral. If the note is secured by personal property, Division 9 of the Commercial Code will also apply. An accommodation party, as a "secondary obligor" under Com C §9102(a)(71), will have rights under Division 9 regarding disposition of collateral and other matters, and Division 9 will govern waiver of those rights. See Com C §§9602, 9624. On limitations on waiver, see *Alcock v Small Bus. Admin. (In re Alcock)* (9th Cir 1995) 50 F3d 1456, 1460 (under federal common law applicable in context of SBA loan, non-negotiated "boilerplate" waiver of defense of impairment of collateral is ineffective).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/9 Multiple Security, Obligations, and Parties/§9.121 4. Relationship to Civil Code Suretyship Provisions

§9.121 4. Relationship to Civil Code Suretyship Provisions

An accommodation party within Division 3 of the Commercial Code is also within the definition of a "surety" in CC §2787 (surety or guarantor includes "one who promises to answer for the debt, default, or miscarriage of another"). See Official Comment 3 to UCC §3-419 ("An accommodation party is always a surety."). Nothing in the Civil Code surety provisions (see §§9.89-9.90B) excludes accommodation parties, and thus those provisions may also apply.

There are substantive differences between the Civil Code surety provisions and Division 3's accommodation-party provisions, as seen in the following examples:

- Under CC §2819, material modification of the underlying obligation may completely exonerate a surety even if the modification is beneficial. *Driscoll v Winters* (1898) 122 C 65, 54 P 387. See §9.88V. Under Com C §3605(d), the discharge defense triggered by a material modification is limited to the loss suffered as a consequence.
- Under CC §2792, separate consideration is required for a surety obligation undertaken after the underlying obligation. See §9.88L. Under Com C §3419(b), the obligation of an accommodation party is enforceable whether or not that party receives consideration.
- Under CC §2848, as interpreted by certain cases, a guarantor who pays the underlying obligation thereby extinguishes it and is not subrogated to the creditor's right to collect it. See §9.88R. Under Com C §3419(e), an accommodation party who pays an instrument is entitled to enforce it.

In cases of conflicts such as these, the proper resolution is that when a provision of Division 3 applies, it takes precedence over the Civil Code. See Com C §1103(b) ("Unless displaced by the particular provisions of this code, the principles of law and equity … supplement its provisions."); Official Comment 7 to UCC §3-419 ("except to the extent that it is displaced by provisions of this Article [3], the general law of suretyship also applies to the rights of accommodation parties"). See also PEB Commentary No. 11, PEB Commentary on the UCC, 3B ULA App II (Feb. 10, 1994); Restatement (Third) of Suretyship and Guaranty §4(1) (1996). But see *Flojo Int'l, Inc. v Lassleben* (1992) 4 CA4th 713, 722, 6 CR2d 99 ("We have difficulty in accepting the premise that the rights of one who signs as guarantor on the note itself are different from the rights of one who executes the guaranty on a separate piece of paper").

As a practical matter, the significance of differences between the Civil Code and Division 3 of the Commercial Code is diminished by the fact that both permit suretyship defenses to be waived (CC §2856(a); Com C §3605(i)), and such waivers are found in a large percentage of loan transactions.

PRACTICE TIP: The appropriate waiver language for Civil Code rights and defenses (see §9.89P) may be different from that for Division 3. Compare CC §2856 with Com C §3605(i).

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§9.122 D. Subsequent Owners of Property

A new owner of the real property serving as security may be subject to personal liability on the original obligation and in any event has an interest in that obligation because if it is not paid, his or her interest in the property will be lost on foreclosure. A transfer of the property does not work a simple substitution of one obligor for another, because the appearance of a new owner does not by itself relieve the former owner of existing liability; rather, it adds another party concerned (financially if not legally) with satisfying the note. When the new owner undertakes personally to pay the original note (*i.e.,* "assumes" it), without a simultaneous release of the original debtor by the creditor, two parties now are legally obligated to honor a promise originally made by only one of them. The antideficiency rules qualify this rule substantially, however, as discussed in §§9.126-9.135.

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§9.123 1. Effect of Transfers of Encumbered Property: Status of Transferee Generally

Real property is transferable even though the title is subject to a mortgage or deed of trust, but the transfer will not eliminate the existence of that encumbrance. Thus, the grantee takes title to the property subject to all deeds of trust and other encumbrances, whether or not the deed so provides. This means that the property may be sold on foreclosure of that deed of trust if the debt is not paid, even though the original debtor no longer owns the property. Consequently, the new owner of the property is always a necessary party to a judicial foreclosure action (*Goodenow v Ewer* (1860) 16 C 461) and also has the right to reinstate the obligation (CC §2924c) or redeem the property (CC §§2903-2905) before a foreclosure sale.

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§9.124 2. Status of Original Trustor

When a deed of trust default occurs after the original owner transfers the property, the original owner may not be an essential party to foreclosure proceedings. As maker of the note, the original owner remains liable on it until released by the holder. A transfer of the security to a third person is not the equivalent of a release by the holder (even if the holder consented to the transfer under a due-on-sale clause. If the obligation is purchase money, however, there is no personal liability to enforce against the original debtor, and there is no reason to include that party in any foreclosure proceeding, judicial or nonjudicial. *San Diego Realty Co. v Hill* (1914) 168 C 637, 143 P 1021. A judicial foreclosure proceeding may also omit a former owner even in a non-purchase money situation if the creditor does not intend to attempt to collect any deficiency judgment against him or her. Notices of default recite the name of the original trustor (see form in §2.130) regardless of his or her liability status, but solely in order to identify the deed of trust in default.

When the original trustor is properly held for a deficiency, there is no right of reimbursement against a nonassuming grantee or other protected party. See *Frangipani v Boecker* (1998) 64 CA4th 860, 75 CR2d 407. See also §9.127. On seeking reimbursement from assuming grantee, see §9.131.

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§9.125 3. Requirement of a Writing

Under the statute of frauds (CC §1624(a)(6)), an assumption agreement must be in writing to be enforceable, in contrast with early cases in which the courts held that an assumption could be implied from the fact that the grantee did not pay the grantor the full price. See *Banta v Rosasco* (1936) 12 CA2d 420, 55 P2d 601. An agreement that the buyer will take the property "subject to" the deed of trust is not an agreement to assume. *Wolfert v Guadagno* (1933) 130 CA 661, 20 P2d 360. See *Frangipani v Boecker* (1998) 64 CA4th 860, 75 CR2d 407 (contract called for grantee to assume deed of trust, but superseding escrow instructions instead called for conveyance subject to deed of trust). The assumption promise is usually made directly to the grantor ("I promise to pay the debt you owe to *X*"), although it is possible for the promise to be made to the third party creditor instead ("I promise you, *X,* to pay the amount *Y* owes you"). See, *e.g., Bogart v George K. Porter Co.* (1924) 193 C 197, 223 P 959; *Birkhofer v Krumm* (1935) 4 CA2d 43, 40 P2d 553.

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4. Effect of Assumption

§9.126 a. Status of Acquiring Grantee

A purchaser of encumbered property may accept title in one of two ways. The purchaser may accept title as merely "subject to" such encumbrance—a result reached whenever the deed states that title is encumbered or when the deed is entirely silent on the matter, since a grantor can convey only the title the grantor actually has. In the alternative, the grantee may promise the grantor that the grantee will perform the obligations secured by the deed of trust, *i.e.,* "assume" the deed of trust.

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§9.127 b. Nonassuming Grantee

A grantee who does not assume any existing deed of trust obligation on the property purchased has no personal liability on such obligations and cannot be held for any deficiency judgment following a foreclosure sale. *Treat v Craig* (1901) 135 C 91, 67 P 7. A deficiency judgment can be entered only against those who have undertaken responsibility on the underlying obligation, *e.g.,* a maker or guarantor of the note; a stranger to the note does not become liable merely by acquiring secured property. See *Braun v Crew* (1920) 183 C 728, 192 P 531; *Snidow v Hill* (1948) 87 CA2d 803, 197 P2d 801; *Wolfert v Guadagno* (1933) 130 CA 661, 20 P2d 360; Comment, *Assumption of Mortgage Debt by Grantee of Mortgaged Premises: Necessity for Express Promise,* 8 Cal L Rev 447 (1920). On nonassuming grantee's ability to recover attorney fees, see §8.83.

PRACTICE TIP: An interesting issue is posed when the creditor improvidently seeks to foreclose on property owned by a nonassuming grantee. If this grantee is the prevailing party, the grantee may recover attorney fees from the creditor despite the lack of contractual privity. This outcome is grounded on the fact that the nonassuming grantee faced "practical liability" in the sense that the grantee faced loss of the property for enforcement of a debt that would have included the creditor's attorney fees. See *Saucedo v Mercury Sav. & Loan Ass'n* (1980) 111 CA3d 309, 168 CR 552.

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§9.128 c. Creditor Status Under Assumption Agreement

Although a promise by the grantee to the grantor to assume the grantor's liability to the lender appears to be a promise benefiting the lender as a third party beneficiary (see CC §1559), it is not enforced in California on that ground. Instead, it is enforced on equitable subrogation principles: A creditor may reach any security given to the surety for performance of the obligation. CC §2854. As applied, this theory holds that on assuming the debt, the grantee becomes the principal debtor and the grantor becomes a surety. If the grantee does not pay, the beneficiary may enforce the promise of assumption made to the grantor. *Hopkins v Warner* (1895) 109 C 133, 41 P 868. California courts reject the third party beneficiary explanation on the ground that it might entitle the beneficiary to sue the grantee without first foreclosing, in violation of the one-action rule. *Lewis v Hunt* (1933) 133 CA 520, 24 P2d 557. See *Birkhofer v Krumm* (1935) 4 CA2d 43, 40 P2d 553. The courts, however, could have permitted the creditor to enforce an assumption agreement as a third party beneficiary, subject to the limitations of CCP §726, by permitting collection of a deficiency judgment from the assuming grantee, but only after foreclosure. In any event, the foundation of equitable subrogation is third party beneficiary doctrine because that doctrine substitutes the grantee for the trustor as primary debtor. See 2 Nelson & Whitman, Real Estate Finance Law §10.7 (5th ed 2007).

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§9.129 d. Third Party Beneficiary Versus Equitable Subrogation Differences

The differences between the third party beneficiary and equitable subrogation rationales are more than theoretical; they lead to differing results in various situations. For example, under third party beneficiary theory, a grantor cannot release the grantee from his or her promise without the beneficiary's consent, although equitable subrogation theory permits such a release. *Biddel v Brizzolara* (1883) 64 C 354, 30 P 609. Additionally, under California's equitable subrogation rule, there is nothing to assume from a grantor who is not liable for a deficiency judgment. *Mottashed v Central & Pac. Improvement Corp.* (1935) 8 CA2d 256, 47 P2d 525; *Case v Egan* (1922) 57 CA 453, 207 P 388.

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§9.130 e. Liability of Trustor

The grantee's assumption of the debt does not discharge the grantor-trustor from liability, although it does reduce the grantor to surety status. *Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476. See *Layton v West* (1969) 271 CA2d 508, 76 CR 507; *Birkhofer v Krumm* (1935) 4 CA2d 43, 40 P2d 553. Thus, the grantor is not protected from a deficiency judgment (see *Braun v Crew* (1920) 183 C 728, 192 P 531) but may seek reimbursement from the grantee for any judgment he or she pays. Each successive owner may look to subsequent owners who assume the debt. *White v Schader* (1921) 185 C 606, 198 P 19; *Robson v O'Toole* (1919) 45 CA 63, 187 P 110.

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§9.131 f. Liability of Assuming Grantee

An assuming grantee is liable on the debt, but only for a deficiency. An assumption agreement does not convert a grantee into a guarantor, who may be sued before any foreclosure. *Security-First Nat'l Bank v Chapman* (1939) 31 CA2d 182, 87 P2d 724. See *Shuey v Mulcrevy* (1917) 34 CA 218, 166 P 1019 (assuming grantees are thus protected by one-action rule); *Lewis v Hunt* (1933) 133 CA 520, 24 P2d 557. The fair value provisions and CCP §580d also undoubtedly apply. See §§9.133-9.135 for effect of CCP §580b on assuming grantees.

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5. Purchase Money Considerations

§9.132 a. When Original Loan Was Not Purchase Money

When property that was subject to a non-purchase money loan is later transferred to an assuming grantee, the effects of the assumption are not entirely predictable. The creditor may argue that the original non-purchase nature of the loan is not changed merely because title transferred and the grantee made an assumption promise. *Paramount Sav. & Loan Ass'n v Barber* (1968) 263 CA2d 166, 69 CR 390. See *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425; *Stockton Sav. & Loan Bank v Massanet* (1941) 18 C2d 200, 114 P2d 592. Conversely, denial of the right to recover a deficiency judgment against the grantee does not impair the creditor's original remedies, which were to (1) foreclose and (2) recover a deficiency judgment against the original trustor, if necessary.

The grantee may argue that any right to purchase money protection should not depend on whether the grantee signed a note for a new loan or instead signed an assumption agreement on the old loan, because that would permit form to triumph over substance and permit CCP §580b to be waived at the time of purchase.

The original trustor-grantor may argue that giving the grantee §580b protection robs the grantor of the right to recover reimbursement from the grantee if the grantor-trustor is forced to pay a deficiency judgment. See *Frangipani v Boecker* (1998) 64 CA4th 860, 75 CR2d 407. The assumption promise, which may have been the chief inducement of the sale, becomes valueless if it is protected by §580b and bars any reimbursement recovery by the grantor. An unenforceable assumption promise to the seller is functionally indistinguishable from an unenforceable promissory note to the seller for the same amount. But the ability to decide whether to include or exclude antideficiency protection may be granted to the parties themselves. See *Kistler v Vasi* (1969) 71 C2d 261, 78 CR 170.

The effectiveness of these arguments depends somewhat on the circumstances of purchase. When the grantee is not acquiring owner-occupied residential property, analogizing this position to that of a buyer obtaining a new third party loan does the grantee no good since there is no §580b protection in such a situation. The grantee in such case must maintain that the lender, originally a third party, has become a vendor and is barred by §580b despite the nonresidential nature of the property. Such a theory was accepted in *LaForgia v Kolsky* (1987) 196 CA3d 1103, 242 CR 282, in which an original non-purchase money debt was converted into a purchase money debt on the ground that a creditor who participates in the sale and agrees to permit a subsequent purchaser to assume the existing loan is to be treated as a vendor for §580b purposes.

NOTE: *LaForgia*, however, is replete with special circumstances and gives little or no practical guidance to non-purchase money lenders as to how to behave. Language that a party who is essential to the sales transaction to close is thereby a seller leaves practitioners with no idea about how their creditor clients must behave in order not to lose their preexisting deficiency status. Does mere consent to the assumption make the assumption unenforceable? If there is no right to object to the assumption (because, *e.g.,* there is no due-on-sale clause in the documents), is the lender's involvement still a necessary part of the sale? See *Jackson v Taylor* (1969) 272 CA2d 1, 76 CR 891. A rule that too readily deprives lenders of their protected status when property is transferred is likely to disincline them to accept such transfers. Instead, they may demand complete payoff of their loans rather than assist the parties in the transfer, despite the fact that all parties might be better off financially by leaving the original loan in place.

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§9.133 b. When Loan Was Originally for Purchase Money

When the original borrower qualified for CCP §580b protection, the issue is whether that protection will be extended to new purchasers of the property. There are separate considerations for loans made by the vendor and loans made by third parties (see §§9.134-9.135).

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§9.134 (1) Sales by Original Seller

When the original loan was a purchase money loan made by the original seller, subsequent grantees who assume that loan have the same purchase money protection as the original purchaser. *Costanzo v Ganguly* (1993) 12 CA4th 1085, 16 CR2d 55; *Shepherd v Robinson* (1981) 128 CA3d 615, 180 CR 342, disapproved on other grounds in *DeBerard Props. v Lim* (1999) 20 C4th 659, 671, 85 CR2d 292; *Jackson v Taylor* (1969) 272 CA2d 1, 76 CR 891. See *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557; *Weaver v Bay* (1963) 216 CA2d 559, 31 CR 211. The seller is said to remain a seller as far as the loan is concerned and is not converted into a third party lender in relation to the new purchasers. *Wright v Johnston* (1988) 206 CA3d 333, 253 CR 418 (holding that seller who also subordinates to construction loan may come within *Spangler* variant to CCP §580b (see *Spangler v Memel* (1972) 7 C3d 603, 102 CR 807)). But see *Lawler v Jacobs* (2000) 83 CA4th 723, 100 CR2d 52, one of several cases narrowly construing the *Spangler* "nonstandard transaction" exception. It is difficult to understand how a former owner can be called a seller of land (as CCP §580b requires) because the buyer later reconveyed the property to a third party who assumed the original loan. No explanation has been given about what the original owner has "sold" as part of the reconveyance or how his or her necessary participation makes him or her any more a seller than any of the many other parties whose interests require similar participation. The effect of deficiency immunity, however, is consistent with the general propositions that one cannot assume a loan from a party not personally liable on it and that purchase money loans retain their original nature. Financially, because of §580b, the original grantor had no expectation of recovering a deficiency judgment from the buyer despite receiving a promissory note from the buyer, and extending the same deficiency protection to the grantee, despite the grantee's assumption, puts the seller in no worse condition than before the transfer. Although there has never been serious judicial discussion of the continuation or modification of purchase money status loan refinances during resales, the two supreme court decisions in *Ghirardo v Antonioli* (1994) 8 C4th 791, 35 CR2d 418, and *Ghirardo v Antonioli* (1996) 14 C4th 39, 57 CR2d 687, both seem to imply acceptance of the principle that an assuming grantee is protected by §580b.

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§9.135 (2) Third Party Lenders

A third party lender is subject to CCP §580b if the loan financed acquisition of a one-to-four-unit owner-occupied residential premises. Such status is likely to continue when the original trustor conveys the property to a grantee who also occupies the premises, because a new loan to the same buyer would also be protected by the section. When the new buyer does not intend to reside on the premises (so that a new loan would not be subject to §580b), the outcome is not clear. Technically, the grantee's assumption promise is meaningless; there is nothing to assume, because the seller has no personal liability. That a new loan made to the buyers would not be a purchase money loan may be irrelevant if the parties are treated as free to create or eliminate purchase money protection. See *Kistler v Vasi* (1969) 71 C2d 261, 78 CR 170, discussed in §5.37. Whether the original loan was or was not purchase money, a cooperating lender runs the risk that a court may hold that it was a necessary party to the sale and will be recharacterized as a seller and thus subject to §580b. See *LaForgia v Kolsky* (1987) 196 CA3d 1103, 242 CR 282.

If there is a due-on-sale clause in the deed of trust, the lender may compel the purchaser to take out a new non-purchase money loan rather than permit assumption of the old loan (see §8.19).

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§9.136 6. Grantee as Guarantor

In *Everts v Matteson* (1942) 21 C2d 437, 132 P2d 476, buyers who both guaranteed and assumed the seller's loan were held eligible for CCP §580a protection as principal debtors under the assumption agreement, despite their guarantor status. On the other hand, in *Indusco Mgmt. Corp. v Robertson* (1974) 40 CA3d 456, 114 CR 47, a nonassuming purchaser guaranteed the seller's original non-purchase money note and was treated throughout the opinion as a guarantor rather than a trustor for CCP §580d purposes. Neither case involved purchase money security, and the distinction between assuming and guaranteeing makes most sense in the non-purchase money area. However, if the note initially evidenced a purchase money loan, neither an assumption nor a guaranty of it by the purchaser should be any more effective than would an initial purchaser's guarantee of the purchase money note.

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10

Workouts of Problem Loans

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I. INTRODUCTION

§10.1 A. "Workout" Broadly Defined

At the origination of a commercial loan secured by real property, the borrower and lender are generally focused on the negotiation of terms and conditions that will maximize their profits from the real property and loan, respectively. As long as market conditions remain basically consistent with the borrower's proforma and the lender's underwriting, the borrower and lender may have no reason to discuss the loan after the closing. However, significant unanticipated declines in commercial real property values or credit market conditions may force the borrower and lender to revisit the terms and conditions of the original loan to respond to these unforeseen circumstances and seek to prevent or minimize losses. The legal and financial issues to consider usually go far beyond the potential impact of California's foreclosure statutes.

In this chapter, the term "workout" is used to refer broadly to *any* predefault or postdefault negotiations or consensual actions that are undertaken by the parties to the loan to avoid an imminent default or to resolve a default or other problem between the parties without the borrower instituting bankruptcy proceedings. Realistically, many loan workouts are negotiated in the context of a potential or impending borrower bankruptcy. For discussion of the effects of bankruptcy on collection of secured loans and foreclosure actions and discussion of procedures for creditor claims in bankruptcy and relief from the automatic stay, see chaps 7, 11.

A workout might be completely consensual in nature, such as an agreement between the lender and the borrower to refinance or modify the existing loan or the lender's acceptance of a deed in lieu of foreclosure from the borrower. Or a workout might be negotiated through, or involve, one or more parties instituting litigation or pursuing remedies against the other parties. For example, the lender may decide to initiate foreclosure; the borrower might institute litigation, raising claims against the lender; or the lender, the borrower, or both may bring actions against third parties connected with the distressed project or property.

In advising the lender or the borrower on the workout of a problem loan, counsel must be familiar with the basic tools of workouts. Generally, these are not only the relevant facts and circumstances, the loan file, and applicable law but are also the evaluations, analyses, and forecasts that the parties and their consultants may use to assess the situation and formulate the means to cope with the financial and other problems of the borrower or the borrower's project. See §§10.2-10.8. Before undertaking representation of clients for a loan modification, counsel should review relevant rules of professional conduct applicable to attorneys. See §10.1A.

The lender's initial strategy considerations in approaching the workout of a problem loan are discussed in §§10.9-10.19, 12.128-12.137. Some typical workouts are described in §§10.20-10.42. In addition, factors to be considered by the lender in exercising remedies as a result of its borrower's default are discussed in §§10.43-10.64. Finally, factors to be considered by the borrower in connection with its lender's exercise of remedies as a result of the borrower's default are discussed in §§10.65-10.77. On lender liability in workout process, see §§12.128-12.137.

PRACTICE TIP: Before beginning the task of formulating a workout strategy, counsel should first consider some basic questions.

- Is a workout consistent with the client's business goals?
- Are the problems facing the borrower and its project capable of being solved in this manner?
- Are the possible workout strategies that may be considered viable in light of other known constraints facing the lender or the borrower?
- Are the lender's or borrower's goals more realistically achievable through foreclosure, litigation, bankruptcy, or other means?

At the outset, these and other formative questions should be considered and discussed with the client.

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§10.1A B. Rules of Professional Conduct on Workouts

Attorneys and nonattorney professionals may be involved in negotiating workouts. Under Bus & P C §10131(d), anyone who solicits borrowers or lenders for, or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in connection with, loans secured directly or collaterally by liens on real property or on a business opportunity must have a real estate broker license. The California Department of Real Estate (DRE) interprets this to include anyone soliciting, negotiating, or collecting payments under loan modifications and has issued orders against nonlicensees who are engaged in loan modifications without the benefit of a real estate broker's license or an exemption to the licensing requirement, such as a licensed lawyer who is practicing law. See Bus & P C §§10133, 10133.5. A newly enacted amendment to the licensing requirement exempts any organization or employee of an organization that provides free residential loan modification counseling services under the approval of the Department of Housing and Urban Development. See Bus & P C §10133.1(11).

If an attorney performs legal services on behalf of a client to negotiate or document a loan modification, that is beyond the jurisdiction of the DRE. Bus & P C §§10133(a)(3), 10133.5(a)(5). However, in an attempt to take advantage of the current economic downturn, some attorneys act as "fronts" for loan modification companies, while others collect retainer fees, *i.e.,* advance fees, and then share those fees with the real estate licensees. On advance fee limitations applicable to real estate brokers, see California Real Estate Brokers: Law and Litigation §8.2 (Cal CEB 2009).

To the extent that an attorney's activities go beyond performing legal services for a client, they may subject the attorney to discipline under Bus & P C §10131(d). The DRE may issue a Desist and Refrain Order (see RE Brokers §9.22) and, if not complied with, turn the matter over to law enforcement. Some attorneys are using real estate licensees to solicit loan modifications; however, attorneys may not be in business with nonlawyers nor split fees with them, and to do so risks discipline from the State Bar Association as well as action by the DRE. See Cal Rules of Prof Cond 1-310, 1-320.

Newly enacted Bus & P C §10085.6 prohibits brokers involved in residential loan modifications from collecting "advance fees" or a power of attorney from clients, and newly enacted CC §2944.7 prohibits anyone (including attorneys) from collecting such fees or obtaining a power of attorney from clients. Penalties for violating these statutes include fines of up to $50,000 for entities and $10,000 and 1-year imprisonment in county jail for individuals. Under Bus & P C §6106.3, attorneys who violate CC §§2944.6-2944.7 are subject to disciplinary procedures. To review the complete bill on advance fees and related amendments, see Stats 2009, ch 630 (SB 94). Notably, SB 94 does not apply to actions taken by a person offering loan modifications on loans owned or serviced by that person. All provisions of SB 94 sunset on January 1, 2013, unless extended.

Many nonprofit organizations with attorney support are successfully representing residential owners in loan modifications nationwide. One is the Neighborhood Assistance Corporation of America, which can be found online at https://www.naca.com. Some for-profit businesses with or without attorney support are offering to assist homeowners for large sums of up-front advance fees. Many of these are "foreclosure rescue scams." Before the passage of SB 94, the State Bar of California had issued a report on these scams; the report must be viewed with SB 94 in mind. The report has guidance for counsel on ethics rules and other considerations in representing clients in loan modifications. See http://calbar.ca.gov/calbar/pdfs/ethics/Ethics-Alert-Foreclosure.pdf.

When an attorney acts as a loan broker and improvidently assists a client in becoming a party to an inappropriate or predatory loan, the attorney could be disciplined for violating Rules of Prof Cond 3-300 (for receiving a nonattorney fee from a business transaction that was disadvantageous to the client) and be liable in tort for breach of fiduciary duty. See *Wood v Jamison* (2008) 167 CA4th 156, 83 CR3d 877, analyzed in Bernhardt, *Three Lessons for Lawyers,* 31 CEB Real Prop L Rep 188 (Nov. 2008).

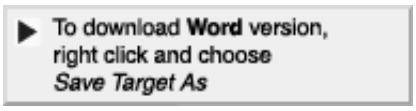
On lender liability in workout process, see §§12.128-12.137.

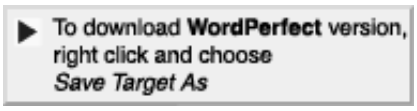
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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ C. Basic Tools of Workouts/§10.2 1. Checklist: Loan Contract Documents

C. Basic Tools of Workouts

§10.2 1. Checklist: Loan Contract Documents





The parties' rights when the loan is in default depend to a large extent on the provisions of the loan documents. (Basic commercial loan negotiation, drafting, and documentation is discussed extensively in California Real Estate Finance Practice: Strategies and Forms (Cal CEB 2000).) Whether representing the lender or the borrower, the lawyer should assemble a file that includes copies of at least the following agreements and documents (and any amendments) pertinent to the loan transaction:

- (a) For any type of commercial loan:
- (1) The deed of trust. See Real Estate Finance, chap 4.
- (2) The promissory note(s). See Real Estate Finance, chap 3.
- (3) Any other documents evidencing secured advances made to the borrower. If the lender has made additional secured advances beyond the amount of the original loan, issues of priority will need to be considered (see §§9.68-9.73).
- (4) Any modifications, any consolidation and assumption agreements, any partial releases pertaining to the deed of trust, and any subordination agreements governing lien priorities to the real property security.
- (5) Any personal guaranties or indemnities. See Real Estate Finance, chap 6.
- (6) Any environmental indemnity agreements. See Real Estate Finance, chap 5A.
- (7) Any interest rate hedge security agreements and copies of any associated interest rate caps, interest rate swaps, or other hedging instruments related to the loan.
- (8) Any additional pledge agreements or security agreements. See Real Estate Finance, chap 7.
- (9) The loan disbursement instructions (sometimes called "loan escrow instructions") governing how the loan proceeds are to be disbursed, and the loan closing statement showing such disbursements.
- (10) The loan payment records, including records showing how loan payments were applied to principal, interest, and other items of indebtedness, and records showing any unapplied credits in favor of the borrower.
- (11) The lender's title insurance policy and any subsequent title guaranties, endorsements, or reports. The lender should consider ordering a new title search as soon as possible.
- (12) For loans secured by the borrower-tenant's interest in a ground or similar lease, a copy of the lease and any agreement, estoppel, lease provision, or lease amendment by which the borrower's landlord agreed to give the lender notice of, and an opportunity to cure, the borrower-tenant's default under the lease. An unprotected lender that has a security interest in a leasehold may lose its interest in an unlawful detainer action against the borrower. *Glendale Fed. Bank v Hadden* (1999) 73 CA4th 1150, 87 CR2d 102. See Ground Lease Practice, chap 11 (2d ed Cal CEB 2009).
- (13) The loan commitment. See Real Estate Finance, chap 2.
- (14) Any fee letters, post-closing letters, or other side letters entered into between the parties in connection with the closing of the loan.
- (15) Any estoppel letters signed by the parties.
- (16) Documents indicating whether lender and borrower agree on the outstanding loan balance.
- (17) Any appraisal, environmental, engineering, zoning, or other third party reports obtained by the lender in connection with underwriting or administering the loan.

- (18) Pre-workout correspondence, including any pre-negotiation or pre-workout letter entered into between the parties. See Warning in §10.21.
- (19) Evidence of the insurance required by the loan documents and copies of the policies.
- (20) Copies of any environmental insurance policies obtained by the borrower or lender that are applicable to the property.
- (21) Any existing intercreditor agreements, subordination agreements, co-lender agreements, or participation agreements governing the relationship among senior and junior lenders, co-lenders, co-lenders and their administrative agents, or lenders and their participants.
- (22) Copies of any legal opinions written in connection with the original loan. See Real Estate Finance, chap 8.
- (b) For a commercial construction loan, in addition to the agreements and documents described in §10.2(a):
- (1) The construction loan agreement describing the borrower's obligations to improve the property and the method and conditions for disbursement of the loan proceeds. On construction loans, see Real Estate Finance, chap 9.
- (2) Construction cost estimates and breakdowns for the improvements the borrower agreed to construct. Current cost estimates should be prepared and reviewed, as the original estimates may have changed since loan inception.
- (3) The building loan account records (sometimes called the "loans-in-process account"), which show the lender's disbursements of loan proceeds held for construction purposes.
- (4) Construction inspection reports based on inspections conducted within the preceding 30 days.
- (5) Any outstanding mechanics' liens, stop notice claims, and other information regarding unpaid bills for labor, material, or equipment. Information on mechanics' liens and stop notices may be obtained from a title company lien report. On mechanics' liens generally, see California Mechanics' Liens and Related Construction Remedies (3d ed Cal CEB 1998).
- (6) Copies of all design and construction contracts and related materials, any assignments to the lender of the borrower's rights under those contracts, and the consents of the design professionals and contractors to such assignments. On construction contracts generally, see California Construction Contracts, Defects, and Litigation (Cal CEB 2008).
- (7) Copies of all signed change orders and permits.
- (8) Any performance or payment bonds and any lender's "set-aside" letters or lender's or third party's letters of credit issued in respect of offsite improvements.
- (9) Any outstanding "take-out," "standby," or other loan commitments of a third party lender to refinance or purchase the lender's loan, including any buy-sell agreement or tri-party agreement.
- (c) For a commercial loan on income-producing property, in addition to the above agreements and documents described in §10.2(a):
- (1) Current rent roll, including accounting of security deposits.
- (2) Copies of existing leases (especially important for commercial or industrial property) and any assignments of leases from the borrower to the lender separate from any such assignments contained in the deed of trust.
- (3) Current income and expense statements.
- (4) Copies of the management agreement(s) if property is being managed by a third party and any assignment of the management agreement(s) by the borrower or third parties to the lender.
- (5) Any subordination agreements, nondisturbance or recognition agreements, and attornment agreements between the lender and any tenants with respect to leases affecting the real property.
- (6) Any assignments of contracts, warranties, permits, or other project-related collateral.
- (7) Any account security agreements and related control agreements.
- (8) Any lockbox agreements.
- (9) Any cash management agreements.

- (10) For hotel properties, copies of any license or franchise agreement and estoppel certificates or comfort letters signed by the licensor or franchisor.

- (d) For a commercial loan that has been securitized, in addition to the above agreements and documents described in §10.2(a)-(c), as applicable:

- (1) All pooling and servicing agreements governing the servicing of the loan. (In public offerings, copies of these agreements can normally be found attached as an exhibit to the Form 8-K filed by the real estate mortgage investment conduit (REMIC) as issuer of the mortgage-backed securities on public websites such as http://www.sec.gov/edgar.shtml.)

- (2) Any existing intercreditor agreements, subordination agreements, or co-lender agreements governing the relationship between the REMIC that owns the loan and any co-lender or mezzanine lender.

- (3) Copies of the documents assigning and transferring the loan to the REMIC, including copies of the assignments of the deed of trust, the assignment of leases and rents, and any other recorded security instruments.

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2. Default Notices; Demand Letters

§10.2A a. Distinguish Between Absolute and Conditional Defaults

Default notices and demand letters are given in accordance with the terms of the loan documents. Lender's counsel, therefore, should consult with their clients and review the loan documents to determine whether the circumstances merit giving a default notice or demand letter. The principal distinction between these two types of notices pertains to the type of default that has occurred.

Typically, loan documents differentiate between absolute and conditional defaults. A lender may not exercise remedies with respect to a conditional default until after the lender notifies the borrower that a default or breach of the loan documents exists and demands that it be cured within the time period provided in the loan documents. This type of notice is often called a "demand letter," and it can be specific or general about the actions required to cure the default or breach.

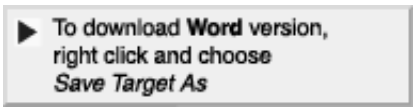
By comparison, a borrower is not provided with a cure period for absolute defaults, so the lender may exercise its remedies at any time after an absolute default occurs. Notice of an absolute default or notice that a conditional default has not been cured within the applicable cure period is called a "default notice." Although loan documents rarely require the lender to notify the borrower of an absolute default (or the failure to cure a conditional default within the applicable cure period) before the lender may exercise its remedies, there is no harm to the lender in providing a default notice before, or concurrently with, exercising its remedies (*e.g.,* recording a notice of default and election to sell under CC §2924). A default notice or demand letter may also describe certain ramifications of the default or breach provided in the loan documents, such as terminating future borrowing rights in a construction loan or credit facility.

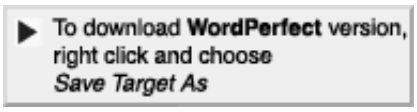
PRACTICE TIP: Counsel should make sure that the delivery of a default notice or demand letter complies with the notice provisions of the loan documents both with respect to the method of delivery and the parties to whom it is delivered. For further considerations in drafting default notices, see §§10.11-10.15.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.2B b. Form: Default Notice

§10.2B b. Form: Default Notice





_ _[*date*]_ _

VIA _ _[*identify mode of delivery, e.g., Federal Express, UPS*]_ _

_ _[*Name and address of borrower*]_ _	)	_ _[*Name and address of guarantor*]_ _
Attention:	)	**Attention:**
	)	
	)	

Re: $_ _[*amount*]_ _ **Loan (Loan) from** _ _[*name and type of entity*]_ _ **(Lender) to** _ _[*name and type of entity*]_ _ **(Borrower)**

Ladies and Gentlemen:

This letter concerns the Loan, which was made pursuant to that certain _ _[*identify loan agreement/note*]_ _ **dated** _ _[*date*]_ _**, executed by Borrower and payable to Lender (as amended, the** _ _[*Loan Agreement/Note*]_ _**). All initially capitalized terms not otherwise defined in this letter shall have the meanings given to them in the** _ _[*Loan Agreement/Note*]_ _**. This letter shall serve to notify Borrower of the following:**

Failure to Pay; Late Charge. **Borrower's failure to make the payment that was due on or before** _ _[*date*]_ _ **(Missed Payment Date) under Section** _ _[*specify*]_ _ **of the Note (in the amount of** $_ _[*amount*]_ _**) (Default Amount) constitutes an Event of Default under Section** _ _[*specify*]_ _ **of the** _ _[*Loan Agreement/Note*]_ _**. Because the Default Amount was not paid on or before** _ _[*date*]_ _ **(*i.e.,* within** _ _[*number*]_ _ **days after the Missed Payment Date), Lender demands, pursuant to Section** _ _[*specify*]_ _ **of the** _ _[*Loan Agreement/Note*]_ _**, that Borrower pay the Late Charge applicable to the Default Amount (in the amount of** $_ _[*amount*]_ _**) (Late Charge Amount). In connection therewith, Lender demands that Guarantor pay the Default Amount and the Late Charge Amount as required pursuant to Section** _ _[*specify*]_ _ **of the Guaranty.**

Failure to Perform. **Borrower's failure to** _ _[*describe obligation*]_ _ **on or before** _ _[*date*]_ _ **as required by Section** _ _[*specify*]_ _ **of the *[Loan Agreement/Note]* constitutes an Event of Default under Section** _ _[*specify*]_ _ **of the** _ _[*Loan Agreement/Note*]_ _**.**

Demand to Perform. **Borrower failed to** _ _[*describe obligation*]_ _ **on or before** _ _[*date*]_ _ **as required by Section** _ _[*specify*]_ _ **of the** _ _[*Loan Agreement/Note*]_ _ **(Breached Obligation). The Breached Obligation constitutes a potential default, and Borrower's failure to perform the Breached Obligation (or provide Lender with reasonable evidence that the Breached Obligation has been performed) on or before** _ _[*date*]_ _ **(*i.e.,* within** _ _[*number*]_ _ **days after Borrower's receipt of this letter) shall constitute an Event of Default under Section** _ _[*specify*]_ _ **of the** _ _[*Loan Agreement/Note*]_ _**.**

Demand to Comply. **Borrower's** _ _[*describe action*]_ _ **violated the restriction set forth in Section** _ _[*specify*]_ _ **of the** _ _[*Loan Agreement/Note*]_ _ **(Prohibited Action). The Prohibited Action constitutes a potential default and Borrower's failure to either (i)** _ _[*terminate/rescind/remove/cure*]_ _ **the Prohibited Action or (ii) obtain Lender's consent to the Prohibited Action, on or before** _ _[*date*]_ _ **(*i.e.,* within** _ _[*number*]_ _ **days after Borrower's receipt of this letter), shall constitute an Event of Default under Section** _ _[*specify*]_ _ **of the** _ _[*Loan Agreement/Note*]_ _**.**

Demand to Pay. **Lender has determined, under Section** _ _[*specify*]_ _ **of the** _ _[*Loan Agreement/Note*]_ _**, that**

the remaining _ _[*describe project cost*]_ _ to be funded from the _ _[*describe budget line item*]_ _ is $_ _[*amount*]_ _ greater than the remaining amount of the _ _[*describe budget line item*]_ _ (Out-of-Balance Event). Lender demands, pursuant to Section _ _[*specify*]_ _ of the _ _[*Loan Agreement/Note*]_ _ and Section _ _[*specify*]_ _ of the Guaranty, that Borrower and/or Guarantor, respectively, cure the Out-of-Balance Event (*i.e.,* bring the _ _[*describe budget line item*]_ _ "in balance") by depositing funds (not from proceeds of the Loan) with Lender in an amount equal to $_ _[*amount*]_ _ **(Out-of-Balance Deposit). Lender's failure to receive the Out-of-Balance Deposit on or before _ _[*date*]_ _ (*i.e.,* within _ _[*number*]_ _ days after Borrower's and Guarantor's receipt of this letter) shall constitute an Event of Default under Section _ _[*specify*]_ _ of the _ _[*Loan Agreement/Note*]_ _.**

Limitations on Certain Rights and Obligations. **As provided in Section _ _[*specify*]_ _ of the _ _[*Loan Agreement/Note*]_ _, while a potential default or an Event of Default is continuing, Lender shall not be obligated to _ _[*describe obligation, e.g., make additional advances*]_ _. Furthermore, as provided in Section _ _[*specify*]_ _ of the _ _[*Loan Agreement/Note*]_ _, while a potential default or an Event of Default is continuing, Borrower shall not _ _[*describe right, e.g., make any distributions to its members/partners/owners*]_ _.**

No Waiver, Forbearance, or Modification. **While an Event of Default is continuing, Lender shall have all rights and remedies provided under the Loan Documents, at law, in equity, or otherwise (including, without limitation, the right to (i) increase the interest rate applicable to the Loan to the Default Rate and (ii) accelerate the indebtedness evidenced by the Note), and nothing contained in this letter, or in any discussions either before or after the date of this letter, is intended to waive, limit, or otherwise affect, nor shall it be deemed to waive, limit, or otherwise affect, any such rights or remedies with respect to each potential default and Event of Default described in this letter or any other past, present, or future potential default or Event of Default. In addition, nothing contained in this letter, or in any discussions either before or after the date of this letter, is intended to constitute, nor shall it be deemed to constitute, an agreement by Lender to forbear from exercising any of its rights or remedies under the Loan Documents or an amendment or modification of the provisions of the Loan Documents.**

Reservation. **To this end, Lender reserves all rights and remedies available to it under the Loan Documents or otherwise, including, without limitation, its right to take any action, at any time and from time to time, that it deems appropriate under the circumstances.**

Very truly yours,

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

cc: _ _[*name(s)*]_ _

Comment: On drafting default notices, see §§10.2A, 10.11-10.18.

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3. Pre-Negotiation Letter

§10.3 a. Purpose and Scope of Pre-Negotiation Letter

To establish ground rules for the negotiation of possible terms and conditions for the workout of a loan, the parties should consider signing a pre-negotiation letter that reserves rights and does not obligate either party to continue negotiations or to reach an agreement. Pre-negotiation letters also typically (1) exclude the matters discussed during such negotiations from being admitted as evidence in any judicial or similar proceeding and (2) require that such matters be kept confidential. The parties should consider whether the pre-negotiation letter should be applicable to any prior discussions regarding the status of the loan. In addition, because a successful workout may require concessions from guarantors and/or other lenders, it may make sense to have the pre-negotiation letter signed by those parties as well.

Although a pre-negotiation letter is not generally used to modify the terms and conditions of a loan or the liability of the parties with respect to a loan, some lenders require their borrowers to provide a release or an acknowledgment of the status of the loan before they will sign a pre-negotiation letter. From the borrower's perspective, the pre-negotiation letter is merely a lender prerequisite to discussing a possible loan workout. Although the lender receives a variety of protections from this letter, the borrower receives none. So if possible, borrower's counsel should resist granting any waivers or making any concessions to the lender in the pre-negotiation letter.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.3A b. Form: Pre-Negotiation Letter

§10.3A b. Form: Pre-Negotiation Letter

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_ _[*date*]_ _

VIA _ _[*identify mode of delivery, e.g., Federal Express, UPS*]_ _

_ _[*Name and address of borrower*]_ _	)	_ _[*Name and address of guarantor*]_ _
Attention:	)	**Attention:**
	)	
	)	

Re: $_ _[*amount*]_ _ **Loan (Loan) from** _ _[*name and type of entity*]_ _ **(Lender) to** _ _[*name and type of entity*]_ _ **(Borrower)**

Ladies and Gentlemen:

This letter (Pre-Negotiation Letter) concerns the Loan, which was made pursuant to that certain _ _[*full name of loan agreement/note*]_ _ **dated** _ _[*date*]_ _**, executed by Borrower and payable to Lender (as amended,** _ _[*Loan Agreement/Note*]_ _**). All initially capitalized terms not otherwise defined herein shall have the meanings given thereto in the** _ _[*Loan Agreement/Note*]_ _**.**

Lender has previously notified Borrower and _ _[*name and type of entity*]_ _ **(Guarantor) of certain facts and circumstances that do, or could, constitute potential defaults and/or events of default under the Loan Documents as more specifically described in that certain letter from Lender to Borrower and Guarantor dated** _ _[*date*]_ _ **(Default Notice). Before engaging in any discussions (including, without limitation, negotiations and other forms of communication and correspondence, regardless of the medium used) between representatives of Borrower, Guarantor, and Lender (collectively, the Parties, and individually, a Party) regarding various possible courses of action that might be in each party's mutual interest with respect to the Default Notice and the Loan (Contemplated Discussions), Lender has proposed, and Borrower and Guarantor have agreed, that it is important to have a common understanding of the ground rules for the Contemplated Discussions so that no Party gives up any rights, or incurs any obligations, unless and until there is a "Binding Agreement" (as defined below). Accordingly, the Parties acknowledge and agree as follows:**

1. The Parties contemplate engaging in the Contemplated Discussions, but only on the condition that the Contemplated Discussions occurring (a) after _ _[*insert date of acceptance and agreement by Borrower and Guarantor of this Pre-Negotiation Letter*]_ _ **and (b) before the termination of the Contemplated Discussions as provided herein be governed by this Pre-Negotiation Letter.**

2. This Pre-Negotiation Letter is not, and shall not be construed to be, an agreement to negotiate, an agreement to agree, a letter of intent, or any other similar agreement requiring the Parties to engage, or attempt to engage, in the Contemplated Discussions, and it is the intention of the Parties that no covenant of good faith and fair dealing, express or implied, shall require, or be deemed to require, any Party to engage or re-engage in the Contemplated Discussions. Without limiting the generality of the foregoing sentence, Lender's acceptance of a partial payment of any amount due under the Loan Documents (including, without limitation, amounts specified in the Default Notice) or Borrower's payment of the fees and costs described in Paragraph _ _[*e.g., 11*]_ _**, shall not (a) require, or be deemed to require, Lender to engage in or continue with the Contemplated Discussions or enter into a Binding Agreement or (b) prohibit Lender from collecting, or be construed to prejudice Lender's right to collect, any remaining unpaid amounts.**

3. Each Party may, acting independently and in its sole and absolute discretion and without any further

obligation or liability to any other Party, elect to engage in, continue, or terminate the Contemplated Discussions at any time. Without limiting the generality of the foregoing sentence, any Party may, for any reason or no reason and with or without notice, terminate the Contemplated Discussions. If any Party believes that another Party has terminated the Contemplated Discussions, such Party may confirm that termination by delivering notice of such belief to the other Party. Notwithstanding anything herein to the contrary, the Contemplated Discussions shall automatically terminate (a) if there is a Binding Agreement or (b) on _ _[*date*]_ _.

4. The Contemplated Discussions may be lengthy and complex. Although the Parties may reach agreement on one or more preliminary issues that are part of the problem they are trying to resolve, no Party will be bound by any agreement on an individual issue or a group of issues until an agreement is reached and reduced to a fully integrated written agreement approved (as provided in Paragraph _ _[*e.g., 8*]_ _) and executed by the Parties (Binding Agreement). This means, for instance, that oral statements made during the Contemplated Discussions, unsigned draft agreements, e-mail correspondence, term sheets, or anything else short of a fully approved, signed, and delivered written agreement cannot constitute a Binding Agreement.

5. Neither this Pre-Negotiation Letter nor the Contemplated Discussions constitute or shall be construed as (a) a waiver of (or an agreement to waive) the Parties' rights under the Loan Documents; (b) a modification of (or an agreement to modify) the Loan Documents; (c) an agreement by Lender to make additional advances with respect to the Loan; (d) an agreement by Lender to grant any new financial accommodations to Borrower; (e) an agreement by Lender to negotiate in good faith; (f) a waiver of (or an agreement to waive) the defaults described in the Default Notice or any other default under the Loan Documents; or (g) an agreement by Lender to forbear from enforcing any of its rights or remedies under the Loan Documents, at law, in equity, or otherwise. Without limiting the generality of the foregoing sentence, nothing in this Pre-Negotiation Letter shall be construed to prohibit or otherwise prejudice Lender from exercising any right or remedy that it may have under the Loan Documents, at law, in equity, or otherwise with respect to the defaults described in the Default Notice or elsewhere while the Contemplated Discussions are continuing or at any other time. Lender reserves all of these rights and remedies, including, without limitation, the right to initiate foreclosure proceedings with respect to the collateral that secures the Loan.

6. All evidence of conduct and communications of any nature whatsoever (whether verbal or nonverbal, or express or implied) of any Party in connection with the Contemplated Discussions shall be inadmissible for any purpose in any judicial or similar proceeding including, without limitation, as proof of admissions of liability or for other evidentiary purposes. The foregoing sentence is intended to be broader than the restrictions on admissibility contained in Rule 408 of the Federal Rules of Evidence (or any similar statutory or judicial law including, without limitation, California Evidence Code §1152); provided, however, that nothing contained in this Paragraph _ _[*e.g., 6*]_ _ shall (a) impair the admissibility, effect, or validity, or restrict the taking, giving, or use, of any action or notice (including, without limitation, the Default Notice) by Lender to preserve or enforce its rights and remedies under the Loan Documents, at law, in equity, or otherwise; (b) require the exclusion of evidence that is otherwise discoverable solely because such evidence was presented in connection with the Contemplated Discussions; or (c) limit the admissibility of evidence when it is offered for a purpose unrelated to the subject matter of this Pre-Negotiation Letter.

7. Because the Contemplated Discussions may not produce a Binding Agreement, Borrower and Guarantor are advised not to (a) forgo other opportunities to cure the defaults described in the Default Notice in accordance with the Loan Documents or to obtain alternative financing or (b) incur any expense or take any action (detrimental or otherwise) in reliance on the Contemplated Discussions producing a Binding Agreement.

8. Borrower and Guarantor acknowledge that the persons who will participate in the Contemplated Discussions on behalf of Lender are not authorized to enter into a Binding Agreement unless they first obtain the appropriate approval of any proposed agreement that may result from the Contemplated Discussions from Lender's senior management.

9. Nothing in this Pre-Negotiation Letter shall effect the validity, effectiveness, or enforceability of the Loan Documents.

10. Borrower and Guarantor understand that Lender would not enter into the Contemplated Discussions without this Pre-Negotiation Letter clarifying the ground rules for the Contemplated Discussions.

11. Borrower shall pay all reasonable fees, costs, and expenses incurred by Lender in connection with the

Contemplated Discussions and the drafting and negotiation of this Pre-Negotiation Letter and any Binding Agreement within _ _[*e.g., 10*]_ _ days after receipt of demand therefor from Lender.

12. The Parties understand that this Pre-Negotiation Letter is a legally binding agreement that may affect each Party's rights. Each Party represents to the other that it (a) has received legal advice from legal counsel of its choice regarding the meaning and legal significance of this Pre-Negotiation Letter; (b) is satisfied with its legal counsel and the legal advice received from such legal counsel; and (c) has voluntarily, and without coercion or duress of any kind, entered into this Pre-Negotiation Letter.

13. Should any provisions of this Pre-Negotiation Letter require judicial interpretation, the court interpreting the same shall not apply a presumption that the provisions hereof shall be more strictly construed against any Party by reason of the rule of construction that a document is to be construed more strictly against the party who itself, or through its agent, prepared the same, it being agreed that the Parties have participated in the preparation of this Pre-Negotiation Letter.

14. Because publicity about the existence, nature, or content of the Contemplated Discussions might injure the Parties, the Loan, or the collateral that secures the Loan, the Contemplated Discussions shall be kept strictly confidential. No Party shall disclose to any third party (other than to agents of the Parties, *e.g.,* attorneys, accountants, and brokers, on a "need to know" basis) the existence, nature, or content of the Contemplated Discussions without the consent of the Parties.

15. This Pre-Negotiation Letter shall survive termination of the Contemplated Discussions but shall only be applicable with respect to the Contemplated Discussions.

16. All notices to be given or received hereunder shall be given and received as provided in the Loan Documents.

17. Should any action be brought to enforce this Pre-Negotiation Letter or otherwise resolve any dispute under it, the prevailing Party in that action shall be entitled to recover all costs, expenses, and fees incurred thereby in connection with such action from any non-prevailing Party. The right to recover such costs, expenses, and fees shall accrue on the commencement of the action regardless of whether the action is prosecuted to final judgment. In addition to the foregoing award of costs, expenses, and fees, the prevailing Party shall be entitled to recover all costs, expenses, and fees incurred thereby in connection with any post-judgment proceedings to collect or enforce any judgment from any non-prevailing Party. This provision is separate and several and shall survive the merger of this provision into any judgment on this Pre-Negotiation Letter.

18. This Pre-Negotiation Letter constitutes the entire agreement of the Parties concerning the Contemplated Discussions and supersedes any prior or contemporaneous agreements (to the extent not contained herein) concerning the same. This Pre-Negotiation Letter will inure to the benefit of, and be binding on, the Parties and their respective agents and permitted successors and assigns. This Pre-Negotiation Letter shall be governed by, and construed and enforced in accordance with, the laws of the State of California, without giving effect to the principles of conflicts of laws. Each and every provision of this Pre-Negotiation Letter shall be construed in accordance with the principle that time is of the essence. This Pre-Negotiation Letter may be executed and delivered via facsimile or electronic mail in any number of counterparts, each of which shall be deemed an original, but all such counterparts together shall constitute but one and the same agreement. This Pre-Negotiation Letter may only be amended, or its provisions waived, in writing. Each person signing this Pre-Negotiation Letter on behalf of a Party represents that he/she/it has the full authority and legal power to do so.

Kindly sign this Pre-Negotiation Letter in the space provided below and return one counterpart, so executed, to the undersigned in order to indicate your acceptance of the ground rules set forth herein.

Very truly yours,

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

cc:

ACCEPTED AND AGREED TO BY BORROWER AND GUARANTOR ON _ _[*date*]_ _**:**

BORROWER:

Date: _ _ _ _ _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

GUARANTOR:

Date: _ _ _ _ _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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§10.4 4. Rights and Liabilities of Lender, Borrower, and Third Parties

Before advising the lender or the borrower on the workout of a problem loan, the lawyer must analyze the respective rights and liabilities of each under the particular loan documents. The strengths and weaknesses of each party's position on matters affecting acceleration, lien enforcement, personal liability, potential bankruptcy, and right of possession before foreclosure may well determine the degrees of willingness and flexibility with which the parties approach any negotiations for a workout.

Lender's lawyer. The lender's lawyer should consider or evaluate a wide range of matters, including, among other things, the following:

- Identification of all existing and potential defaults, both monetary and nonmonetary (see chaps 1-3, 8);
- Whether the defaults permit the lender to accelerate the loan and institute foreclosure or other remedies (see §§12.18, 12.142);
- Whether the rights and obligations of the parties under the loan documents are clear and unambiguous and whether any of the loan documents potentially could be vulnerable to recharacterization;
- Identification of guaranties, indemnities, and other suretyship obligations of third parties, and assessment of whether they contain appropriate suretyship waivers or may be vulnerable to claims of exoneration or other potential defenses;
- Whether the borrower has breached any unsecured obligations for which a suit for personal money judgment may lie;
- Location of borrower's bank accounts and assets, and if they are pledged or subject to security agreements (see §10.15);
- Whether the amount of all secured monetary obligations now exceeds, or is likely to exceed, the value of the real property security; if so, lender may consider forgoing a trustee sale and instead filing a suit for judicial foreclosure and a deficiency judgment under CCP §726 (see chap 3);
- Lender's choices of collection remedies, bearing in mind the one-action and antideficiency rules (see chaps 4-5);
- If multiple real properties or a combination of real and personal properties secure the loan, then by what methods and in what order they should be foreclosed to maximize the lender's recovery and avoid waiver of any such security (see chaps 2-3, 9);
- If the lender wishes to enforce the assignment of rents agreement during foreclosure, what legal bases the lender may have for doing so and what steps must be taken to perfect the lender's right to possession of rents or to obtain the appointment of a receiver to collect the rents (see chap 6);
- Evaluating with qualified environmental counsel whether the lender can rely on safe harbor protections under applicable federal and state environmental laws; and
- Developing guidelines and determining an action plan for assessing and, if necessary, responding to issues of contamination that may arise with respect to any real property securing the loan.

A lender should enter into workout negotiations only in good faith. See, *e.g., Auerbach v Great W. Bank* (1999) 74 CA4th 1172, 88 CR2d 718, discussed extensively in §§12.128-12.137.

Borrower's lawyer. The borrower's lawyer should also consider a wide range of matters, including, among other things, the following:

- Whether, and to what extent, the borrower or others may be personally liable for any monetary and nonmonetary breaches of the loan documents or other acts or omissions;
- Whether any conditions precedent to the lender's declaration of particular defaults have been fulfilled, such as notice requirements (see chaps 2-3);
- Whether the borrower has any right to rescind the loan (see chaps 7, 12);
- Whether other grounds exist for the borrower's contesting of any breaches or defaults being asserted by the lender (see chaps 7-8, 12);

- Whether the defaults are sufficient for the lender to accelerate the loan or pursue remedies against parties liable under the loan documents (see §§12.18, 12.142);
- Whether parties liable under the loan documents may be able to assert claims for exoneration or other defenses to enforcement (see chap 9);
- Whether any of the loan documents are potentially subject to recharacterization;
- Timing and procedural requirements for pursuing judicial or nonjudicial foreclosure, the appointment of a receiver, and enforcement of assignments of rents or security interests in other collateral for the loan (see chaps 2-3, 6, 9);
- The extent of the borrower's obligations regarding reinstatement of the loan (under CC §2924c) or full payoff before any trustee sale (under CC §§2903-2905) (see chap 2);
- Whether there are other potential adverse consequences to the borrower if the loan goes into default, such as breaching financial covenants or triggering cross-defaults or notice requirements under other obligations; and
- Market conditions and other circumstances that might motivate the lender to negotiate a workout.

Whether one party to the loan transaction may have incurred some independent tort liability to the other for acts either before or after making the loan may also have a significant impact on the desirability for, and terms and conditions of, a workout. Both the lender's and borrower's lawyers should discuss the relevant facts with their respective clients and try to assess the potential risks of such liability.

In virtually every problem loan situation, there are third parties who have a present or potential financial stake in the distressed project or problem loan. Therefore, the lawyer for the lender or borrower should, in addition to analyzing his or her client's rights and liabilities under the loan contracts, consider how lien enforcement or other aspects of a proposed workout may affect the client's rights against, or liabilities to, such third parties.

The third parties whose involvements and interests may be materially affected by the workout of a problem loan include title insurers, bonding companies, guarantors, issuers of outstanding loan commitments, governmental agencies having jurisdiction over the project, design professionals, contractors, construction disbursement agents, other lienors on the real property security (including junior lienholders, existing and potential mechanics' lien claimants, and holders of easements or other property interests that are junior in priority to the subject loan), partners or joint venturers of the borrower (including limited partners), mezzanine lenders, ground lessors, licensors or franchisors, tenants or prospective tenants of the project, and other creditors of the borrower.

If the loan is securitized, both the lender's and borrower's lawyers will also need to (1) consider and evaluate the rights of the master and special servicers and co-lenders under the applicable pooling and servicing agreement, intercreditor agreements, and other applicable documents and (2) take into account the procedures, decision-making criteria, and limitations on loan modifications and other workout strategies imposed by these agreements and by the federal income tax laws and regulations applicable to real estate mortgage investment conduits.

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§10.5 5. Assessing Property Value and Client's Financial Situation

In assisting the lender or the borrower to formulate and achieve a successful workout, the lawyer's primary task will be to analyze the legal implications of the various alternative workout plans suggested by the particular circumstances. Identifying these alternatives requires the input and business judgment of the client and its staff and perhaps even outside experts whom the client may find it necessary to engage. It also requires independently assessing the experience, expertise, creditworthiness, and business judgment skills of the borrower. Additionally, the parties must update appraisals so they know the current value of the real property security (*i.e.,* the value of the loan collateral) and whether the property is underwater or has negative value (defined in §10.9).

The lawyer will perform a key role in structuring and documenting any proposed or adopted workout plan, but only after the client has determined that the objectives and essential elements of the plan are desirable and feasible legally and economically. The lender must ultimately judge whether its loan will remain a viable investment if restructured in a particular manner or whether foreclosure or other disposition strategies appear to be the best business plan for salvaging its investment. If the loan has been securitized, then a different decision-making process and set of considerations will apply. The loan servicers and their counsel must comply with the dictates of the pooling and servicing agreements and to limitations imposed by loan servicing standards, their obligations to investors, and the federal income tax laws and regulations applicable to real estate mortgage investment conduits.

The lender may ask the borrower to propose a workout plan. This proposal may help the lender evaluate the borrower's current abilities and commitment to the project and determine whether the borrower can realistically cope with the problems that led to the loan default. On the other hand, the borrower must decide whether a proposed workout merits spending further time and resources in light of not only its future prospects for profitable operations but also its potential liabilities from abandoning the property and project. The borrower and its qualified tax advisors must also weigh potential tax liability or other tax issues resulting from a foreclosure or a workout. See §10.24. See also chap 2.

Before formulating a specific plan, lender's and borrower's counsel doing commercial loan workouts should be thoroughly familiar with guidelines published on October 30, 2009, by the Federal Deposit Insurance Corporation (FDIC) in its Policy Statement on Prudent Commercial Real Estate Loan Workouts. These guidelines state the FDIC's recognition that institutional lenders face significant challenges on loans secured by commercial real estate when borrowers experience diminished operating cash-flows, depreciated security values, or prolonged sales and rental absorption periods. The guidelines focus in great detail on the following issues:

- Risk management elements for lenders engaging in commercial loan workout programs;
- Loan workout arrangements, including renewal or extension of loan terms, extension of additional credit, or restructuring with or without concessions;
- Borrower's ability to repay loan, including borrower's willingness and capacity to repay under reasonable terms;
- Cash-flow potential of underlying security or business;
- Financial capability of guarantors, including their willingness to provide loan support through ongoing payments, curtailments, or re-margining;
- Value of security, including (1) review of past and current appraisals or valuations and (2) internal lender policies and procedures for re-evaluating security as market conditions change or borrower's financial condition deteriorates;
- Institutional lenders' duty to prepare regulatory reports according to generally acceptable accounting principles, comply with regulatory reporting requirements, and adopt effective internal supervisory policies and procedures; and
- Revised federal loan classification standards so that loans with these characteristics are not adversely classified automatically:

- Loans adequately protected by current sound worth and debt service capacity of borrower, guarantor, or

underlying security;

- Loans to financially sound borrowers that are renewed or restructured in accordance with prudent underwriting standards, unless well-defined weaknesses exist that jeopardize repayment; or
- Loans previously made to borrowers associated with particular industries that are currently experiencing financial difficulties.

These commercial loan workout guidelines are available online at http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf. On FDIC guidelines for residential loan workouts, see §10.8B.

On being retained as counsel for the lender or the borrower, the lawyer should work closely with the client to obtain the additional data, analyses, and expert opinions necessary to enable the client to realistically evaluate the financial implications and feasibilities of the various workout alternatives. When the workout concerns a construction loan, for example, the assessment should include engaging independent workout consultants to do some or all of the following:

- Prepare new project and cash-flow budgets based on (1) current estimates of time and costs to complete construction, (2) the amount of unpaid construction bills, and (3) current projections of the rate and costs of renting or selling;
- Obtain confirmations that the existing contractor and subcontractors will finish their jobs under the workout arrangement, or conversely, find a new contractor or subcontractors for the completion phase (which will usually have to be on "cost-plus" terms; on cost-plus contracts, see California Construction Contracts, Defects, and Litigation, chap 2 (Cal CEB 2008));
- Obtain new appraisals that consider current economic and competitive conditions; and
- Identify and pursue new sources of additional funding, either from prospective investors or lenders or from third parties with an interest in the project.

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§10.6 6. Decision-Making Procedure for Multiple Lenders

When more than one lender owns a loan, the co-lender agreement must be reviewed to determine how decisions are to be made by the lenders with respect to a workout of the loan. This may also be the case if only one lender owns a loan but that lender has participated its interest in it to other lenders (in which case, the participation agreement must be reviewed). Civil Code §2941.9 provides decision-making procedures for when there are multiple beneficiaries of a deed of trust and no co-lender or similar agreement between or among such beneficiaries exists. Under these circumstances, all of the beneficiaries can agree in writing to be governed by beneficiaries holding more than 50 percent of the "record beneficial interest" in the notes. See §1.46 for further discussion of multiple beneficiary situations.

Intercreditor agreements between senior and junior or mezzanine lenders will often restrict the ability of one lender (usually the junior or mezzanine lender) to work out its loan and, therefore, should also be consulted before taking any action. Because senior lenders (either among co-lenders or with junior or mezzanine lenders) usually have less incentive to work out a loan (*i.e.,* because senior lenders are more likely to be adequately secured), the junior lenders are typically given some range of authority to make decisions on the occurrence of a default (although the junior lender may only be given such authority for a limited period of time). Knowing which lender controls such decision making and what risks that controlling junior lender faces in the event of an unsuccessful workout may provide the borrower with a certain amount of leverage in its negotiations with the controlling junior lender.

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§10.6A 7. Decision-Making Procedure for Multiple Borrowers

When a deed of trust has more than one trustor, the power of the trustors to enter into a workout will usually be governed by the same agreement that governs their ownership and operation of the property (*e.g.,* a tenancy in common or joint tenancy agreement). Many tenancy in common agreements (especially when the property was acquired through an IRC §1031 exchange) require the approval of all cotenants for any workout. Counsel should review the tenancy in common agreement and be aware of these possible limitations on the cotenants' authority to enter into a binding workout involving the property.

Negotiating with, and obtaining the approval of, all cotenants will take time. Cotenants may have conflicting interests that will make negotiating a successful workout difficult to achieve. One or more cotenants may use their veto power over the terms and conditions of a workout to try to persuade the other cotenants to purchase their interest in the property. Also, if the lender has recourse to the assets of the cotenants to satisfy the loan, the cotenants will generally have joint and several liability for this obligation notwithstanding that they each own less than 100 percent of the property. This may give the owner of a 1-percent interest more incentive to work out the loan because the lender could recover 100 percent of any deficiency from the 1-percent owner, leaving the 1-percent owner to collect 99 percent of the deficiency judgment paid to the lender from the other owners. However, if the lender does not have any such recourse or there is not joint and several liability among the cotenants, then the owner of a 1-percent interest will have less incentive to work out the loan because a 1-percent owner has less to lose than a 25-percent owner. As a further possible complication, the bankruptcy of a single cotenant will generally trigger the automatic stay with respect to the loan as a whole. On bankruptcy, see chap 11.

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D. Requirements for Lenders Under SB 1137

§10.7 1. Meet-and-Confer Not Applicable to Nonresidential Trustee Sales

In the current state of the law, when a lender or a borrower initiates workout negotiations on a commercial loan, it is completely voluntary. In 2008 the California legislature, concerned about the increase in foreclosures on residential mortgage loans, enacted Civil Code §2923.5, which requires notice and a dialogue between the secured lender (or its assignee) and its homeowner borrower to explore alternatives to foreclosure, including a possible workout, before the lender commences nonjudicial foreclosure. This law applies only to loans on owner-occupied (noninvestment) residential property made between January 1, 2003, and December 31, 2007. See Stats 2008, ch 69, §§1-10 (SB 1137). For further discussion, see §10.8A.

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§10.8 2. Workouts of Securitized Loans

Ownership of mortgage loans has changed dramatically since the era of loan securitizations began in the early 1990s. A significant portion of loans originated by financial institutions are now packaged and sold off into loan pools held by tax-favored investment vehicles called "real estate mortgage investment conduits" (REMICs). REMICs are passive title-holding entities that sell to investors interests in the loan pool commonly known as mortgage-backed securities. Each loan pool serves as collateral for repayment of amounts payable to investors on account of the securities issued by the owner of that pool. The rights and obligations of the agents who service the loan pools are governed by contracts called "pooling and servicing agreements." Typically there is an administrative or master servicer who collects payments from borrowers, administers the loans, and remits coupon payments to investors. With limited exceptions, the master servicer does not have authority to modify or sell loans or engage in workouts. However, if a material default occurs under a loan, or is imminent, the problem loan is transferred to a special servicer. Subject to limitations imposed by applicable tax laws and the terms of the pooling and servicing agreement, the special servicer has broader authority to assess alternatives for maximizing the net present value recovery to the investors, make recommendations in regard to collection activities and workouts, and negotiate modifications with the borrower. The special servicer is also charged with authority to initiate and pursue collection activities and manage and dispose of foreclosed properties. The special servicer is entitled to certain fees for assets under its management, which typically include default interest and modification fees, paid by the borrower, as well as disposition fees for selling foreclosed assets.

As a result, in many instances, the original lender who negotiated the loan may have assigned its interest in the loan and be entirely out of the picture. So the borrower may have no business relationship with the current lender or loan servicer, and it may be extremely difficult for the borrower to contact it, especially if the default or foreclosure is in the hands of an entity, such as MERS, Inc. (Mortgage Electronic Registration Systems), acting as a servicing agent or indenture trustee. See §7.15. Borrowers may find that this makes it substantially more difficult to negotiate a workout, effectuate a deed in lieu of foreclosure, or pursue any other remedy short of bankruptcy. See, *e.g.,* Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine,* 35 Creighton L Rev 50 (Apr. 2002).

Even a bankruptcy filing can be problematic for a borrower. Normal underwriting standards for securitized commercial loans (1) require the borrower's sponsor to guarantee the borrower will not file bankruptcy and (2) impose personal liability on the sponsor in such event. So filing bankruptcy can have significant new consequences that must be considered.

Also, in many instances, the pooling and servicing agreement does not give the loan servicer sufficient authority to negotiate a workout without consent of the controlling class of investors. Depending on the ownership structure of the loan pool, other third parties (such as co-lenders) may also have approval or consultation rights. The various participants are often affected differently by the prospect of a workout and may not share the same goals or investment horizon. These potential conflicts of interest among the participants further complicate any proposed workout solution.

PRACTICE TIP: The borrower and its counsel should realize from the beginning that workouts of securitized loans are not based on business relationships. Strategies and approaches that may work in relationship lending or for other types of loans often have no prospect of success. Instead, counsel should become familiar with the decision-making process and standards for workouts set forth in the pooling and servicing agreement governing the loan and, if possible, with any relevant intercreditor agreements. Counsel should also become familiar with the limitations on workout alternatives imposed by the federal tax laws and regulations applicable to real estate mortgage investment conduits (see IRC §§860D-860G; Treas Reg §1.860G-2). Lastly, counsel should consider the business and economic motivations of the loan servicers, investors, and other participants. On the basis of these standards and considerations, the borrower and its counsel can seek to formulate a realistic workout plan and express that plan in terms that offer the best chance to succeed.

Although not mandating any specific form of loan workout, SB 1137 (Stats 2008, ch 69, §3) added CC §2923.6 to encourage loan restructuring in securitized loans. The legislature declared in effect that (1) loan modifications and workouts with borrowers are in the best interests of all parties to a loan pool when anticipated recovery under the modification or workout plan is greater than the anticipated recovery through foreclosure and (2) loan servicers may act accordingly and in the general interest of the pool and its investors without breaching their duties as loan servicers. CC §2923.6(a). This section applies to all California real property secured loans.

Under CC §2923.6(b), the legislature declared its intent that the beneficiary or its authorized agent "offer the borrower a loan modification or workout plan if such a modification or plan is consistent with its contractual or other authority." The intent of this legislation was to help ease the severe housing crisis exacerbated by the subprime mortgage meltdown. The legislature hoped to encourage lenders to modify loans rather than conduct foreclosures that could further depress housing prices. It is not clear whether this legislation has had any effect on lender behavior in California or on the severity of the housing crisis.

On legislation enabling federal agencies to restructure loans through their regulatory powers, see §10.8B. On borrower strategies in defending against foreclosure of securitized loans, see chaps 7, 12.

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E. Residential Loan Workouts and Modifications

§10.8A 1. Lender Obligations Under SB 1137 and ABX2 7

Ordinarily a lender's or a borrower's decision to initiate loan workout negotiations is completely voluntary. However, in the last 2 years, the California legislature has been active in promoting residential loan workouts through legislation.

The California legislature enacted urgency measures on July 8, 2008, effective on enactment through the end of 2012. Stats 2008, ch 69, §§1-10 (SB 1137). (Although some parts of the legislation did not become operative until 60 days after the effective date (see Stats 2008, ch 69, §100), all provisions are scheduled to sunset by January 1, 2013, unless extended.)

Civil Code §2923.5, effective September 8, 2008, requires notice and, when possible, a dialogue between a secured lender or its assignee and its homeowner borrower to explore alternatives to foreclosure, which may include a possible workout, before the lender commences a nonjudicial foreclosure process by sending a notice of default. This procedure applies only to loans on owner-occupied (noninvestment) residential property made between January 1, 2003, and December 31, 2007. It precludes the filing of a notice of default until 30 days after the lender has contacted the borrower or 30 days after the lender has satisfied specified "due diligence" requirements in attempting to contact the borrower. This section further requires in the notice of default or notice of sale a lender declaration concerning contact with the borrower or the lender's due diligence. See §§2.37-2.38, 2.49, 2.63.

Under CC §2923.5(a)(2), the beneficiary or its authorized agent must first contact the borrower personally or by telephone "to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure." During the initial contact, the beneficiary or its authorized agent must advise the borrower of the right to request a subsequent meeting; if a meeting is requested, the beneficiary or its authorized agent must schedule the meeting, which may be in person or by telephone, on a date that is within 14 days of the initial contact. The assessment of the borrower's financial situation and discussion of options may occur during the first contact or at the subsequent meeting. In either event, the beneficiary or its authorized agent must give the borrower the toll-free telephone number made available by the United States Department of Housing and Urban Development (HUD) to find a HUD-certified housing counseling agency.

Under CC §2923.5(h), some of these statutory obligations do not apply if any of the following has occurred:

(1) The borrower surrendered the property by either a letter confirming the surrender or delivery of the keys to the property to the trustee, beneficiary, or an authorized agent.

(2) The borrower has entered into a contract "with an organization, person, or entity whose primary business is advising people who have decided to leave their homes on how to extend the foreclosure process and avoid their contractual obligations to mortgagees or beneficiaries."

(3) The borrower has filed a petition for relief in the bankruptcy court, "and the proceedings have not been finalized."

In February 2009, the California legislature enacted (for a relatively limited class of residential loans) the California Foreclosure Prevention Act (CFPA) (CC §§2924, 2923.52-2923.55). Enacted as an emergency measure at a second 2008-2009 legislative session as ABX2 7 (Stats 2008, 2d Extra Sess, ch 5), the CFPA sunsets on January 1, 2011, unless extended. CFPA §§2-7. (Note that SBX2 7, an identical bill, was also enacted as Stats 2008, 2d Extra Sess, ch 4.)

The primary purpose of ABX2 7 was to impose an additional 90-day waiting period in the nonjudicial foreclosure process before issuing a notice of trustee sale. See §§2.62-2.62A. It also established guidelines for workouts by offering lenders an exemption from the 90-day delay if they set up residential loan modification programs meeting specified criteria. Under CC §2923.53(a), to qualify for the exemption, the lender must adopt a program that has the following features:

- It must be intended to keep a borrower in the home when the lender's net recovery under the workout plan exceeds the anticipated recovery through foreclosure on a net present value basis. CC §2923.53(a)(1).
- It must target a ratio of the borrower's housing-related debt-to-gross income of 38 percent or less. (This is

considerably higher than the 31 percent targeted by the federal Homeowner Affordability and Stability Plan.) CC §2923.53(a)(2).

- It must include "some combination" of interest rate reduction for a fixed term of at least 5 years; an extension of the amortization period to no more than 40 years from the loan's date of origin; deferral of "some portion" of principal to the loan maturity date; reduction of principal; compliance with a federally mandated loan modification program; and other factors deemed appropriate by the Commissioner of Corporations (with due regard to successful programs in other jurisdictions). CC §2923.53(a)(3)(A)-(F).

These criteria suggest a practical model for any kind of residential loan workout. On workout strategies based on these criteria, see §10.8D. On public policy issues in ABX2 7, see §2.62C. For an online list of lenders and mortgage loan servicers who are exempt under CC §2923.53(a), go to http://www.corp.ca.gov/FSD/CFP/default.asp. Significantly, ABX2 7 does not require the lender to actually grant the loan modification to anyone in order to be exempt from the additional 90-day period, but only to put a complying program in place.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/§10.8B 2. Federal and Private Loan Modification Incentives

§10.8B 2. Federal and Private Loan Modification Incentives

Depression-level rates of homeowner default and foreclosure in 2008 led to the creation of a variety of federal programs designed to avoid foreclosures in default and imminent default situations that hold some promise for being remedied with moderate modifications in loan terms. These programs are intended to augment a variety of voluntary private and industry programs.

Federal initiatives include Pub L 111-22, §203, 123 Stat 1646, effective May 20, 2009, which permits the Secretary of Housing and Urban Development to encourage loan and interest rate modifications on delinquent federally insured loans through the application of mortgage insurance benefits, the assignment of the mortgages to the Secretary, and the disposition of the modified loans into pools to buyers or to the pre-modification lenders. See 12 USC §1715u(c).

The federal programs include the Home Affordable Modification Program (HAMP), the Hope for Homeowners program, and the Home Affordable Refinance Program. A separate Making Home Affordable program permits a relatively narrow class of homeowners with currently performing loans with moderate loan-to-value (LTV) ratios (not greater than 125 percent LTV as of 2009) to refinance on fixed-rate 15- or 30-year terms. More information on opportunities under this program can be obtained at the following internet sites or by calling 800-7FANNIE or 800-FREDDIE:

- http://www.financialstability.gov;
- http://www.makinghomeaffordable.gov/;
- http://loanlookup.fanniemae.com/loanlookup; or
- https://ww3.freddiemac.com/corporate/.

These programs generally do not help homeowners who are deep in default or whose LTV ratio has deteriorated too drastically. Lenders and servicers who have implemented programs that comply with these federal programs may qualify for exemption from emergency California legislation that provides for additional statutory delays prior to certain residential nonjudicial foreclosures. See §§2.62A-2.62C.

Additional websites for residential loan modification program descriptions, guidance, information, and criteria are as follows:

United States Treasury Department:

- http://www.treas.gov/press/releases/reports/modification_program_guidelines.pdf; and
- http://www.financialstability.gov/roadtostability/homeowner.html.

Federal Deposit Insurance Corporation:

- http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html (residential loan modifications); and
- http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf (commercial loan modifications; see summary in §10.5).

In 2008, the federal government created incentives for financial institutions to engage in loan modifications and enabled modifications by outright regulation. The Federal Emergency Economic Stabilization Act of 2008 and the Troubled Assets Relief Program (TARP) (together, Pub L 110-343, 122 Stat 3765) (the 2008 Act) authorize federal agencies to exercise their regulatory power to, among other things, reduce foreclosure rates by reducing principal or interest rates or by modifying other terms of troubled loans.

A modification program for home loans owned or serviced by Fannie Mae or Freddie Mac was announced in December 2008. See http://www.freddiemac.com/singlefamily/service/streamlined_modification.html. As a condition of receiving monetary assistance under TARP, a participating lender must provide a program parallel to that of Fannie Mae and Freddie Mac. See, *e.g.,* bank program described at http://www.citigroup.com/citi/citizen/community/homeownershippreservation/.

Under TARP, a lender may offer one or more of the following options for a residential loan modification after a 3- to

4-month trial period during which the borrower makes reduced monthly payments:

- Reducing the remaining principal owed on the note to the current market value of the home;
- Lowering the interest rate to 2 or 3 percent, fixed term;
- Modifying adjustable-rate loans into fixed-rate loans;
- Reducing adjustable interest rates and lowering caps on them;
- Arranging delinquent amounts to be paid at the end of the loan or at an extended term of the loan;
- Writing off or reducing delinquent amounts; or
- Discounting payoff of forbearance amounts.

Some banks instituted their own voluntary workout or foreclosure forbearance programs. See descriptions and contact information at http://www.bankofamerica.com/loansandhomes/financial-difficulty/index.cfm?adlink=&cm_sp=&type=&cm_mmc=&statecheck=TX and https://www.chase.com/chf/mortgage/keeping-your-home.

Some private lenders, often encouraged by legislation such as TARP, have put in place programs and moratoria of various lengths. These may be of some benefit in cases of less advanced defaults and more manageable debt service and loan-to-value situations. Programs differ among the lenders and are generally described at lender-sponsored websites identified by the lender's name and some variant of "homeowner assistance," "foreclosure prevention," or "homeownership preservation." Such programs do little if anything for homeowners whose loans were bundled and sold to various nonbank holders, whose identity may be obscure. Many borrowers have found that lenders lack genuine commitment to the loan modification or renegotiation mandated or incentivized by state or federal programs. Some of the problems with such programs are likely the result of confusion brought on by (1) the proliferation of state, federal, and private programs created on an urgency basis and frequently modified on short notice and (2) a large number of different types of nonattorney real estate professionals engaging in the business of loan modifications. See §§10.1A, 10.8C.

The multitude of pending legislation that exists in different versions is difficult to track. In 2009, more than six bills were introduced in the United States Congress to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence. Two of these are HR 1106, 111th Cong, 1st Sess (2009) and S 61, 111th Cong, 1st Sess (2009). Proposed language also provides additional remedies for violations of TILA or other consumer statutes. The first of these passed in the House in early 2009 and was sent to the Senate, where both bills are apparently stalled. For further information, go to http://www.govtrack.us/congress/bill.xpd?bill=h111-1106 and http://www.govtrack.us/congress/bill.xpd?bill=s111-61.

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§10.8C 3. Residential Loan Modification Process

The process for home loan modifications is approached by lenders and counsel for borrowers much differently than for commercial loan modifications, but there are commonalities. A thorough review of loan documents is essential at the beginning. See checklist in §10.2. This may determine not only the current terms of the loan but also whether the lender violated the law in the loan origination or closing, including whether the borrower is a victim of predatory lending. On predatory lending, see §§12.50-12.116. During the loan documents review, the attorney should search for lender or broker miscalculations and determine if the loan terms are accurate, were adequately disclosed, and otherwise met the requirements of applicable federal or state consumer protection statutes. See summary in §§12.11, 12.23. The attorney may also look at the loan servicing process and monthly statements to see if payments were properly applied to principal and interest owing. See detailed discussion of governing statutes in chap 12.

EXAMPLE: If the attorney discovers violations of the Truth in Lending Act (TILA) (15 USC §§1601-1667f), then the borrower may be eligible for a loan rescission, which may include crediting back to the borrower all interest collected by the lender on the loan, loan origination fees, broker fees, lender fees, statutory penalties, and attorney fees. See §§12.11, 12.59-12.73. When presented with this alternative, lenders are often more willing to compromise the TILA claim with a loan modification that meets the needs of the borrower.

Another phase of the attorney's investigation is the client interview to determine if any common law remedies might apply. The following causes of action are the most relevant in home loan claims.

Constructive fraud. Material facts include the terms of the loan, interest rate, whether the loan is a variable interest loan or has a prepayment penalty, and any other information that a reasonable borrower would want to know before accepting the loan. Did the broker or lender, or anyone working for the broker or lender, act in a fiduciary capacity and fail to disclose any material facts to the borrower? See §§12.12-12.17.

Fraud or negligent misrepresentation. Were any representations, statements, promises, or comments, written or oral, made by the lender, loan broker, notary, or anyone else connected with the lender that contradicted the actual terms of the loan documents? See §12.5.

Negligence or duress. When a lender or its representative makes errors that a reasonably diligent mortgage professional would not have made, he or she may be liable for the damage caused to the borrower by the negligence. See §§12.6-12.7.

Breach of contract. The loan documents (promissory note, deed of trust, and their attachments) are a contract. The loan broker who usually prepares the documents must ensure consistency between the loan documents and required disclosures, such as the way the interest is calculated and the penalties it assesses. The lender may have breached the contract if it failed to comply with the contract after the loan closed. See §§12.2-12.4.

On rules of professional conduct applicable to loan modification activities of attorneys and nonattorney professionals, see §10.1A. On additional strategies for residential loan modifications, see §10.8D.

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§10.8D 4. Strategies for Residential Modifications Under ABX2 7

In February 2009, the California legislature enacted the California Foreclosure Prevention Act (CFPA) (CC §§2924, 2923.52-2923.55) as an emergency measure, ABX2 7 (Stats 2008, 2d Extra Sess, ch 5). It sunsets on January 1, 2011, unless extended. CFPA §§2-7. One purpose, which has the potential for affecting a large class of residential loans, established guidelines for workouts through a combination of regulation and lender design. See list of standards and loan modification terms in §10.8A. (On public policy issues in ABX2 7, see §2.62C.) The following points may help practitioners take advantage of the limited opportunities afforded by the CFPA:

- The explicit provisions of CC §2923.53(a)(1)-(3) give homeowner's counsel some defined standards for a loan modification that a lender or loan servicer, acting in good faith, should be willing to implement. This provides lawyers, who are trained to marshal arguments and evidence, to do some classic "lawyering" in context of residential loan modifications.
- Attorneys who negotiate with lenders in loan default situations know that some lenders, in commercial as well as residential loan defaults, often reject loan modifications that seem to hold the promise of a better ultimate return to the lender than does foreclosure. The reasons for this lender behavior is at the core of what might be called "mortgage lender culture" and include such points as not wanting to reward a borrower who has defaulted and thus potentially encourage other borrowers to default. A major thrust of the CFPA is to encourage lenders and servicers to do workouts that are in the lender's prospective economic interest.
- The creation by loan servicers of organizational arms to negotiate loan workouts and loan modifications may bring personnel into the process who are more focused on mutually beneficial results than those who have historically played the "workout" or "special assets" role.
- Ultimately, attorneys representing residential borrowers have to be prepared to convince lenders and loan servicers to negotiate workouts in good faith and not throw substantive or procedural roadblocks in the way of proposals that meet the standards set in CC §§2923.52 and 2923.53. While it is too early to know how much oversight the Corporations Commissioner will provide over qualified loan modification programs, it is not difficult to imagine that even the remote risk that a previously qualified program would be disqualified could have a strongly motivating effect on a lender that complied with the CFPA only to avoid the additional 90-day wait. For example, if a program lost its qualified status, how would that legally affect pending or even completed trustee sales in which the additional 90-day wait had been avoided by dint of the lender's qualification of a loan modification plan?

PRACTICE TIP: Homeowner's counsel who see lenders acting in bad faith in residential workout negotiations should raise such issues with the Commissioner of Corporations (see §2.62A) and with the legal department of the lender or loan servicer.

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II. LENDER'S INITIAL STRATEGY

A. Deciding Whether to Foreclose

§10.9 1. Determining Causes for Problem Loans

Determining the underlying reasons why a loan is nonperforming is often the most significant factor influencing a lender's decision whether to pursue lien enforcement or negotiate a workout with the borrower. Yet many additional factors and circumstances will be considered and may impact this decision.

The lender first will need to fully understand the underlying reasons why the loan is nonperforming and ultimately be convinced that a proposed workout solution is in the lender's best interests. As a practical matter, the loan officer responsible for the nonperforming loan will also need to convince his or her superiors, and usually the lender's management committee, that the workout plan is viable. It is therefore incumbent on both parties to candidly assess the circumstances and to formulate a workout proposal that addresses these underlying problems and provides a road map to recoup the lender's investment.

Because the real causes for a problem loan may not be readily apparent, particularly in construction loans, a prudent lender will make its own investigation and evaluation of the matter rather than rely solely on what the borrower claims the causes to be.

PRACTICE TIP: In construction loan situations, it is a good idea to employ a workout consultant or a construction consultant to determine if there are disputed items or unissued change orders. Fees for such consultants should be reimbursable as secured loan administration or enforcement expenses.

There could be any number of reasons that, through no fault of the borrower, the loan has gone into default. General economic or local market conditions may have resulted in tenant troubles or slow rentals or sales. In many areas of the country, including California, both residential and commercial property may be "underwater" or have "negative value"; this means the property is secured by a loan or loans having a total principal balance greater than the market value of the property, and thus the loan-to-value ratio is greater than 100 percent. Systemic problems in the credit markets may render it difficult for the borrower to obtain financing to repay a maturing loan. Unforeseen problems with a contractor's performance or unavailability of labor or materials may have caused substantial delays in completing construction. Unavoidable cost overruns may have left the borrower with insufficient funds to complete construction. In these situations, the lender may be more inclined to enter into workout arrangements with the borrower.

On the other hand, the lender's investigation into the present conditions of the borrower and the project may disclose that the borrower's financial condition has substantially deteriorated, the borrower's construction or management of the project was incompetent, the borrower diverted funds or resources earmarked for the project to other pursuits, the borrower became openly uninterested or uncooperative, or the intended project will in fact require substantially more money than the remaining available budget provides.

The lender's decision to proceed with lien enforcement or pursue a workout will also be influenced by a variety of other factors. The lender will assess the borrower's credibility, experience, creditworthiness, commitment, and importance to the future success of the project. It will also focus its attention on more immediate concerns such as the loss of rents or risks of harm to the project if possession is not secured. If these factors are perceived as detrimental, the lender may conclude that it needs to proceed quickly with lien enforcement to avert damage to its collateral. General economic circumstances, such as the health of the local real estate market and the availability of purchase financing, can be influential too. In addition, the lender will consider a variety of legal considerations, such as the nature of the borrower's default, the terms and conditions of the loan documents, the viability of appointing a receiver or obtaining other relief from the court, defenses to acceleration or lien enforcement, potential risks of lender liability, the environmental condition of the property, and the impact of a borrower bankruptcy filing. Finally, the lender's internal policies and procedures, capital reserve requirements, and other factors associated with the management of its business will also play a role.

In construction lending, a lender should be alert for obvious signs of trouble such as mechanics' lien filings, delays in paying the general contractor or subcontractors, fewer workers present at the job site, the receipt of bonded or unbonded stop notices, excessive change orders (which can be attributable to poor bidding procedures, rising interest rates, or subcontractors in financial distress), an out-of-balance construction loan (meaning the remaining loan funds are insufficient to complete the project contemplated by the plans), delays in construction, increased use of the contingency line item in the budget, loss of a take-out commitment from another lender or investor, loss of a major tenant, poor marketing of the project, and delay or failure of permits to be issued. Various combinations of these circumstances may compel the lender to elect to sue on the note or foreclose its lien and, if there is a legal basis for it, pursue the borrower personally for a deficiency judgment or for tort damages for waste (such as the failure to pay taxes).

PRACTICE TIP: Whether the lender decides to foreclose or attempt a workout, the appointment of a receiver to secure and manage the construction site or to complete construction should be seriously considered. See §§10.33, 10.36.

If the loan is securitized, the procedures and servicing standards for loan modifications set forth in the pooling and servicing agreement and the federal tax laws and regulations applicable to real estate mortgage investment conduits will be paramount. See §10.8. The loan servicer must follow these standards and fulfill its duties to the investors. However, other limitations unique to this lending environment will apply. For example, loan servicers will not be able to make new loans, advance additional funds, or permit subordinate mortgage financing if the project requires additional capital. They cannot extend loans beyond the time period permitted by the pooling and servicing agreement. Loan servicers may also impose stricter requirements on the borrower, such as requiring further equity investment in the project, before they will consider approving a loan modification. Consequently, any workout proposal for this loan type will need to take into account the special considerations applicable to securitized loans.

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§10.10 2. Relationship of Foreclosure Process to Workout Negotiations

Even when the lender might prefer to negotiate with the borrower for a workout, circumstances might require or commend the institution of foreclosure proceedings. For example, the existence of a third party agreement (such as a fee owner's consent to hypothecation underlying the lender's loan on a leasehold, or an outstanding loan commitment to "take out" or purchase the construction lender's loan) may oblige the lender to diligently pursue foreclosure to keep the third party agreement in good standing. Or, in its business judgment, the lender may believe that the pendency of a foreclosure is desirable because that would strengthen its negotiating position with the borrower or would expedite a trustee sale of the real property security if the workout negotiations fail. If the lender is uncertain whether a workout agreement can be reached or will be successful, the lender may consider commencing both a judicial and a nonjudicial foreclosure sale in order to start the running of relevant time periods. If a workout agreement is signed, the foreclosure proceedings can be dismissed. If the workout fails, having initiated both types of foreclosure gives the lender several advantages. First, it increases pressure on the borrower to enter into a workout on the lender's terms. Second, time will be running. Third, during this period, the lender can investigate all aspects of the project, including whether there are any environmental problems. The lender can then decide whether to proceed with the judicial or nonjudicial foreclosure.

WARNING: If the loan security consists of a partially completed construction project, the lender should carefully consider and anticipate what adverse effects could ensue from foreclosure. Such adverse effects might include cessation of further work on the project, the borrower's, contractor's, or subcontractor's removal of building materials from the job site, abandonment of the project by the borrower, or removal of personnel or devices designed to guard against vandalism and deterioration of construction completed so far.

Any of these adverse events could require the lender to take immediate steps to protect its security, including filing an action to have a receiver appointed to take possession of and secure the property. For discussion on obtaining appointment of receiver, see §§10.36, 10.43-10.50; see also chap 6. Because of the major impact the appointment of a receiver can have on the project, some lenders hesitate to initiate any type of foreclosure proceedings until it becomes clear that the workout efforts may not succeed. If foreclosure is initiated on a construction loan project or on income-producing property, the appointment of a receiver should be among the first steps taken in such litigation. The benefits of a receivership include insulating the lender from liabilities associated with property and from being viewed by third parties as the "deep pocket."

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3. Drafting Notice of Default

§10.11 a. Including All Defaults

When the lender decides to proceed with nonjudicial foreclosure of a problem loan, its counsel should try to ascertain all existing monetary and nonmonetary defaults for possible inclusion in the notice of default required to be recorded under CC §2924. The failure to *adequately describe* a claimed default in a recorded notice of default will preclude the lender from requiring that the particular default be cured as a condition to reinstatement of the loan and from relying on such default as a basis for any subsequent trustee sale. *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 152, 98 CR 735 (failure to specify whether delinquent loan payment was for principal, interest, or something else).

The lender's failure to include an existing default in the recorded notice of default does not necessarily mean that the trustor may reinstate the loan and have the notice of default rescinded without curing the omitted default. See CC §§2924, 2924c. Under CC §2924, the notice of default may state the beneficiary's election to sell to satisfy the defaults listed and "any other obligation secured by the deed of trust or mortgage that is in default" (as of the date of foreclosure sale). Therefore, the notice of default does not always give the trustor a list of all defaults for which the property might be foreclosed.

The "other obligation" may have existed at the time of the notice of default. However, by implication, the "other obligation" must not have been actually known to the beneficiary when the notice of default. However, by implication, the "other obligation" must not have been actually known to the beneficiary when the notice of default was recorded. Under CC §2924(e), there is a rebuttable presumption that the beneficiary actually knew of all "unpaid loan payments" as of the notice of default.

However, even if the beneficiary fails to include a known default in the notice of default, the notice is not invalidated and the beneficiary is not precluded from asserting a claim to the omitted default in a later notice of default. This later listing is provided for in the last sentence of CC §2924. It accommodates a beneficiary that might wish to insist that the trustor comply with certain major obligations, such as payment of principal and interest, but is indifferent about foreclosing for less important obligations.

WARNING: Although many note and deed of trust documents have an extended list of what constitutes an event of default, declaring nonmonetary defaults (see, *e.g.,* §§3.6, 3.52, 6.10. 6.15) is fertile ground for lender liability actions (see chaps 7, 12). Consequently, the lender must weigh the risk of including nonmonetary defaults in any notice of default and of requiring the borrower to cure nonmonetary defaults as a condition for loan reinstatement. Some nonmonetary defaults cannot be cured. See §§2.51, 7.35, 8.20, 12.142.

For additional considerations in drafting default notices and a form notice, see §§10.2A-10.2B. For general discussion of default notice statutes and procedures in nonjudicial foreclosure context, see chap 2.

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§10.12 b. Late Fees and Default Interest

Late charges under mortgage loan documents are enforceable only if they represent a reasonable attempt to estimate the lender's actual damages resulting from the default. *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378. The California Supreme Court looked beyond the form the lender chose for its charges and instead focused on whether the charge operated as a penalty for late payment. 17 C4th at 979. The court disallowed as a penalty and forfeiture a lender's claim for a prepayment premium equal to 6 months' interest on the principal balance, noting that it could be assessed only after default, which in this case was a failure to pay monthly installments. The court distinguished California law permitting collection of prepayment fees not conditioned on default, because such fees could be tied to lost interest, tax liability, or other adverse consequences to the lender. 17 C4th at 978.

The supreme court reiterated the continuing vitality of its prior rulings that late charges assessed against a borrower that are designed to compel performance of the loan contract and penalize its breach must satisfy California's standards for liquidated damages under CC §§1670-1671. The court rejected the argument that the later recodification of California law on liquidated damages required deference to contract terms negotiated for a commercial loan such as that at issue. 17 C4th at 981 n5.

Ridgley was followed in *Allen v Smith* (2002) 94 CA4th 1270, 114 CR2d 898, a case involving the purchase and sale of residential property. The seller sought to have additional deposits construed as a nonrefundable option fee, but the court held that a liquidated damages clause may not exceed the amount the buyer actually paid as a deposit.

When determining the amount of the debt for making demand on the borrower and for recordation of notices of default, the lender must read carefully the default interest provisions in the promissory note. The Ninth Circuit examined the application of a default interest rate included with a provision allowing the lender to accelerate the maturity date for payment of the principal amount; it held that the plain language of the note precluded the lender from collecting default interest for the period of loan default that preceded the lender's exercise of its option to accelerate the maturity date. *Beal Bank v Crystal Props., Ltd. (In re Crystal Props., Ltd.)* (9th Cir 2001) 268 F3d 743.

For further discussion of late fees, default interest, and the *Ridgley* decision, see chap 8.

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§10.13 c. Prerequisites to Declaring Defaults

Counsel should consider whether the lender's declaration of any of the apparent defaults requires some prior demand or notice to the borrower. Such communication is often required for certain types of defaults by a borrower under the construction loan agreement (such as failure to correct defective work or failure to deposit additional funds in a building loan account when the lender has ascertained that the remaining loan proceeds are insufficient to complete the project). In such cases, the lender invariably has the right to require the borrower to put its own funds into the building loan account and to disburse those funds first before the lender resumes disbursement of its funds. In *Storek & Storek v Citicorp Real Estate* (2002) 100 CA4th 44, 122 CR2d 267, the court of appeal for the First District held that the question whether the covenant of good faith and fair dealing applies to a loan agreement was a question of law (and not of fact for the jury). The precise issue addressed by the court was whether the lender owed a duty to act in good faith when deciding whether to disburse the remaining loan funds when the loan was out of balance. The court held that the lender was required to make only an objectively reasonable determination that the project budget was not in balance and that the lender had no duty to act in subjective good faith when making that determination.

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§10.14 d. Protective Advances

Provisions in the deed of trust often call for the borrower to expend funds for particular purposes related to protecting the lien or the real property security. These provisions typically include paying for hazard insurance, paying ad valorem property taxes, and making lease payments when the loan obligation is secured by a ground leasehold estate. When the borrower fails to perform under these provisions, the lender has a choice of how to treat this breach for purposes of the intended notice of default.

The lender may simply declare a default based on the borrower's breach of such a provision (*Manning v Queen* (1968) 263 CA2d 672, 674, 69 CR 734), or the lender may make a secured advance to pay the item or to perform the act for which the borrower was obligated and then declare a default based on the borrower's nonrepayment of the secured advance (CC §2876; *United Sav. & Loan Ass'n v Hoffman* (1973) 30 CA3d 306, 313, 106 CR 275).

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§10.15 e. Unapplied Funds or Credits of Borrower

When a loan goes into default, the lender or its agent will often hold or control funds of the borrower for purposes connected with the real property security. Examples of such funds are credit balances in a tax and insurance impound account maintained by the lender, impounds deposited into a repair or leasing reserve, and, in a construction loan, undisbursed sums in the building loan account. In securitized loans, rents may be deposited into a collection account maintained by the lender's agent and held and disbursed periodically in accordance with a cash management system. The lender should exercise caution before deciding to hold or control such funds because of the defense and sanction effects of the one-action rule in CCP §726. See chap 4.

For example, in *Bank of America v Daily* (1984) 152 CA3d 767, 199 CR 557, a mortgage lender set off the balance in a bank account in which it had no security interest for application to the mortgage loan. The court held that the exercise of the common setoff right constituted an action under §726 and barred the lender from foreclosing its mortgage. However, in *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, the court held that the setoff against a bank account in which the lender held no security interest was not an action for purposes of §726 but rather that such setoff violated the security-first rule of §726. Interestingly, the *Wozab* court noted in dicta that if a low-level bank employee had inadvertently set off against the bank account and the setoff was promptly reversed, there might be no sanction under §726. For worse conduct on the part of the lender, the court stated that the lender could lose its security and perhaps risk the enforceability of the debt.

PRACTICE TIP: To avoid the serious consequences of exercising setoff rights, lenders should take a personal property security interest in all accounts maintained by the lender or its agents in connection with the loan as further security for the loan. The lender can then foreclose on its security interest in the accounts without violating the one-action rule in CCP §726.

In many instances, the loan documents expressly provide that the lender may, but need not, apply such funds to the loan in the event of default and that such application will not effect a waiver of existing defaults. These funds, therefore, are potential credits against the sums owing under the defaulted loan. Arguably, the mere fact that the lender has possession of, and a security interest in, the borrower's funds but elects not to apply them to defaulted obligations should not provide a defense to the borrower for failing to pay the obligations. That would be inconsistent with the lender's legitimate interests in seeking repayment of the loan and preserving its collateral. If the lender elects to apply all or a portion of such funds to the obligations, then the amount available to apply and how they are applied will determine whether the particular defaults continue. However, the lender should also take care to exercise its discretion in good faith in accordance with its legitimate interests and not in a manner aimed at harming the borrower.

The lender should reserve the right to apply and reapply funds in which it has a security interest to any of the borrower's obligations to (1) preserve flexibility and (2) retain the ability to potentially recharacterize application of payments to other obligations of the borrower if a court (particularly a bankruptcy court) rules that the original application of funds was inappropriate. For example, if a lender is undersecured and applies such funds to the payment of interest to itself, a bankruptcy court may reverse such payment and disgorge the funds to the estate (*United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626). If the lender had applied such funds to the principal portion of the obligations, such application should survive court scrutiny.

In preparing to record a notice of default, the lender holding such funds should consider whether to apply them to the loan immediately or later in the foreclosure process. The decision will usually depend on the prospects for a workout that contemplates avoiding foreclosure. If foreclosure appears inevitable, there may be no reason to delay applying the funds to the loan (especially if the funds' application will not effect a waiver of existing loan defaults). However, if the lender foresees the likelihood of a workout that, *e.g.,* would allow the borrower to remain in ownership of an investment property or would allow a construction borrower to complete and sell the project, then the funds should probably be reserved for later use in structuring and implementing the workout. This is especially true in securitized commercial loans, where modifications to reserves and to the payment provisions or "waterfall" of any cash management system

may be critical to the success of the workout.

In securitized commercial loans that use cash management systems, the lender and its agents must comply with the provisions of the loan documents governing the application and use of project funds. If the loan is not in default, the lender risks potential liability if it withholds or redirects funds in a manner inconsistent with the express provisions of the loan documents, especially if those actions result in a loan default or cause other damage to the borrower. Even after a default has occurred, the lender should exercise whatever discretionary rights it has under the loan documents to direct the use of such funds in good faith in accordance with its legitimate interests and not in a manner aimed at harming the borrower.

Lender-established reserves may be junior in priority to claims of laborers and materialmen (including funds reserved and assigned to the lender that are applied before stop notice claims are received and funds applied in payment of loan origination fees and accrued interest). *Familian Corp. v Imperial Bank* (1989) 213 CA3d 681, 262 CR 101. A previously reported case (in which a court of appeal expressly disagreed with *Familian*) held that a stop notice does not reach the sums that a lender previously disbursed to itself for legitimately incurred loan fees and interest. See *Steiny & Co., Inc. v Citicorp Real Estate, Inc.* (review dismissed and cause remanded to court of appeal July 11, 2001; ordered not published Sept. 12, 2001; superseded opinion at 72 CA4th 199, 85 CR2d 38). *Familian* has not been overruled or clarified by any subsequent decision, and no further published decision has been rendered in *Steiny*. Further, the reasoning in *Steiny* may or may not ultimately prevail for earned loan fees and interest. For further discussion of priorities among construction liens and deeds of trust, see California Mechanics' Liens and Related Construction Remedies (3d ed Cal CEB 1998).

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B. Deciding Whether to Take Possession of Security

§10.16 1. Lender's Possession Rights

In California, a lender has no right of possession to mortgaged real property without an express agreement with the borrower. CC §2927. The only apparent statutory exception to the rule is found in CCP §564(b)(2), which enables the lender, in a judicial foreclosure action, to obtain appointment of a receiver to take possession by showing that "the mortgaged property is in danger of being lost, removed, or materially injured, or that the condition of the deed of trust or mortgage has not been performed, and that the property is probably insufficient" in value to satisfy the secured debt. Lenders seldom seek appointment of a receiver under this section, however, because of the difficulty in making the showings required under CCP §564(b)(2).

Code of Civil Procedure §564(b)(11)-(12) permits the appointment of a receiver if the deed of trust or other loan documentation specifically contains an "assignment of rents" clause, which states that on a default the lender may take possession of the rents, issues, or profits of the mortgaged property either personally (including by an agent) or by a court-appointed receiver and without regard to the adequacy of the security (see §§10.19, 10.36, 10.43). For comprehensive discussion of the appointment of a receiver to specifically enforce an assignment of rents clause, see chap 6. For discussion of the lender's right to obtain the appointment of a receiver from a drafting perspective, see California Real Estate Finance Practice: Strategies and Forms, chap 5 (Cal CEB 2000).

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§10.17 2. Relevant Factors

Before deciding to seek to take possession of the mortgaged property, the lender should weigh the risks of leaving the defaulting borrower in possession against the benefits and burdens that the lender will realize in taking possession. Other matters to be considered should include the magnitude of the borrower's defaults and the current loan-to-value ratio (the percentage relationship between the amount of the unpaid loan and the present value of the real property security).

Lenders consider taking possession most often after a borrower default when mid-construction workouts fail or when the property is income producing. When a lender is not equipped to supervise the completion of construction and to market or rent the property, or when the lender is concerned about potential warranty or liability exposure to future purchasers of the project, counsel should assist the lender in considering the advantages of having the court appoint a receiver or of creating a single-purpose entity. See §§10.19, 10.33-10.34, 10.36. Allowing the borrower to remain in possession may create a risk that rental income accruing from the property will be irretrievably lost as security for the loan or may expose the mortgaged property to serious risks of deterioration, vandalism, or other waste. On the other hand, a lender who personally enters into possession will incur management and other responsibilities to the borrower and third parties (see §10.18), while a lender who takes possession through a court-appointed receiver will incur the burden and expense of litigation (see §§10.36, 10.45-10.50; see also chap 6), will subject rents collected to expenses of the receivership administration, and may also be liable (see §10.50) for any net deficit resulting from the receiver's operations.

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§10.18 3. Lender as "Mortgagee in Possession"

See §§6.3-6.8 for discussion of the advantages and liabilities of a lender becoming a mortgagee in possession. Because of concerns about lender liability to the borrower, the guarantor, and junior lienholders, lawyers hesitate to recommend this remedy except in noncontentious circumstances. Even in these cases, counsel must fully evaluate the potential liabilities to the lender, including whether the lender's management responsibilities as a mortgagee in possession could adversely impact its ability to rely on safe harbor protection under applicable federal and state environmental laws. See, *e.g.,* Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (Pub L 104-208, 110 Stat 3009-462, 3009-468), discussed in §12.152. In a mid-construction situation, the lender could also potentially incur liability to others for uncompleted work and unresolved issues with various governmental agencies and local entities that oversee the project. Additional potential liability to the ultimate purchaser of the project or others for negligent construction and strict liability for construction defects in residential projects may also exist. See §§10.34-10.36.

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§10.19 4. Taking Possession Through Court-Appointed Receiver

When deciding to take possession of mortgaged real property from a defaulting borrower, the lender will usually choose to do so through a court-appointed receiver. This procedure requires that the lender file a legal action against the borrower for specific performance of its assignment of rents clause. CCP §564(b)(11)-(12); *Mines v Superior Court* (1932) 216 C 776, 16 P2d 732; *Santacroce Bros. v Edgewater-Santa Clara, Inc.* (1966) 242 CA2d 584, 51 CR 613. See §10.43; see also chap 6. Without a contractual right to possession, such as an assignment of rents or an agreement in a construction loan allowing the lender to take possession, the lender would have to seek appointment of a receiver by a stipulation or under CCP §564(b)(2), which requires a showing of waste or that the property is probably of insufficient value to secure the debt. See §§6.15, 10.16, 10.46.

California Rules of Court 3.1175-3.1184 govern receivers and restrict their powers. On procedures for obtaining court appointment of receiver and related forms, see chap 6.

PRACTICE TIP: Sometimes the receivership alternative is not considered by the lender early enough in the workout process. This is not primarily a legal issue but a business issue. If the lender decides the borrower is untrustworthy or has incurred potential liability to third parties, the lender should consider disengaging from the borrower and taking possession through a receivership as soon as possible; this may reduce future litigation costs and liability and often produces higher net recoveries for the lender.

The expenses of receivership are significant, and both lender and its counsel need to consider them. In many cases, the benefits to the lender of enforcing its possessory rights through a neutral court officer may outweigh the litigation and receivership expenses involved. First, all property of which the receiver takes possession is regarded as being in custodia legis and thus immune from removal or repossession by the borrower or any third party without prior consent of the court. Second, management of the mortgaged property will become the receiver's sole responsibility so that the receiver and the CCP §567 receiver's bond, not the lender, will be liable to the borrower or any third party for mismanagement of the property or any other improper performance in connection with the receivership. Thus, the lender does not have the problems of the mortgagee in possession, as discussed in chap 6.

Moreover, the particular powers and duties with which a receiver may be invested are determined by the appointing court in its discretion and may be customized to the particular mortgaged real property and business operation involved. Thus, for income-producing property (see §10.43; see also chap 6), the receiver would be authorized to act as manager and rent collector, and for a problem construction loan (see §§10.36, 10.45-10.50), the receiver could be authorized to do whatever the lender has the right to do under the construction loan agreement relative to completing construction of the project.

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III. WORKOUT AGREEMENTS

§10.20 A. Workouts Contemplating Avoidance of Foreclosure

The concept of a workout involving avoidance of foreclosure is inherently attractive to both lender and borrower because it is calculated to realize their original objectives in entering into the loan transaction. If the lender is a regulated financial institution, effectuating a workout agreement may also help the lender achieve a more favorable classification of the loan and avoid regulatory difficulties and possible loan reserves. Regulatory considerations may also influence the form a workout may take if, for example, the sale of the loan is more beneficial to the lender from a regulatory perspective than a loan modification. However, as previously discussed (see §§10.4-10.5), the parties' willingness to attempt such a workout will depend on how each assesses and appraises a variety of legal and economic factors and conditions.

There are three basic kinds of workouts designed to resolve the issues between the parties raised by a nonperforming loan:

(1) **A simple forbearance agreement,** under which the lender defers or postpones further exercise of the foreclosure remedy while leaving the delinquency status of the loan unchanged. See form in §10.22A. A forbearance agreement is by nature a temporary solution often entered into while the parties are seeking to refinance the debt, sell the property, or solve other fundamental issues necessary to permit them to enter into a longer-term solution.

(2) **A loan modification agreement,** which may involve not only a formal loan extension or renewal but also material changes in loan provisions affecting such matters as principal amount, interest rate, frequency and amount of installments, delivery of additional security, and maturity date. See discussion of this form in §§10.23-10.27. Modifications of a problem construction loan may also involve extensive changes in the existing agreements on the construction project and replenishment and disbursement of building loan account balances.

(3) **A deed in lieu of foreclosure agreement,** in which the borrower and guarantor agree to voluntarily transfer title to the collateral to the lender or its nominee in exchange for a release of their respective loan obligations. See discussion of deeds in lieu of foreclosure in §§10.28-10.32.

Forbearance and modification agreements give the lender an opportunity to review the original loan documentation and eliminate errors and omissions and to add new provisions mandated by changes in statutory or case law since the inception of the loan. Additionally, in a mixed real and personal property collateral situation, the lender can review the financing statements it has filed for compliance with revisions to Division 9 of the California Commercial Code and conduct a full lien, tax lien, and judgment search to ascertain whether the borrower has impermissibly encumbered the property, paid its taxes, or suffered a judgment. (On mixed collateral security agreements and their enforcement, see chap 9. See also California Real Estate Finance Practice: Strategies and Forms, chap 7 (Cal CEB 2000); Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).)

If the loan has been securitized and the lender is considering a workout, the loan's special servicer (see §§10.4, 10.8) must undertake the decision-making process specified in the pooling and servicing agreement governing the loan. Typically this involves ordering a new appraisal, reviewing title, inspecting the property and property-related due diligence, and generally evaluating the terms of the proposed workout to determine whether the servicer should recommend it as the best alternative to maximize the net present value recovery to the investors. The special servicer also may need to seek consent from the controlling class of investors and other parties whose consent is required by applicable intercreditor or similar agreements. This process takes substantial time—often 3 months or more. During this period, the special servicer will often require the borrower and guarantor to enter into a forbearance agreement to preserve the status quo.

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§10.21 1. Statute of Frauds

Because a note or a deed of trust is a contract in writing, an executory oral agreement to postpone or forbear from a trustee sale, or to modify any of the loan provisions, will ordinarily be unenforceable. See CC §1698; *Secrest v Security Nat'l Mortgage Loan Trust 2002-2* (2008) 167 CA4th 544, 553, 84 CR3d 275; *Nguyen v Calhoun* (2003) 105 CA4th 428, 444, 129 CR2d 436 (cited in §§2.73, 2.79, 7.67); *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 121, 92 CR 851.

A party may avoid the operation of §1698, however, and modify a written agreement by an *executed* oral agreement unless the underlying written agreement provides for written modifications only. *Conley v Matthes* (1997) 56 CA4th 1453, 1465, 66 CR2d 518. Even if the underlying written agreement so provides, the lender can still be estopped from excluding evidence of the oral modification if the lender accepted the benefits of the modification. 56 CA4th at 1466. Similarly, if an oral promise to postpone foreclosure is supported by consideration such as the borrower's promise to pay or to do something, or if the circumstances result in an estoppel against the lender's assertion of the Statute of Frauds, the oral promise is enforceable either in law (by an award in damages) or in equity (by a decree setting aside the foreclosure). *Raedeke v Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 673, 111 CR 693.

Some courts strictly apply the rule in §1698 and conclude that part performance, such as the borrower's payment of money, is not sufficient to estop the lender from asserting the Statute of Frauds as a defense against an oral forbearance agreement. See, *e.g., Secrest,* 167 CA4th at 555.

Other cases involving forbearances and loan modifications have also addressed issues of waiver and estoppel as bases for enforcing oral agreements. In *Tully v World Sav. & Loan Ass'n* (1997) 56 CA4th 654, 659, 65 CR2d 545, the court held that a lender may be estopped from proceeding with foreclosure if it accepts a partial payment from the borrower without objection and the borrower is misled into believing the default was cured. In *Tully*, the borrower made a partial payment on a defaulted loan after discussing a repayment plan over the telephone. The lender then sent the borrower a letter setting forth the terms of the repayment plan, but the borrower objected because of alleged discrepancies between the letter and the parties' oral agreement. The borrower asserted that the lender's acceptance of the requested payment without objection, and under circumstances that led the borrower to believe that its payment was sufficient to terminate the pending foreclosure, could constitute an enforceable "repayment agreement." The appellate court said this was a triable issue of fact and reversed summary judgment in favor of the lender.

In another case, the court held that a 3-month forbearance or "stop" on the borrower's loan account may have resulted in a payment agreement, the meaning of which was a factual issue to be determined at trial. See *Sutherland v Barclays Am./Mortgage Corp*. (1997) 53 CA4th 299, 61 CR2d 614 (borrower argued that she was given right to stop making monthly payments for 3 months to catch up on unforeseen earthquake expenses, while lender argued that payments were simply postponed and due in full at end of 3-month period). See also *Storek & Storek v Citicorp Real Estate* (2002) 100 CA4th 44, 122 CR2d 267, discussed in §10.13.

However, in *Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 26 CR3d 413, the court distinguished *Tully* and upheld a trustee sale following the lender's acceptance of a partial payment. In *Melendrez*, the court's focus appears to have been on protecting the integrity of the foreclosure process and the interests of bona fide purchasers.

WARNING: The safest practice with respect to forbearance or modification agreements is to make sure all agreements are in writing. See form in §10.22A. Another alternative to help prevent claims of estoppel or waiver is for the lender to send a pre-negotiation letter that documents the beginning of the negotiation process but reserves rights and does not obligate the lender to continue negotiations or to settle. This approach is a generally recommended practice for all lenders engaging in workout discussions of any kind. See form and discussion in §§10.3-10.3A. As a matter of good practice, lender's counsel should also be sure that all loan documents contain a provision stating that modifications to the agreement must be in writing and signed by the party to be charged in order to be binding. If such a provision is not found in existing loan documents that are the subject of a workout, then lender's counsel should try to correct this defect in connection with any loan modification.

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2. Forbearance Agreement

§10.22 a. Purposes of Forbearance Agreement

In its simplest form, a forbearance agreement gives the parties a specified period of time before the lender will commence or complete the exercise of any of its remedies. This time can be used for many purposes. If the ownership interest in the borrower was recently transferred to a mezzanine lender, it will give the mezzanine lender time to assess the property and determine what, if any, actions it will take to protect its "investment" in the borrower. It may also give the borrower time to do some or all of the following:

- Find a buyer for the property (in which case, the forbearance agreement could include provisions permitting a discounted payoff of the loan in connection with a sale of the property);
- Refinance the loan or find a source of new equity to cure the default (in which case, the forbearance agreement could include provisions permitting a cure for less than the full amount of the default, *e.g.,* by waiving late charges or default interest);
- Give the lender time to commence, but not complete, an exercise of its remedies (*e.g.,* foreclosure); or
- Negotiate a temporary modification of the loan documents (*e.g.,* the lender's waiver of the borrower's obligation to pay monthly installments during the forbearance period) or the option to extend the forbearance period on payment of additional consideration.

The borrower's confirmations of current loan balances and the validity of pending foreclosure proceedings in the forbearance agreement may substantially help the lender in opposing any attack by the borrower on a later scheduled or completed foreclosure sale based on the prior loan history. The lender should also obtain the reaffirmation of the guarantor's obligations under the payment guaranty and its consent to the execution and delivery of the forbearance agreement to ensure that the guarantor will not attempt to use the agreement as a potential defense. Additionally, most lenders routinely include in the forbearance agreement a general release with appropriate waivers under CC §1542 for any possible claims and causes of action that either the borrower or the guarantor may have against the lender at the time of the forbearance.

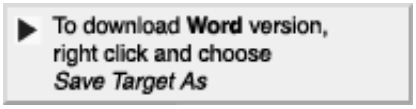
In some instances, a lender also may require the borrower to deposit a deed in lieu of foreclosure with an escrow company to be held by the escrow agent in accordance with the terms and conditions of an escrow agreement that permit the recordation of such deed on the expiration or earlier termination (due to a default thereunder by the borrower) of the forbearance period. See §10.22A for a form of such an escrow agreement; see also §10.32.

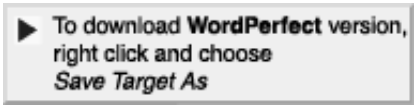
When significant risks exist that the lender's security may be materially impaired during the intended forbearance period, the lender may include in the forbearance agreement one or more conditions subsequent to the lender's continuing obligation to forbear from foreclosure. For example, the lender might require that the borrower timely pay loan installments or other monetary obligations (such as taxes or installments under senior liens) that accrue during the forbearance period or perform special nonmonetary obligations during that period related to the maintenance, protection, or improvement of the mortgaged real property. Similarly, the lender might expand its possessory rights by defining additional circumstances entitling it to take possession or by broadening its powers to do certain things for the protection and preservation of the property.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.22A b. Form: Forbearance Agreement

§10.22A b. Form: Forbearance Agreement





FORBEARANCE AGREEMENT

THIS FORBEARANCE AGREEMENT (Agreement) is made as of _ _[*date*]_ _, by and among _ _[*name and type of entity*]_ _ (Borrower); _ _[*name and type of entity*]_ _, (Guarantor); and _ _[*name and type of entity*]_ _, (Lender), with respect to the following:

RECITALS

A. Lender made a loan to Borrower in the original principal amount of $_ _[*amount*]_ _ on the terms, and subject to the conditions, set forth in the agreements, instruments, and documents identified on Exhibit _ _[*specify*]_ _(collectively, Loan Documents). All initially capitalized terms not otherwise defined in this Agreement shall have the meanings given to them in the Loan Documents.

B. An Event of Default has occurred (Subject Default) as described in that certain letter dated _ _[*date*]_ _, from Lender to Borrower and Guarantor.

C. Borrower, Guarantor, and Lender executed that certain letter dated _ _[*date*]_ _, from Lender to Borrower and Guarantor with respect to ongoing discussions and negotiations regarding the status of the Loan (Pre-Negotiation Letter).

D. Borrower has requested that Lender forbear from enforcing its rights and remedies under the Loan Documents as a result of the Subject Default in order to provide time to _ _[*modify the terms of the Loan/sell the Project*]_ _. Lender has agreed to so forbear on the terms, and subject to the conditions, set forth in this Agreement.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Borrower, Guarantor, and Lender agree as follows:

1. CONDITIONS PRECEDENT. This Agreement shall not become effective, and Borrower, Guarantor, and Lender shall have no obligation to perform their obligations under this Agreement, unless the following conditions (collectively, Conditions Precedent) have been satisfied in full on or before _ _[*date*]_ _ (Termination Date):

1.1. *Fees, Costs, and Expenses.* Borrower and Guarantor have paid all reasonable fees, costs, and expenses of third parties (including attorney fees and costs) actually incurred by Lender in connection with this Agreement.

1.2. _ _[*Add other fact-specific Conditions Precedent*]_ _

If the Conditions Precedent have not been satisfied on or before the Termination Date, then the outstanding principal balance of the Loan, all accrued and unpaid interest, and all other amounts payable under and/or secured by the Loan Documents shall become immediately due and payable, without presentment, demand, protest, notice of intent to accelerate, notice of acceleration, or notice requirements of any other kind, all of which are waived by Borrower and Guarantor, and Lender may exercise any or all of its rights and remedies under the Loan Documents, at law, in equity, or otherwise, unhindered in any way by the terms and conditions of this Agreement.

2. FORBEARANCE.

2.1. *Forbearance Period.* Lender agrees to forbear from enforcing its rights and remedies under the Loan Documents as a result of the Subject Default during the period commencing on the date the conditions described in Sections _ _[*e.g., 1.1-1.2*]_ _ have been satisfied (Effective Date) and terminating on the first to occur of (a) the _ _[*specify*]_ _ day after the Effective Date and (b) a "Forbearance Default" (as defined below). The period of forbearance described in the immediately preceding sentence shall be referred to herein as the "Forbearance Period."

2.2. *Status of Loan.* Borrower, Guarantor, and Lender acknowledge and agree that (a) the Subject Default has occurred and constitutes an Event of Default; (b) Lender has no obligation to make any further disbursements of the Loan; (c) the outstanding principal balance of the Loan as of the date hereof is $_ _[*amount*]_ _; (d) interest, fees, and costs continue to accrue under the Loan Documents (provided, however, that Lender shall forbear from collecting the same during the Forbearance Period); (e) Lender is agreeing to forbear from enforcing its rights and remedies under the Loan Documents as a result of the Subject Default as an accommodation to Borrower; and (f) but for Lender entering into this Agreement, Lender would have the right to enforce all of its rights and remedies under the Loan Documents as a result of the Subject Default.

2.3. _ _[*Add fact-specific obligations to be performed*]_ _

2.4. *Forbearance Default.* Each of the following shall be deemed a "Forbearance Default":

2.4.1. The failure of Borrower or Guarantor to perform when due any obligation required pursuant to this Agreement, it being understood that time is of the essence with respect to each deadline for performance.

2.4.2. Any incorrect or incomplete representation or warranty, in any material respect, made by Borrower or Guarantor under this Agreement.

2.4.3. The filing of any lawsuit or other legal action challenging the enforceability or validity of this Agreement and Lender notifying Borrower and Guarantor that the same constitutes a "Forbearance Default."

2.4.4. Borrower or Guarantor becoming enjoined, restrained, or in any other way prevented by court order from performing its obligations under this Agreement.

The occurrence of any of the foregoing shall immediately and automatically constitute a Forbearance Default (*i.e.,* there shall be no notice and/or cure rights with respect thereto).

3. TERMINATION. On the expiration of the Forbearance Period:

3.1. *No Further Forbearance.* Lender's obligation to forbear from enforcing its rights and remedies under the Loan Documents as a result of the Subject Default as provided in this Agreement shall terminate.

3.2. *Foreclosure of Additional Collateral.* Lender shall be immediately entitled to foreclose its security interest in the _ _[*describe additional collateral*]_ _ and to apply any and all sums on deposit therein to the outstanding balance of the Loan.

3.3. *Acceleration of Loan.* The outstanding principal balance of the Loan, all accrued and unpaid interest, and all other amounts payable under and/or secured by the Loan Documents shall become immediately due and payable, without presentment, demand, protest, notice of intent to accelerate, notice of acceleration, or notice requirements of any other kind, all of which are waived by Borrower and Guarantor, and Lender may exercise any or all of its rights and remedies under the Loan Documents, at law, in equity, or otherwise (including obtaining a judgment in a foreclosure action), unhindered in any way by the terms and conditions of this Agreement.

4. EFFECT OF FORBEARANCE.

4.1. *No Waiver.* Except with respect to the Subject Default and as otherwise provided in this Agreement, Lender's forbearance from enforcing its rights and remedies under the Loan Documents as a result of the

Subject Default shall not constitute a waiver of (a) any of Lender's rights or remedies available under the Loan Documents, at law, in equity, or otherwise or (b) any term or condition required to be performed by Borrower under the Loan Documents.

4.2. *Tolling.* Any statute of limitation and defense of laches that may be applicable to Lender's enforcement of its rights and remedies under the Loan Documents are tolled and otherwise suspended during the Forbearance Period to the maximum extent permitted by law.

5. EFFECT ON LOAN. The parties acknowledge and agree that (a) Lender has not agreed to modify or restructure the Loan or to provide a new loan; (b) this Agreement constitutes (i) a "Binding Agreement" for purposes of the Pre-Negotiation Letter and (ii) a "Loan Document" for purposes of the other Loan Documents; (c) this Agreement is not intended to constitute a novation, or in any way adversely affect the lien and security interest, of the Loan Documents; (d) except as set forth in this Agreement, all of the terms and conditions of the Loan Documents are in full force and effect, without waiver or modification; (e) they renew, reaffirm, ratify, and confirm their obligations under the Loan Documents; and (f) in the event of any conflict or inconsistency between the provisions of this Agreement and the provisions of the Loan Documents, the provisions of this Agreement shall prevail.

6. RESERVATION OF RIGHTS. Except for the rights and remedies that Lender has agreed to forbear from enforcing as provided in this Agreement, Lender reserves all rights and remedies to which it is, or may become, legally entitled with respect to Borrower, Guarantor, or any other party, including:

6.1. *Secured Creditor Rights.* The right to take any action to preserve or protect Lender's position or priority as a secured creditor of Borrower.

6.2. *Rights in Project.* The right to take any action to preserve or protect Lender's rights or interest in or to all or any part of the Project, including the rights (a) to prevent the loss, seizure, or sale of all or part of the Project pursuant to any foreclosure sale, writ of execution, writ of attachment, or any other legal process or (b) to resist or oppose any claim by any other creditor or any legal action by Borrower or any other party to effect the disposition of all or part of the Project.

6.3. *Counterclaim Rights.* The right to take any legal action to enforce the collection of any and all indebtedness of Borrower or Guarantor if such action is a necessary or permissive counterclaim or cross-complaint in any action that Borrower, Guarantor, or any other party commences against Lender.

This reservation of rights is not intended, and shall not be construed, to be exclusive.

7. REVIVAL OF OBLIGATIONS.

7.1. *Voidable Transfer.* The parties acknowledge and agree that in the event any payment of money or transfer of assets contemplated by this Agreement should for any reason subsequently be declared to be "fraudulent" within the meaning of the Bankruptcy Code or any other federal, foreign, or state law (collectively, Voidable Transfer), and in the event any party to this Agreement is required to pay or restore any such Voidable Transfer, or any portion thereof, then as to that which is repaid or restored pursuant to any such Voidable Transfer (including all costs, expenses, and attorney fees related to the Voidable Transfer, including relief from stay or similar proceedings), the liability of the parties shall automatically be revived, reinstated, and restored to the extent thereof and shall exist as though such Voidable Transfer had never been made.

7.2. *Settlement.* Nothing set forth in this Agreement is an admission that such Voidable Transfer has occurred. The parties acknowledge that any party hereto that is required to repay or restore a Voidable Transfer may rely on advice of counsel and, if so advised by counsel, may, in the exercise of such party's sole and absolute discretion, settle, without defending, any action to void any alleged Voidable Transfer and that on such settlement, the parties hereto shall again be liable for any deficiency resulting from such settlement as provided in this Agreement.

8. REPRESENTATIONS AND WARRANTIES. Each party (Representing Party) represents and warrants to the other parties hereto as follows (and such Representing Party acknowledges and agrees that these other parties are relying on such representations and warranties in entering into this Agreement):

8.1. *Power and Authority; Enforceability.* Representing Party has all power and authority to execute and

deliver this Agreement and to perform its obligations hereunder. This Agreement constitutes a legal, valid, and binding obligation of Representing Party, enforceable against such Representing Party in accordance with its terms.

8.2. *Approval and Authorization.* Representing Party's execution and delivery of this Agreement require no approvals or authorizations from, or registrations with, any party not previously obtained and do not violate, contravene, or conflict with any law, order, or regulation by any court, governmental authority, official, or agency, or any other contract, indenture, or instrument to which such Representing Party is a party or by which such Representing Party or the Project may be bound.

8.3. *Explained by Counsel.* Representing Party's independent legal counsel has participated in the preparation and negotiation of this Agreement and explained the legal effect of this Agreement to such Representing Party.

8.4. *Reviewed by Representing Party.* Representing Party has reviewed this Agreement (including the accuracy of the recitals) and understands the significance and consequences of this Agreement (including that the provisions hereof are contractual in nature).

8.5. *No Duress.* Representing Party is entering into this Agreement freely and without duress.

8.6. *No Proceedings.* To Representing Party's knowledge, there is no action, cause of action, claim, suit, or other proceeding at law or in equity or by or before any governmental agency of any local, state, or federal government now pending against the Project.

9. RELEASE OF LENDER PARTIES.

9.1. *General Release.* Borrower and Guarantor, and their successors and assigns (jointly and severally, Releasor), fully and forever release and discharge Lender, its accountants, affiliates, agents, attorneys, employees, directors, members, officers, parents, partners, representatives, stockholders, and subsidiaries, and their successors and assigns (collectively, Lender Parties), from any act, action, agreement, breach, claim, controversy, cost, damage, debt, default, demand, dispute, expense, injury, judgment, liability, loss, malfeasance, misfeasance, obligation, omission, and/or suit of every character, kind, nature, and type (*e.g.,* whether legal or equitable, known or unknown, suspected or unsuspected, contingent or fixed) (collectively, Claims) that have arisen or accrued with respect to the Loan and/or the Project as of the date of this Agreement, provided, however, that such release and discharge shall not be applicable with respect to (but only to the extent of) any gross negligence or willful misconduct by the Lender Parties.

9.2. *Section 1542 Waiver.* Releasor acknowledges that certain facts may exist that are not presently known or suspected by Releasor that could give rise to Claims by Releasor against the Lender Parties and agrees that the release and discharge of the Lender Parties by Releasor in Section _ _[*e.g., 9.1*]_ _ (Release) was made after considering, and notwithstanding, such possibility. To that end, Releasor waives any rights provided by California Civil Code §1542 (Section 1542) and, by doing so, intends that the Release be given full force and effect notwithstanding the existence of any such unknown or unsuspected facts. Section 1542 provides:

> **A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS OR HER FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM OR HER MUST HAVE MATERIALLY AFFECTED HIS OR HER SETTLEMENT WITH THE DEBTOR.**

9.3. *No Liability.* Releasor acknowledges and agrees that the Release shall not be deemed or construed to be an admission of liability by the Lender Parties, and the Lender Parties deny any liability, with respect to Claims covered by the Release. The Release shall constitute a complete defense to the Claims covered by the Release.

9.4. *Sole Owner.* Releasor represents and warrants to the Lender Parties that (a) Releasor is the sole and lawful owner of all right, title, and interest in and to the Claims covered by the Release and (b) Releasor has not assigned or otherwise transferred any right, title, or interest in or to the Claims covered by the Release to a third party.

10. MISCELLANEOUS.

[*Add miscellaneous provisions similar to those in §10.23A*]

IN WITNESS WHEREOF, Borrower, Guarantor, and Lender have executed this Forbearance Agreement as of the day and year first above written.

BORROWER:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

GUARANTOR:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

LENDER:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This form is representative of a forbearance agreement that simply provides the parties with an agreed-on period of time before the lender will commence or complete the exercise of any of its remedies. As discussed in §10.22, particular facts and circumstances affecting the borrower or project will dictate other conditions or business terms that need to be addressed in the agreement.

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3. Deed in Lieu Escrow Agreement

§10.22B a. Purpose of Deed in Lieu Escrow Agreement

If a forbearance period will provide sufficient time for the borrower to sell or refinance the property or otherwise allow the parties to make a final decision regarding the viability of a workout, then the lender may seek to have the borrower deliver a deed in lieu of foreclosure (together with other transfer documents) to an escrow agent concurrently with the commencement of the forbearance period. This avoids the need to negotiate a deed in lieu of foreclosure agreement after the expiration or earlier termination of the forbearance period. Depending on the circumstances giving rise to the workout and the relative negotiating leverage of the parties, the borrower is likely to resist this approach. Unlike most other workout documents, this agreement must be reviewed and approved by a third party, so the escrow agent should be consulted as early in the process as possible, especially with respect to the escrow agent's obligation to comply with instructions from the parties.

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§10.22C b. Form: Escrow Agreement for Deed in Lieu of Foreclosure

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

ESCROW AGREEMENT
for
DEED IN LIEU OF FORECLOSURE

THIS ESCROW AGREEMENT FOR DEED IN LIEU OF FORECLOSURE (Escrow Agreement) is made as of _ _[*date*]_ _, by and among _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Borrower); _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Escrow Agent); and _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Lender), with respect to the following:

RECITALS

A. On or about _ _[*date*]_ _, Lender made a loan to Borrower in the original principal amount of $_ _[*amount*]_ _ (Loan), which was secured by, among other things, the real property commonly known as "_ _[*name*]_ _" located at _ _[*address*]_ _ in the City of _ _[*name*]_ _, County of _ _[*name*]_ _, State of California (Project).

B. Concurrently herewith, Borrower and Lender entered into that certain Forbearance Agreement (Forbearance Agreement) under which, among other things, Lender agreed to forbear, for a limited time and under the circumstances set forth in the Forbearance Agreement, from exercising its rights and remedies as a result of certain defaults under the Loan.

C. All initially capitalized terms not otherwise defined in this Escrow Agreement shall have the meanings given to such words and terms in the Forbearance Agreement.

D. Under Section _ _[*specify*]_ _ of the Forbearance Agreement, and as a condition precedent to Lender's agreement to forbear, Borrower has agreed to (i) execute and deliver to Escrow Agent the transfer documents attached as Exhibits _ _[*specify*]_ _ through _ _[*specify*]_ _, inclusive (collectively, Transfer Documents) and (ii) enter into this Escrow Agreement with Escrow Agent and Lender to provide a procedure for holding, recording, and delivering the Transfer Documents.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Borrower, Escrow Agent, and Lender agree as follows:

1. APPOINTMENT OF ESCROW AGENT. Borrower and Lender appoint Escrow Agent to serve as the escrow agent under this Escrow Agreement for the purposes, and subject to the terms and conditions, set forth herein. Escrow Agent accepts such appointment and agrees to perform the obligations of the escrow agent under this Escrow Agreement and to be bound by the terms and conditions set forth in this Escrow Agreement.

**2. DEPOSIT OF TRANSFER DOCUMENTS. Concurrently herewith Borrower deposited, and Escrow Agent acknowledges receipt of, originals of the Transfer Documents executed by Borrower and Lender. The Transfer Documents shall be held, recorded, and delivered by Escrow Agent in accordance with the provisions of this Escrow Agreement. Escrow Agent, Borrower, and Lender acknowledge and agree that the Transfer Documents delivered to Escrow Agent by Borrower and Lender have not been dated but that Borrower and Lender authorize and empower Escrow Agent, as attorney in fact of Borrower and Lender, to date the Transfer Documents as of the date the Transfer Documents are recorded by Escrow Agent under the provisions of this Escrow Agreement. The power of attorney granted by Borrower and Lender to Escrow Agent under this Section _ _[*e.g., 2*]_ _ shall be durable, shall be deemed coupled with an interest, and shall be irrevocable. Escrow Agent acknowledges that, but for dating the Transfer Documents as provided in this Section _ _[*e.g.,*

2]_ _, the originals of the recordable Transfer Documents received by Escrow Agent are in recordable form.

3. RECORDATION/DELIVERY OF TRANSFER DOCUMENTS. Escrow Agent shall hold the Transfer Documents, in escrow, until the first to occur of the following:

3.1. *Joint Directions.* Promptly after Escrow Agent's receipt of an instrument signed by Borrower and Lender instructing Escrow Agent to record and/or deliver the Transfer Documents, the Transfer Documents shall be recorded and/or delivered as instructed in such instrument.

3.2. *Repayment of Loan.* Promptly after Escrow Agent's receipt of an instrument signed by Lender confirming that the Loan has been repaid in accordance with the provisions of the Forbearance Agreement, the Transfer Documents shall be delivered to Borrower. Lender shall deliver such instrument to Escrow Agent promptly on repayment of the Loan in accordance with the provisions of the Forbearance Agreement.

3.3. *Forbearance Period—Early Expiration.* Promptly after Escrow Agent's receipt of a copy of notice from Lender to Borrower stating that the Forbearance Period has expired (including as a result of the occurrence of a Forbearance Default (Default Notice)), the recordable Transfer Documents shall be recorded immediately and the other Transfer Documents shall be delivered to Lender, provided that if Escrow Agent receives an order from a court of competent jurisdiction before such recording and delivery ordering Escrow Agent to not record the recordable Transfer Documents or deliver the other Transfer Documents to Lender (Injunction), Escrow Agent shall continue holding the Transfer Documents in escrow until the Injunction is lifted. After the Injunction is lifted, Escrow Agent shall proceed to record and deliver the Transfer Documents in accordance with this Section _ _[*e.g., 3.3*]_ _ unless otherwise instructed pursuant to Section _ _[*e.g., 3.1*]_ _.

3.4. *Forbearance Period—Stated Expiration.* Promptly after Escrow Agent's receipt of an instrument signed by Lender instructing Escrow Agent to record the recordable Transfer Documents and deliver the other Transfer Documents to Lender anytime after the _ _[*specify*]_ _ day following the date of this Escrow Agreement, the recordable Transfer Documents shall be recorded in the Official Records of _ _[*name*]_ _ County, California, and the other Transfer Documents shall be delivered to Lender promptly after receipt of an instrument signed by Lender instructing Escrow Agent to so record and deliver the Transfer Documents.

Lender shall provide Borrower with a copy of all notices provided by Lender to Escrow Agent pursuant to this Section _ _[*e.g., 3*]_ _, concurrently with the delivery of the notice to Escrow Agent.

4. TRANSFER ABSOLUTE. Borrower acknowledges and agrees that at the time the Transfer Documents are properly recorded and delivered to Lender pursuant to Section _ _[*e.g., 3*]_ _, then (a) such recordation and delivery is intended to effect a present and absolute conveyance and unconditional transfer of all of Borrower's right, title, and interest in and to the Project and the other property transferred pursuant to the Transfer Documents and is not given as security; (b) Borrower will deliver possession and enjoyment of the Project and the other property transferred pursuant to the Transfer Documents to Lender (or its designee or assignee), and Lender (or its designee or assignee) shall thereafter have the immediate right to occupy (subject to the rights of tenants of the Project), operate, manage, use, maintain, lease, and transfer the same for its own account and in its sole and absolute discretion; (c) title to the Project shall remain subject to the lien of the Deed of Trust to the full extent of the outstanding balance of the Loan, and recording of the attached Deed in Lieu of Foreclosure as Exhibit _ _[*specify*]_ _ (Deed) shall not result in a merger of Lender's interest as a lienholder under the Deed of Trust with Lender's interest as title holder pursuant to the Deed; and (d) Borrower will reasonably cooperate with Lender (or its designee or assignee) to facilitate an orderly transfer of the ownership and management of the Project, including the delivery of the following: (i) all cash and noncash security and other deposits and any interest required by law or agreement to be paid thereon; (ii) a key code inventory and all keys to the Project; (iii) originals (or, if originals are not available, copies) of (A) all leases and contracts; (B) all licenses and permits; (C) all warranties; (D) all plans and specifications; and (E) all books, records, bills, invoices, lease files, credit reports, and other documents related to the ownership, occupancy, operation, management, use, maintenance, or leasing of the Project; and (iv) any rental payment or other payment from any tenant or other occupant or user of the Project received by Borrower (which shall be delivered to Lender (or its designee or assignee) with proper endorsements not later than _ _[*e.g., 5*]_ _ days following receipt of such payment). The terms and conditions of this Section _ _[*e.g., 4*]_ _ shall survive the recordation of the Deed.

5. OBLIGATIONS OF ESCROW AGENT.

5.1. *No Further Instructions.* Borrower and Lender authorize, direct, and consent to Escrow Agent acting in accordance with the instructions contained in this Escrow Agreement without any further authorization, direction, or consent of any kind or character.

5.2. *No Other Actions.* Escrow Agent shall not be required to take any action with respect to the Transfer Documents other than to receive, hold, record, and/or deliver the same as provided in this Escrow Agreement or by reason of a final judgment of a court of competent jurisdiction.

5.3. *No Determinations.* Escrow Agent shall not be required to determine the validity or sufficiency, whether in form or in substance, of any notice or other instrument referred to in this Escrow Agreement or the identity or authority of the persons executing the same, but it shall be sufficient if any writing purporting to be such notice or instrument is delivered to Escrow Agent and purports on its face to be in correct form and signed or otherwise executed by the parties required to sign or execute the same under this Escrow Agreement.

5.4. *Irrevocable Instructions.* Borrower and Lender acknowledge and agree that the instructions provided in any instrument delivered to Escrow Agent pursuant to this Section _ _[*e.g., 5*]_ _ are irrevocable instructions to Escrow Agent.

6. INTERPLEADER. On receipt of an Injunction, Escrow Agent shall not take any action but instead shall await the disposition of the proceedings pursuant to which the Injunction was issued, or, at Escrow Agent's option, Escrow Agent may interplead Borrower and Lender and deliver the Transfer Documents to a court of competent jurisdiction, in which event Escrow Agent may recover all of its court costs and reasonable attorney fees. Unless a court decides otherwise, Borrower and Lender shall be jointly and severally obligated to pay these costs and fees of Escrow Agent.

7. LIABILITY OF ESCROW AGENT. Borrower and Lender acknowledge that Escrow Agent is acting solely as a stakeholder at their request and for their convenience, that Escrow Agent shall not be deemed to be the agent of either Borrower or Lender, and that Escrow Agent shall not be liable to either Borrower or Lender for any act or omission taken or made by Escrow Agent in good faith and not in disregard of this Escrow Agreement, provided, however, that Escrow Agent shall be liable for any loss, cost, or expense incurred by Borrower or Lender resulting from Escrow Agent's willful misconduct, gross negligence, or mistake of law with respect to the scope or nature of its obligations under this Escrow Agreement. Borrower and Lender shall jointly and severally indemnify, defend, and hold Escrow Agent harmless from and against all third party claims brought against Escrow Agent with respect to Escrow Agent's performance of its obligations under this Escrow Agreement, except with respect to actions or omissions taken or made by Escrow Agent in bad faith or in disregard of this Escrow Agreement or involving Escrow Agent's willful misconduct or gross negligence.

8. ESCROW FEE. The escrow fee charged by Escrow Agent for holding, recording, and delivering the Transfer Documents shall be paid by _ _[*Borrower/Lender*]_ _. In addition, _ _[*Borrower/Lender*]_ _ shall pay all other fees, costs, premiums, and taxes that are payable in connection with the transfer contemplated by the Transfer Documents, and Escrow Agent shall not be obligated to perform any of its obligations under this Escrow Agreement that require the payment thereof unless and until _ _[*Borrower/Lender*]_ _ has paid the same.

9. RESIGNATION OF ESCROW AGENT. Escrow Agent may resign its obligations under this Escrow Agreement by giving notice of its resignation to Borrower and Lender at least _ _[*e.g., 30*]_ _ days before the date specified for such resignation to take effect. On the effective date of such resignation, the Transfer Documents shall be delivered by Escrow Agent to a successor escrow agent designated by the mutual agreement of Borrower and Lender or, if there is no such agreement, to a title and/or escrow company selected by Lender, provided such company has agreed in writing to comply with the terms and conditions of this Escrow Agreement (Successor Escrow Agent). Successor Escrow Agent shall evidence its agreement to comply with the obligations of the escrow agent under this Escrow Agreement, and thereafter it shall succeed to all of the rights and obligations of Escrow Agent under this Escrow Agreement.

10. SPECIFIC PERFORMANCE. The parties acknowledge and agree that a breach of, or default under, this Escrow Agreement may cause material damages not compensable by monetary damages and that, as a result, the parties to this Escrow Agreement shall be entitled to bring an action in equity (including as described in Sections _ _[*e.g., 3.3 and 6*]_ _, as well as an action for specific performance, injunctive relief, or other provisional remedies) to enforce compliance with the terms and conditions of this Escrow Agreement. To the extent permitted by applicable law, the parties shall have the right to obtain injunctive relief without the

necessity of posting a bond.

11. FORECLOSURE. Nothing in this Escrow Agreement shall preclude Lender from initiating and pursuing a nonjudicial or judicial foreclosure of the Deed of Trust to the extent not prohibited by the Forbearance Agreement.

12. MISCELLANEOUS.

12.1. *Notices*. Any notice or other communication (*e.g.,* any request, direction, demand, consent, waiver, or approval) required or permitted to be given under this Escrow Agreement shall not be effective unless it is given in writing and delivered (a) in person; (b) by certified mail, postage prepaid, return receipt requested; (c) by facsimile; or (d) by a commercial overnight courier that guarantees next-day delivery and provides a receipt, and addressed to the parties at the addresses stated below (or at such other address designated by a party as aforementioned):

To Borrower: _ _[*address*]_ _

with a copy to: _ _[*address of attorney*]_ _

To Escrow Agent: _ _[*address*]_ _

with a copy to: _ _[*address of attorney*]_ _

To Lender: _ _[*address*]_ _

with a copy to: _ _[*e.g., address of attorney*]_ _

Service of any such notice or other communication shall be deemed effective on the day of actual delivery (whether accepted or refused) (i) as shown by the addressee's return receipt if by certified mail; (ii) as evidenced by confirmed answerback if by facsimile (provided, however, that if any notice or other communication to be delivered by facsimile is unable to be transmitted because of a problem affecting the receiving party's facsimile machine, the deadline for receiving such notice or other communication shall be extended by another day); or (iii) as confirmed by the courier service if by courier (provided, however, that if such actual delivery occurs after _ _[*e.g., 5:00 p.m.*]_ _ (local time where received), then such notice or demand so made shall be deemed effective on the day immediately following the day of actual delivery). Electronic mail shall not be effective to give any such notice or other communication under this Escrow Agreement.

12.2. *Further Assurances.* The parties agree to execute such other and further documents as may be reasonably requested to implement the terms and conditions of this Escrow Agreement, including Escrow Agent's general instructions, provided, however, that in the event of any conflict between the provisions of this Escrow Agreement and such general instructions, the provisions of this Escrow Agreement shall prevail.

[*Add other miscellaneous provisions similar to those in §10.23A*]

IN WITNESS WHEREOF, Borrower, Escrow Agent, and Lender have executed this Escrow Agreement for Deed in Lieu of Foreclosure as of the day and year first above written.

BORROWER:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

ESCROW AGENT:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

LENDER:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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4. Loan Modification Agreement

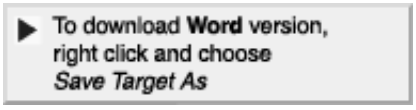
§10.23 a. Purpose and Scope of Loan Modification Agreement

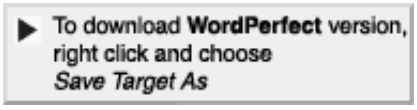
A loan modification agreement can range from a simple extension of the maturity date or change in the interest rate or release prices to an overall restructuring of the debtor-creditor relationship. However, the more numerous and significant such modifications are, the more concerned the lender must be about their potential adverse effects on the lender's lien priority (in which case it is prudent at least to record a memorandum of such modifications) and the liabilities of guarantors and others secondarily liable to the lender on the loan. A modification can be accomplished with a new single agreement, by amending and restating existing documents, or by a combination of the foregoing. As is done in a forbearance agreement, the lender should obtain the reaffirmation of the guarantor's obligations under its guaranty as a condition of permitting the loan modification agreement. A modification should generally be used to establish new terms and conditions that will allow the project and the loan to regain and maintain stability such that all defaults that created the need for a workout are cured by such terms and conditions. This may require that additional security or other forms of credit enhancements be provided by the borrower, while the lender may be required to make concessions regarding certain of the borrower's payment and performance obligations.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.23A b. Form: Loan Modification Agreement

§10.23A b. Form: Loan Modification Agreement





LOAN MODIFICATION AGREEMENT

THIS LOAN MODIFICATION AGREEMENT (Agreement) is made as of _ _[*date*]_ _, by and among _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Borrower); _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Guarantor); and _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Lender), with respect to the following:

RECITALS

A. Lender made a loan to Borrower in the original principal amount of $_ _[*amount*]_ _ (Loan). The Loan is evidenced by, among other things, that certain Loan Agreement executed by Borrower and Lender and dated as of _ _[*date*]_ _ (Loan Agreement) and that certain Promissory Note made by Borrower, payable to Lender and dated _ _[*date*]_ _ (Note). The Note is secured by, among other things, that certain Deed of Trust, Assignment of Leases and Rents, Security Agreement, and Fixture Filing executed by Borrower for the benefit of Lender, dated as of _ _[*date*]_ _ and recorded in the Official Records of _ _[*name*]_ _ County, California (Official Records), on _ _[*date*]_ _, as Document No. _ _[*specify*]_ _ (Deed of Trust).

[*If appropriate, add the following sentence to paragraph A. Before doing so, check original loan documents to be sure that incorporating capitalized terms in this manner is appropriate; otherwise, capitalized terms used in this agreement will need to be defined in recitals*]

Initially capitalized terms used in this Agreement without definition shall have the meanings set forth in the Loan Agreement.

[*Continue*]

B. As of _ _[*date*]_ _, the outstanding principal balance of the Note was $_ _[*amount*]_ _.

C. In order to, among other things, cure an Event of Default, Borrower and Lender have agreed to modify the Loan Documents on the terms, and subject to the conditions, set forth in this Agreement.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Borrower, Guarantor, and Lender agree as follows:

1. CONDITIONS PRECEDENT. Lender shall have no obligation to execute this Agreement or perform its obligations under this Agreement unless and until the following conditions are satisfied in full (to Lender's satisfaction, in its sole discretion), provided, however, that such conditions shall be deemed to have been satisfied or waived on recordation of the "Memorandum" (as defined in Section _ _[*e.g., 1.1*]_ _) in the Official Records (Effective Date):

1.1. *Execution and Delivery.* Borrower shall, and Borrower shall have caused Guarantor to, execute and deliver all documents and agreements required by Lender in connection with this Agreement, including this Agreement, the Memorandum of Modification in the form attached as Exhibit _ _[*specify*]_ _ (Memorandum), and the _ _[*newly executed document providing additional collateral or credit enhancement*]_ _ in the form attached as Exhibit _ _[*specify*]_ _ (collectively, Modification Documents).

1.2. *Deposit.* Borrower shall have deposited (from its own funds, and not from proceeds of the Loan) the sum of $_ _[*amount*]_ _ in the _ _[*Deposit/Pledge/Lockbox/Escrow*]_ _ Account.

1.3. *No Default.* Except as set forth in the _ _[*Default Notice/Forbearance Agreement*]_ _ (as defined in

Section _ _[*e.g., 2*]_ _), no Event of Default exists.

1.4. *Endorsement.* Title Company shall be unconditionally and irrevocably committed to (a) record the Memorandum in the Official Records and (b) issue a CLTA 110.5 endorsement to the Title Policy insuring that the Deed of Trust continues to have the same priority as it had before the recordation of the Memorandum.

1.5. *Opinion.* Borrower and Guarantor have provided Lender with an opinion from their counsel that they have the power and authority to execute and deliver the Modification Documents and to perform their obligations thereunder.

1.6. *Modification Fee.* Borrower shall have paid Lender a nonrefundable fee for the _ _[*modification, increase, and/or extension of the Loan*]_ _ in an amount equal to $_ _[*amount*]_ _.

1.7. *Fees, Costs, and Expenses.* Borrower and Guarantor have paid all reasonable fees, costs, and expenses of third parties (including attorney fees and costs) actually incurred by Lender in connection with this Agreement.

[*Add one of the following alternatives*]

[*Alternative 1: Rescission of default notice]*

2. RESCISSION OF DEFAULT NOTICE. From and after the Effective Date, that certain letter from Lender to Borrower and Guarantor dated _ _[*date*]_ _, regarding a potential default as a result of _ _[*describe default*]_ _ and an Event of Default as a result of _ _[*describe default*]_ _, shall be rescinded and of no further force or effect.

[*Alternative 2: Termination of forbearance agreement]*

2. TERMINATION OF FORBEARANCE AGREEMENT. From and after the Effective Date, that certain Forbearance Agreement executed by Borrower, Guarantor, and Lender dated as of _ _[*date*]_ _ shall be terminated and of no further force or effect such that it shall no longer constitute a Loan Document.

[*Continue*]

3. MODIFICATION OF LOAN DOCUMENTS. From and after the date of this Agreement, the Loan Documents shall be modified as follows:

3.1. All references to _ _[*insert existing amount (e.g., existing maximum loan amount)*]_ _ in the _ _[*identify loan document being modified*]_ _ shall be _ _[*deemed/modified*]_ _ to be references to _ _[*insert new amount (e.g., new maximum loan amount)*]_ _.

3.2. The definition of _ _[*defined word/term*]_ _ in Section _ _[*specify*]_ _ of the _ _[*identify loan document being modified*]_ _ is deleted in its entirety and replaced with the following: _ _[*insert new defined term*]_ _.

3.3. A new definition of _ _[*defined word/term*]_ _ is added to Section _ _[*specify*]_ _ of the _ _[*identify loan document being modified*]_ _ as follows: _ _[*insert new definition*]_ _.

3.4. Section _ _[*specify*]_ _ of the _ _[*identify loan document being modified*]_ _ is amended by _ _[*describe amendment*]_ _.

3.5. Section _ _[*specify*]_ _ of the _ _[*identify loan document being modified*]_ _ is deleted in its entirety and replaced with the following: _ _[*identify replacement loan document*]_ _.

3.6. A new Section _ _[*specify*]_ _ of the _ _[*identify loan document being modified*]_ _ is added as follows: _ _[*insert replacement section*]_ _.

3.7. Exhibit _ _[*specify*]_ _ of the _ _[*identify loan document being modified*]_ _ is deleted in its entirety and replaced with the attached Exhibit _ _[*specify*]_ _.

3.8. A new Exhibit _ _[*specify*]_ _ is attached to the _ _[*identify loan document being modified*]_ _ in the form of the attached Exhibit _ _[*specify*]_ _.

3.9. _ _[*Add any other fact-specific modifications and/or new or terminated loan documents*]_ _

4. MODIFICATION OF LOAN DOCUMENTS. From and after the Effective Date, the Loan Documents shall be modified to provide that all references to the _ _[*identify loan document(s) being modified*]_ _ **and the terms defined therein shall be to the** _ _[*identify loan document(s) being modified*]_ _ **and the terms defined therein as modified by this Agreement.**

5. REPRESENTATIONS AND WARRANTIES. As a material inducement for Lender to enter into this Agreement, Borrower and Guarantor represent and warrant to Lender that:

5.1. ***Power and Authority; Enforceability.*** **Borrower and Guarantor each have full power and authority to execute, deliver, and perform their obligations under the Modification Documents. The Modification Documents constitute legal, valid, and binding obligations of Borrower and Guarantor, enforceable against Borrower and Guarantor in accordance with their terms.**

5.2. ***Approval and Authorization.*** **The execution and delivery of the Modification Documents by Borrower and Guarantor require no approvals or authorizations from, or registrations with, any party not previously obtained and do not violate, contravene, or conflict with any law, order, or regulation by any court, governmental authority, official, or agency, or any other contract, indenture, or instrument to which Borrower or Guarantor is a party or by which Borrower, Guarantor, or the Project may be bound.**

5.3. ***Explained by Counsel.*** **Borrower's and Guarantor's independent legal counsel have participated in the preparation and negotiation of the Modification Documents and explained the legal effect of the Modification Documents to Borrower and Guarantor.**

5.4. ***Reviewed by Borrower and Guarantor.*** **Borrower and Guarantor have reviewed the Modification Documents (including the accuracy of the recitals therein) and understand the significance and consequences of the Modification Documents (including that the provisions of the Modification Documents are contractual in nature).**

5.5. ***No Duress.*** **Borrower and Guarantor are entering into the Modification Documents freely and without duress.**

5.6. ***No Event of Default.*** **Except for any Event of Default that will be cured by, or waived in, the Modification Documents, no Event of Default exists.**

5.7. ***No Offset, Defense, or Claim.*** **Borrower and Guarantor do not have (a) any offsets against the amounts payable under the Loan Documents; (b) defenses to the payment of any amounts under the Loan Documents; or (c) claims against Lender in connection with the Loan Documents.**

5.8. ***No Excuse or Waiver.*** **This Agreement shall not excuse Borrower or Guarantor from any of their obligations under the Loan Documents or constitute a waiver by Lender of any of the provisions of the Loan Documents.**

5.9. ***Continuing Representations and Warranties.*** **The representations and warranties of Borrower and Guarantor set forth in the Loan Documents are true, correct, and complete in all material respects.**

6. LIMITED RELEASE OF KNOWN CLAIMS.

6.1. ***Limited Release*****. As a material inducement for Lender to enter into this Agreement, Borrower and Guarantor, and their successors and assigns (jointly and severally, Releasor), fully and forever release and discharge (Release) Lender, its accountants, affiliates, agents, attorneys, directors, employees, members, officers, parents, partners, representatives, stockholders, and subsidiaries, and their successors and assigns (collectively, Lender Parties), from any act, action, agreement, breach, claim, controversy, cost, damage, debt, default, demand, dispute, expense, injury, judgment, liability, loss, malfeasance, misfeasance, obligation, omission, and/or suit that has arisen or accrued with respect to the Loan and/or the Project as of the Effective Date and that is known to Releasor, provided, however, that such release and discharge shall not be applicable with respect to (but only to the extent of) any gross negligence or willful misconduct by the Lender Parties (collectively, Released Matters).**

6.2. ***No Liability.*** **Releasor acknowledges and agrees that the Release shall not be deemed or construed to be an admission of liability by the Lender Parties, and the Lender Parties deny any liability, with respect to the Released Matters. The Release shall constitute a complete defense to the Released Matters.**

6.3. ***Sole Owner.*** **Releasor represents and warrants to the Lender Parties that (a) Releasor is the sole and lawful owner of all right, title, and interest in and to the Released Matters and (b) Releasor has not assigned or otherwise transferred any right, title, or interest in or to the Released Matters to a third party.**

7. REAFFIRMATION. Borrower, Guarantor, and Lender intend that the Modification Documents shall constitute Loan Documents. The Loan Documents are ratified and reaffirmed by Borrower and Guarantor and shall remain in full force and effect as modified by this Agreement. Any property, or rights to or interests in property, granted as security for the Loan and the obligations of Borrower or Guarantor in the Loan Document shall remain as security therefor.

8. WAIVER OF CERTAIN PROTECTIONS. As a material inducement for Lender to enter into this Agreement, Borrower agrees that, in the event Borrower (a) files with any bankruptcy court of competent jurisdiction or is the subject of any petition under Title 11 of the United States Code, as amended (Title 11); (b) is the subject of any order of relief under Title 11; (c) files, or is the subject of, any petition, order, judgment, or decree petition seeking, or relating to, any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any present or future federal or state law relating to bankruptcy, insolvency, or other relief for debtors; or (d) seeks, or consents or agrees to, the appointment of any trustee, receiver, conservator, or liquidator, then Lender shall be entitled to relief from any automatic stay imposed by 11 USC §362 or otherwise on or against the exercise of its rights and remedies under the Loan Documents or as otherwise provided by law or in equity. Borrower irrevocably waives any benefits or protections that may be afforded by such automatic stay and further waives any benefits or protections that may be afforded by relief similar to such automatic stay under 11 USC §105 or otherwise.

9. CONFLICT. If there is any conflict between the terms and conditions of the Modification Documents and the terms and conditions of the Loan Documents (other than the Modification Documents), the terms and conditions of the Modification Documents shall prevail.

10. MISCELLANEOUS.

10.1. ***Notices.*** **Any notice or other communication (*e.g.,* any request, direction, demand, consent, waiver, or approval) required or permitted to be given under this Agreement shall be given as provided in the Loan Agreement.**

10.2. ***Interpretation.*** **This Agreement has been prepared by Lender and its counsel and reviewed by the other parties to this Agreement and their counsel. The parties, and their respective counsel, believe that this Agreement is the product of all of their efforts. As a result, the parties agree that this Agreement should (a) not be interpreted in favor of, or against, any party to this Agreement and (b) be construed to effectuate the normal and reasonable expectations of sophisticated parties.**

10.3. ***Terminology.*** **As used in this Agreement, (a) the words "include," "includes," and "including" and words of similar import shall be construed as if followed by the words "without limitation"; (b) the words "hereof," "herein," and "hereunder" and words of similar import shall be construed to refer to this Agreement as a whole and not to any particular provisions of this Agreement; (c) pronouns shall include the corresponding masculine, feminine, or neuter forms, and the singular form of nouns and pronouns shall include the plural and vice versa; and (d) the word "dollars" and the symbol "$" refer to the lawful currency of the United States of America.**

10.4. ***References.*** **Except as provided to the contrary in this Agreement, references to any "Section" or "Exhibit" are to the sections and exhibits of this Agreement. References to any agreement or other document defined in this Agreement are to such agreement or document as amended, restated, supplemented, or otherwise modified.**

10.5. ***Waiver.*** **The parties agree that if, and to the extent that, any party does not require strict compliance with the provisions of this Agreement by any other party, that action or inaction shall not constitute a waiver of, or otherwise affect or prejudice in any manner, that party's future rights or remedies under this Agreement, including the right to subsequently require strict performance of such provisions. No**

waiver by any party of a breach of this Agreement by any other party shall be deemed to be a waiver of any other breach by that other party (whether before or after and whether or not of the same or similar nature), and no acceptance of payment or performance by any party after any breach by any other party shall be deemed to be a waiver of any breach by that other party, whether or not the first party knows of the breach at the time it accepts such payment or performance.

10.6. ***Further Assurances.*** **The parties agree to execute such other and further documents as may be reasonably requested to implement the terms and conditions of this Agreement.**

10.7. ***Incorporation.*** **The preamble and recitals of, and the exhibits attached to, this Agreement are incorporated into, and made a part of, this Agreement.**

10.8. ***Governing Law.*** **This Agreement shall be governed by, and construed in accordance with, the laws of the State of California, without giving effect to conflict of laws principles.**

10.9. ***Successors and Assigns.*** **This Agreement shall be binding on and inure to the benefit of the permitted successors and assigns of the parties to this Agreement.**

10.10. ***Attorney Fees.*** **If any action is brought to enforce this Agreement or otherwise resolve any dispute under this Agreement, the prevailing party in that action shall be entitled to recover all costs, expenses, and fees (including its reasonable attorney fees and costs) incurred in connection with such action from any nonprevailing party. The right to recover such costs, expenses, and fees shall accrue on the commencement of the action, regardless of whether the action is prosecuted to final judgment. In addition to this award of costs, expenses, and fees, the prevailing party shall be entitled to recover all costs, expenses, and fees incurred in connection with any post-judgment proceedings to collect or enforce any judgment from any nonprevailing party. This provision is separate and several and shall survive the merger of this provision into any judgment on this Agreement.**

10.11. ***Titles and Headings.*** **The titles and headings of the sections and exhibits of this Agreement are intended for the convenience of reference only and shall not limit or otherwise affect the meaning of any provision of this Agreement.**

10.12. ***Modification.*** **No provision of this Agreement may be waived or otherwise modified except by a written agreement signed by the parties to this Agreement. The parties acknowledge and agree that they intend the previous sentence to be strictly interpreted, enforced, and adhered to, notwithstanding that the law may permit subsequent oral waiver or modification of a contract that includes a provision that requires any such waiver or modification be in writing.**

10.13. ***Entire Agreement.*** **This Agreement constitutes a single, integrated written contract expressing the entire agreement of the parties relative to the subject matter of this Agreement. Except as set forth in this Agreement, the parties have not made any agreements, representations, or warranties of any kind with respect to the subject matter of this Agreement.**

10.14. ***Severability*****. The illegality, unenforceability, or invalidity of any provision of this Agreement with regard to any party or circumstance shall not render that provision illegal, unenforceable, or invalid with regard to any other party or circumstance. All provisions of this Agreement, in all other respects, shall remain legal, enforceable, and valid to the fullest extent permitted by law. If any provision of this Agreement is held to be illegal, unenforceable, or invalid under present or future laws, that provision shall be fully severable, and this Agreement shall be construed and enforced as if such illegal, unenforceable, or invalid provision had never been a part of this Agreement.**

10.15. ***Time of the Essence.*** **Subject to the remainder of this Section _ _[*e.g., 10.15*]_ _, time is of the essence with respect to this Agreement and the performance of each obligation contained in this Agreement. Whenever the time for performance of any obligation under this Agreement, or if under this Agreement a party must act by a particular time or an act is effective only if done by a particular time, and the last date for the performance of such obligation or the doing or effectiveness of such act falls on a Saturday, a Sunday, or a legal holiday under the laws of the State of California, the time for the performance of such obligation or the doing or effectiveness of such act shall be extended to the next day that is not a Saturday, a Sunday, or a legal holiday under the laws of the State of California. The first day shall be excluded and the last day shall be included when computing the time in which an obligation is to be performed or an act is to be done under this**

Agreement. All time periods shall end at _ _[*e.g., 5:00 p.m.*]_ _ California time.

10.16. *Counterparts.* This Agreement may be executed and delivered via facsimile or electronic mail in any number of counterparts, each of which shall be deemed an original, but all such counterparts together shall constitute but one and the same agreement.

10.17. *No Third Party Beneficiaries.* The parties hereto do not intend that there are or will be, and there are not, any third party beneficiaries to this Agreement, including any debtor or trustee in bankruptcy.

IN WITNESS WHEREOF, Borrower, Guarantor, and Lender have executed this Loan Modification Agreement as of the day and year first above written.

BORROWER:

Date: _ _ _ _ _ _ _ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

GUARANTOR:

Date: _ _ _ _ _ _ _ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

LENDER:

Date: _ _ _ _ _ _ _ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: For discussion of considerations in negotiating and preparing this agreement, see §§10.1-10.8D, 10.20, 10.23.

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§10.23B 5. Usury Considerations

If a loan is governed by California law, it presumably qualified for a usury exemption when it was made because (1) the lender was an exempt lender, (2) the loan was arranged by a licensed real estate broker and secured by real property, or (3) another appropriate usury exemption applied. However, the buyer of any such loan may not be an exempt lender. The question of usury law application arises for loan workouts by the holder of a loan who is not an exempt lender.

Reading through the wordy and not well-crafted exemption provision of Cal Const art XV, the operative language appears to be as follows: "None of the above restrictions shall apply … to any successor in interest to any loan or forbearance exempted under this article." This language would seem to lead to the conclusion, at least as the language is structured, that a successor in interest—*i.e.,* the acquirer of the loan—is an exempt lender and not just that the loan continues to be exempt from the usury laws. What happens if the acquirer enters into a workout of the loan? Does the exemption continue? Is there a public policy reason that it should or should not? The purpose behind the successor-in-interest exemption is the free transferability of loans. See, *e.g., Strike v Trans-West Discount Corp.* (1979) 92 CA3d 735, 745, 155 CR 132 (noting that if assignee of exempt lender were not exempt from usury law, it would effectively discourage assignment or sale by banks of commercial property to secondary markets and run contrary to public policy). On this basis, restricting the usury exemption to the original loan and excluding loan modifications or workouts would seem to be contrary to this public policy. On the other hand, if the otherwise nonexempt lender required the interest rate on the loan to increase significantly above the usury rate, that would also seem to be contrary to the public policy underlying usury laws and insuring public scrutiny of those who are exempt lenders.

The closest case somewhat on point is *Ghirardo v Antonioli* (1994) 8 C4th 791, 35 CR2d 418, in which a loan that was originally exempt due to the time-price doctrine was "modified" through the execution of settlement notes whose interest plus a fee charged in connection with the notes would result in the "loan" being usurious if considered a nonexempt loan or forbearance. However, the California Supreme Court stated, "As we shall explain, we hold the usury law does not apply to this debt restructuring because there was no loan or forbearance, the prerequisite to application of the usury law. The transaction was held to be a modification of a credit sale that was not subject to the usury rules. The modification retained the exemption." 8 C4th at 795. Or was Justice Mosk in his dissent correct in criticizing the majority holding in *Ghirardo* that the forbearance and modification was something other than what the usury law was designed to protect when he stated, "[I]n response to the unmistakable legislative intent of the people, courts must be vigilant to pierce the veil of any transaction that in effect results in a loan or forbearance at an interest rate exceeding the legal maximum. I would apply this principle even when a forbearance extends a loan that was originally exempt from the usury law, and even if the parties did not set out to violate the usury law." 8 C4th at 811.

PRACTICE TIP: Overall, it is worth noting that the law is unclear in this area, and counsel representing clients purchasing loans, and especially distressed loans, must advise their clients of this risk and consider whether their clients need to take steps to qualify as exempt lenders before purchasing loans. Another way to reduce the risk is to include a usury savings clause in the loan modification agreement. See *McConnell v Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1978) 21 C3d 365, 146 CR 371.

For discussion of usury savings clauses and usury avoidance strategies in negotiating and drafting real property secured loans, see California Real Estate Finance Practice: Strategies and Forms, chap 3 (Cal CEB 2000).

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§10.24 a. Income Tax Considerations

Whenever the terms of a loan are to be modified, the income tax results to both the lender and the borrower should be considered. Adverse income tax consequences to one side or the other (or both) often take the parties by surprise, possibly because it seems counterintuitive that a taxable transaction arises when no money or other property is actually transferred between the lender and borrower.

The income tax law broadly covers sales or exchanges. Relevant to debt modifications, Treas Reg §1.1001-3 evaluates whether a "modification" is "significant." If so, then the transaction is treated as if the "old" debt instrument were replaced by a "modified" debt instrument. The regulation contains several important safe harbors to aid practitioners in determining whether changes to the terms of a debt instrument, including the yield, length of the payment term, or changes in obligor or security, are significant modifications. The regulation cautions that tests are cumulative and that certain changes to a debt instrument will require testing under more than one safe harbor provision. For example, when a deferral of payments that changes the yield of a fixed-rate debt instrument occurs, a modification of both the term and the yield of the instrument must be tested. Treas Reg §1.1001-3(f).

From the lender's perspective, the transaction is treated as if it had exchanged one debt instrument for another. As a consequence, the lender may have taxable gain or loss measured by the difference between the "amount realized" on receipt of the modified instrument and its "adjusted basis" in the original instrument. The character of the gain or loss is relevant. Whether the gain or loss is capital or ordinary to the lender will depend on the lender's particular facts and circumstances, as will the lender's ability to deduct any tax loss suffered in the deemed exchange. See generally IRC §§1001, 1221-1223, 165.

In addition, a significant modification can have consequences for the debtor. In particular, if the "issue price," usually the face amount, of the modified debt is less than the amount of the outstanding debt under the original instrument, the result will be cancellation of indebtedness income (CODI) to the borrower. See IRC §§61(a)(12), 108(e)(10). CODI is "ordinary"—as opposed to capital—and is included in the borrower's gross income unless an exception applies. IRC §§61(a)(12), 108(a).

A number of exceptions may apply to defer, or in some cases eliminate, CODI. Two of the more common exceptions apply when the taxpayer is bankrupt or insolvent. See IRC §108(a)(1)(A)-(B). Other exceptions may also be available, generally speaking, when the income arises in specific contexts such as for farm debt, real estate business debt, or debt on a residence. See, *e.g.,* IRC §108(a)(1)(C)-(E), (e)(5). Also, for CODI occurring in the context of a trade or business, some borrowers may be able to elect a period of deferral before recognizing CODI. See IRC §108(i). Many of these exceptions were added or amended by the Emergency Economic Stabilization Act of 2008 (Pub L 110-343, 122 Stat 3765) and the American Recovery and Reinvestment Tax Act of 2009 (Pub L 111-5, 123 Stat 115), and it is cautioned that their application is subject to special sunset provisions.

Also, the exceptions to CODI are often not available without a price. To the extent an exception applies, the borrower is typically required to reduce its "tax attributes." See IRC §108(b). As a consequence of attribute reduction, the borrower may have increased tax liability in future years due to the reduction of attributes such as net operating losses (NOLs), tax credits, and tax basis in property.

EXAMPLE: A lender who was not the original seller of the property lends $500 to a borrower. The borrower purchases real estate and gives the lender a mortgage lien on the real estate to secure the loan. Later, when the balance of the loan remains $500, the lender and borrower renegotiate the outstanding principal balance of the loan to lower it to the $400 fair market value of the property. Lowering the outstanding principal balance of the loan triggers a "significant modification," and the lender is deemed to receive a modified note with an "issue price" of $400. As a result of the deemed exchange of the "old" debt for the "modified" debt, the lender will have a loss of $100 (the difference between the issue price, $400, and the lender's adjusted basis in the old debt of $500). The loss may be a capital loss or an ordinary loss depending on the lender's particular facts and circumstances. Generally speaking, the borrower will have CODI equal to the reduced principal balance, $100 on these facts. The borrower may be able to exclude the CODI if it is in bankruptcy or insolvent at the time of the modification or is otherwise

able to take advantage of another exception to such income. If CODI is excluded, the borrower may have to reduce its tax attributes, *e.g.,* its "adjusted basis" in the mortgaged property.

WARNING: The discussion contained in this section is introductory in nature and is meant to highlight certain income tax issues that commonly arise in the context of debt modification transactions involving an individual original borrower and an unrelated individual original lender. Both lenders and borrowers should proactively seek tax advice from competent income tax counsel about the impact of any modification transaction. The body of income tax law that applies in this area is particularly complex, and the IRC and the applicable Treasury Regulations discussed in this section are subject to substantial interplay with other statutory provisions not discussed here. Also, the substantive statutory provisions of the IRC are subject to extensive federal judicial income tax common law. This discussion has not touched on many other substantial issues, such as those arising in transactions involving business entities, related persons or entities, equity for debt transactions, or transactions involving successor borrowers or lenders. Also, this section only discusses federal income tax law. State and federal income tax laws can diverge (such as the income tax provisions of California law that specifically require incorporation of federal law), particularly if federal legislation has been recently enacted.

FURTHER READING: The diligent non-tax practitioner who wishes to study these issues in greater detail may wish to begin with the materials referenced at the end of §10.30.

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§10.25 b. Avoiding Loss of Lender's Lien Priority

A senior lender's material modification of its loan to the detriment of a nonconsenting junior may result in the modified portion of the senior loan giving up priority to the junior. *Lennar Northeast Partners v Buice* (1996) 49 CA4th 1576, 57 CR2d 435 (distinguished full loss of priority imposed in *Gluskin v Atlantic Sav. & Loan Ass'n* (1973) 32 CA3d 307, 108 CR 318, by emphasizing that in *Gluskin* junior was seller subordinated to construction funding, and default before completion had left junior with worthless security). The modification in *Lennar* extended the loan term 6 years, increased the immediately effective interest rate by 3 percent by resetting it from prime-plus-3 percent to 12 percent fixed, and capitalized sums owing for delinquent interest and charges ($50,000), advances for repairs ($15,000), and prepaid interest ($75,000). The *Lennar* court declined to state whether a full loss of priority might be imposed as between "hard money" lenders when partial subordination could not be calculated, when the modification had impaired the underlying security, or when equities otherwise demanded it. The court suggested that the extended maturity date would not in itself have supported adjusting loan priorities, but it did not otherwise separately weigh the modification terms.

When the lender is aware of a previously subordinated junior lien on the mortgaged real property, the lender's agreement to material modifications in its loan without the consent of the junior lienholder may result in a loss of the lender's lien priority over the junior. *Gluskin v Atlantic Sav. & Loan Ass'n* (1973) 32 CA3d 307, 314, 108 CR 318. What modifications are "material" is a question of fact depending on whether, in the particular circumstances, the modification will be found to have increased the possibility of default under the modified loan or to have significantly impaired the security of the junior lien (by, *e.g.,* substantially increasing the borrower's burdens under the modified loan). In *Friery v Sutter Buttes Sav. Bank* (1998) 61 CA4th 869, 72 CR2d 32, the court declined to expand the *Gluskin* rule and held that a senior lienholder has no duty to junior lienholders who have not subordinated and have no special relationship to the senior. See *DMC, Inc. v Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 120 CR2d 761, discussed in §§3.97, 9.48, 9.53.

Applying California law to a foreclosure case, the Ninth Circuit held that a 5-month loan extension given by a construction lender without the knowledge or consent of subordinated lienholders did not nullify the subordination agreement, because the extension did not materially increase the risk of default or otherwise significantly impair the position of the juniors. *Resolution Trust Corp. v BVS Dev., Inc.* (9th Cir 1994) 42 F3d 1206.

PRACTICE TIP: In light of the uncertain effect of a modification without consent, a lender should protect itself against the loss of lien priority either by requiring the junior lienholder's consent or subordination to the modification before it becomes effective or by obtaining title insurance protection in the form of a CLTA Endorsement No. 110.5 (ALTA No. 11) or 110.6 to the lender's existing title insurance policy. Such an endorsement will ensure that a recorded loan modification is valid and has not caused a loss of the lender's priority. See California Title Insurance Practice §§8.87-8.88 (2d ed Cal CEB 1997).

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§10.26 c. Future Advances

The effect of a loan modification that provides for future advances on the priority of the underlying deed of trust is complex, depending on, among other issues, whether the lender has notice of junior lienholders and whether the advances are optional or obligatory. See discussion of optional versus obligatory advances in chap 9.

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§10.27 d. Avoiding Exoneration of Guarantors and Others

Because a guarantor is exonerated in the event of any modification of the principal obligation without consent, the lender must take steps to ensure that any third party guarantors of the secured debt will be bound to the intended loan modification. CC §2819; *V.I.P. Agency v Duffy Elec., Inc.* (1979) 92 CA3d 849, 155 CR 45 (change in time of required payment); *Wexler v McLucas* (1975) 48 CA3d Supp 9, 121 CR 453 (lowering amount of installment payment and waiving security). See chap 9. Mere forbearance by the lender from accelerating or enforcing a remedy against the borrower is not equivalent to a modification. *Oleson v Tellson* (1971) 21 CA3d 671, 98 CR 668.

The contemporaneous consent of the guarantor to the loan modification is not necessary if the guarantor had already consented to the modification. *Southern Cal. First Nat'l Bank v Olsen* (1974) 41 CA3d 234, 116 CR 4. Indeed, most standardized guaranty forms in use today contain a provision authorizing the lender to change the loan terms (or at least some of them) without notice to the guarantor and without affecting the guarantor's liability. For an example of such a clause, see California Real Estate Finance Practice: Strategies and Forms §6.74 (Cal CEB 2000).

A lender should obtain the consent of guarantors in connection with any settlement or other workout agreement. In *Bennett v Leatherby* (1992) 3 CA4th 449, 4 CR2d 340, the court found that a creditor's settlement with the primary obligor, which included a general release of all claims, exonerated the guarantors. See *Alcock v Small Bus. Admin. (In re Alcock)* (9th Cir 1995) 50 F3d 1456 (guarantor exonerated when, without his knowledge, SBA subordinated its first deed of trust on security for primary obligation; guaranty waivers found inadequate to waive guarantor's rights under former Com C §3606 (now Com C §3605(e))). See also *R.P. Richards, Inc. v Chartered Constr. Corp.* (2000) 83 CA4th 146, 99 CR2d 425, in which a subcontractor's settlement with the contractor released the surety. But see *Conner v Conner* (1999) 76 CA4th 646, 90 CR2d 687. In *Conner*, a mortgagee who had filed a secured claim in the borrower's Chapter 11 case did nothing to prejudice the rights of a nondebtor guarantor by (1) refusing to withdraw its secured claim in settlement of the estate's preference action against it or (2) tendering the plan note issued to it to the guarantor and demanding payment of the debt on its original terms. To the contrary, the court found that had the mortgagee acted otherwise, principles of suretyship might have provided a guaranty defense.

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§10.28 B. Workouts Contemplating Lender's Taking Title to Security

At some point in their efforts to deal with a problem loan, one or both of the parties may conclude that foreclosure is inevitable. The lender may see little or no chance of recovering anything beyond the value of what appears to be inadequate security. However, instead of merely allowing a nonjudicial foreclosure to be conducted some months later, it may be in the interests of both parties to consider entering into a workout arrangement in which (1) the lender may be able to acquire title to the mortgaged real property sooner and thus expedite whatever must be done to salvage its investment and (2) the borrower may be able to realize something from the failing project or at least reduce the potential liability that it might otherwise have beyond the loss of the property.

The simplest form of such a workout is a deed in lieu of foreclosure, by which the borrower deeds the property to the lender in satisfaction of the secured debt (and perhaps some other new consideration). See §10.29. When the problem loan is one to finance construction of a project intended to be sold off by the borrower (such as a subdivision or condominium project), the workout may require the lender's commitment to complete construction and market the project after acquiring title, with the borrower to receive some agreed-on compensation for rendering services to the project during the workout period. See §10.33.

WARNING: A lender contemplating taking title to secured property by either a trustee sale or a deed in lieu of foreclosure must examine the risks on both sides. In addition to other issues regarding taking ownership by a deed in lieu, as discussed in §10.29, obtaining the property by a deed in lieu creates the risk of taking title subject to unrecorded liens and claims and other off-record encumbrances. Conversely, a trustee's deed after foreclosure extinguishes any liens or claims that are junior to the underlying deed of trust. See California Mechanics' Liens and Related Construction Remedies §11.20 (3d ed Cal CEB 1998). See also §§2.99, 7.18, 9.54, 9.64.

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§10.29 1. Deed in Lieu of Foreclosure

A deed of conveyance given to a lender is a precarious instrument. The validity and legal effect of such a deed will depend on a variety of factors including, among other things, when the contract is made, the intent of the parties, and whether adequate consideration is given for the conveyance.

Civil Code §2889 renders void all contracts for the forfeiture of mortgaged property in satisfaction of the obligation secured thereby and all contracts in restraint of the right of redemption. Despite this statute's breadth, the courts have held that it does not apply to contracts entered into after the loan is made. *Watson v Edwards* (1894) 105 C 70, 75, 38 P 527. Similarly, CC §2953 renders void contracts made by a borrower at the time or in connection with the making or renewing of a real property secured loan when the borrower agrees to waive its rights under CC §2924, §2924b, or §2924c or CCP §580a or §726. Consequently, deeds of conveyance or other arrangements that are entered into with the borrower when the loan is made and that are intended to circumvent the foreclosure laws are invalid. *Hamud v Hawthorne* (1959) 52 C2d 78, 84, 338 P2d 387 (agreement, made when loan was made, authorizing escrow to record deed to lender on default is void). The lender gains no advantage by such arrangements.

The lender who takes a deed of conveyance to the mortgaged property instead of a mortgage lien is in a worse predicament. The deed is not only invalid to pass absolute title to the lender but also, because the instrument is intended by the parties to act as security for the performance of the borrower's obligations, subject to recharacterization as an equitable mortgage. *Greene v Colburn* (1958) 160 CA2d 355, 325 P2d 148. A lender in these circumstances is left without title to the mortgaged property and without many of the rights and protections it would have by virtue of being the beneficiary of a deed of trust, including, among other things, an assignment of rents, a power of sale, the right to appoint a receiver, clear lien priority, title insurance, and the many other typical loan covenants normally contained in a properly documented deed of trust. In addition, the lender is forced to adjudicate all of its rights in court and pursue a judicial foreclosure action to enforce its rights in the collateral. See, *e.g.,* §§6.9, 6.15-6.16 regarding lender enforcement remedies without an assignment of rents.

In contrast to deeds of conveyance entered into when the loan is made, a deed of conveyance executed by the borrower *after* the loan is made or a deed in lieu of foreclosure executed by the borrower *after* default, and given for adequate consideration, does not violate these statutes. Such a conveyance will be upheld if the parties did not intend the instrument to act as security for the loan and the transaction is "fair, honest, and without fraud, and where no unconscionable advantage has been taken of the [mortgagor's] position by the mortgagee." *Watson,* 105 C at 75. *Wright v Security-First Nat'l Bank* (1939) 35 CA2d 264, 95 P2d 194. See also *Bradbury v Davenport* (1898) 120 C 152, 52 P 301, cited in §§4.65, 7.11.

The law presumes that a deed absolute in form is what it purports to be, and the party challenging its validity bears the burden of proving it was intended to be a mortgage by clear and convincing evidence. *Gronenschild v Ritzenthaler* (1947) 81 CA2d 138, 144, 183 P2d 720. Parol evidence is admissible to show the parties' intent. *Greene,* 160 CA2d at 358. For further discussion of benefits, risks, and other considerations related to deeds in lieu of foreclosure, see chap 7. See also Stillman, *The Treatment in Bankruptcy of Deed in Lieu of Foreclosure Agreements,* 9 Cal Real Prop J 19 (Spring 1991); Brody, *Minimizing Environmental Liability When Taking a Deed in Lieu of Foreclosure,* 9 Cal Real Prop J 25 (Spring 1991).

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§10.29A a. Insurance Considerations

A lender acquiring title at its own foreclosure sale or by accepting a deed in lieu of foreclosure will continue to be insured by any previously issued lender's title policy insuring the validity and priority of its deed of trust. See, *e.g.,* American Land Title Association (ALTA) Loan Policy Conditions 2. However, the lender's acquisition of title does not convert the lender's loan policy to an owner's policy, which means that (1) the loan policy provides coverage only against liens and encumbrances that existed as of the date of the original policy (and not against subsequent matters) and (2) the lender's ability to make a claim under the policy is limited to its damages as a lender, which may be less than its damages as an owner. For these reasons, the lender should condition its acceptance of a deed in lieu on its obtaining a satisfactory new owner's title policy. Because the lender's acceptance of a deed in lieu of foreclosure may result in a merger of the security interest in the fee estate, the lender should at a minimum obtain a nonmerger endorsement to its existing lender's policy. See California Title Insurance Practice §§8.48-8.49 (2d ed Cal CEB 1997).

If a current title report on the property discloses junior liens, the lender may expect that adequate protection against claims of junior lienholders will occur only after foreclosure has eliminated those liens. For discussion of title insurance issues relating to foreclosure and deeds in lieu of foreclosure, see Title Ins §§6.64-6.67, 8.42-8.49, 11.10-11.14.

Lenders who take title by deed in lieu of foreclosure should obtain their own casualty insurance on the property rather than rely on the borrower's policy. See, *e.g., Bonaparte v Allstate Ins. Co.* (9th Cir 1994) 49 F3d 486 (trustors protected by CCP §580b from deficiency judgment had no insurable interest in property after foreclosure, even though policy naming them was still in force and they had not yet surrendered possession; casualty insurer could deny coverage to trustors as named insured and to second mortgagee unnamed in policy who had acquired title).

Construing California law, a bankruptcy appellate panel (BAP) of the Ninth Circuit has held that even if considered equivalent to a full credit bid, the beneficiaries' acceptance of a deed in lieu of foreclosure from the trustor under a purchase money deed of trust did not bar their subsequent fraud action against third parties, including the sellers of the property. *Hardin v Gianni (In re King St. Invs.)* (BAP 9th Cir 1998) 219 BR 848. The BAP held that such postforeclosure fraud actions were not limited by the California Supreme Court's decision in *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, to instances of actual fraud. Constructive fraud actions are also viable. See §§2.123-2.126, 4.48, 5.55.

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b. When Lease Is Collateral for Loan

§10.29B (1) Ground Leases

Lenders that hold a security interest in a ground lease rather than fee title should be careful to take the proper steps to preserve the leasehold estate and the underlying stream of rents when taking title by a deed in lieu of foreclosure. The provisions of the ground lease (and any related estoppel or recognition agreements) should be carefully reviewed to determine what mortgagee protection provisions exist in the ground lease, what procedures must be followed for the lender to assume and preserve the leasehold estate, what outstanding defaults must be cured, and to what extent the lender is required to assume lease obligations. A current title report should be ordered and careful consideration given to what property is owned by the ground lessee so the transfer is fully and properly documented. Often this consists of a recorded assignment of the lessee's interest in the ground lease and a separate assignment and bill of sale transferring any other rights and personal property owned by the lessee related to the property. If the borrower owns the building or other improvements, a separate grant deed or quitclaim deed to the improvements is normally used. If the ground lease does not provide for the lender taking title by deed in lieu of foreclosure, or if it includes a ground lessor purchase option or right of first refusal, then the ground lessor's cooperation will likely be required to consummate a deed in lieu of foreclosure of the leasehold estate.

Careful consideration should also be given to the potential effect of any termination of the ground lease if there is any possibility that this could occur as part of the deed in lieu transaction. A termination of the ground lease may terminate underlying subleases of the property, thus depriving the lender of the right to enforce subleases and collect the rents. Careful analysis of the subleases (and any subordination agreements obtained from the subtenants in connection with the loan) should be undertaken to determine whether the subtenants are required to attorn to the lender as the new ground lessee.

Consideration should also be given to whether a deed in lieu of foreclosure transaction involving a ground lease could result in a reassessment of ad valorem property taxes under Proposition 13, especially if the ground lease is being terminated and replaced or the lender is entering into any amendments to the ground lease affecting its lease term. On the impact of Proposition 13, see California Real Property Sales Transactions, chap 6, App A (4th ed Cal CEB 2007).

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§10.29C (2) Lender's Considerations

Lenders holding security interests in leaseholds should be cautious when negotiating workouts that involve the lender (or the lender's subsidiary) taking title to and possession of the property. When taking title by a deed in lieu of foreclosure, a lender may need to maintain the enforceability of a lease and to realize on personal property. The lender should consider obtaining a separate assignment of the lease and a bill of sale of all rights that would otherwise be transferred automatically with the assignment of the lease, specifically including the originals of the lease documents at the closing. The lender's decision to foreclose or to accept a deed in lieu of foreclosure can have significant consequences with respect to the continued effectiveness of leases affecting the property. See *Dover Mobile Estates v Fiber Form Prods., Inc.* (1990) 220 CA3d 1494, 270 CR 183; *R-Ranch Mkts. #2, Inc. v Old Stone Bank* (1993) 16 CA4th 1323, 21 CR2d 21; *Miscione v Barton Dev. Co.* (1997) 52 CA4th 1320, 61 CR2d 280; *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 77 CR2d 479. Thus, careful analysis of the tenant leases (and any estoppel certificates and subordination agreements obtained from the tenants in connection with the loan) should be undertaken to determine whether the tenants are required to attorn to the lender as the new landlord.

WARNING: When an assignee of the lessee expressly assumes the lease, the assignee's contractual obligations to the lessor survive foreclosure. See *Vallely Invs. v BancAmerica Commercial Corp.* (2001) 88 CA4th 816, 106 CR2d 689, cited in §10.77. On effect of foreclosure on leases and rights and obligations of tenants, see §§6.67-6.98.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.30 c. Income Tax Considerations

§10.30 c. Income Tax Considerations

Borrowers and lenders both need to carefully analyze the tax consequences of a deed in lieu of foreclosure. A voluntary transfer by a deed in lieu of foreclosure is a sale that can result in tax gain or loss to either the lender or the borrower. IRC §1001; Treas Reg §§1.1001-1—1.1001-2. Cancellation of indebtedness income (CODI) (see §10.24) can also result. See Treas Reg §1.1001-2(a)(2).

For borrowers, the tax consequences from a deed in lieu of foreclosure (or an involuntary foreclosure) will depend on whether the underlying debt is recourse or nonrecourse. When a borrower transfers real property to a lender in satisfaction of a nonrecourse debt, the borrower is treated as realizing an amount equal to the amount of the nonrecourse debt that is satisfied in the transaction. Treas Reg §1.1001-2(a)(1). This amount realized is then evaluated against the borrower's "adjusted basis" in the real property transferred to determine its gain or loss. IRC §1001.

By contrast, the transfer of property to a lender in satisfaction of a recourse debt is bifurcated into two transactions. The first transaction is a deemed sale in which the borrower realizes an amount equal to the debt that is satisfied by the transfer. Treas Reg §1.1001-2(a)(2). Generally speaking, this amount is equal to the fair market value of the real property transferred (or, if less, the amount of the discharged debt) and sets the amount for which, under relevant state law, the lender could seek a deficiency judgment against the borrower. The second transaction, then, occurs if and when the deficiency is considered cancelled and results in CODI to the borrower. Treas Reg §1.1001-2(c), Example 8.

The differences to a borrower in the case of a transaction involving nonrecourse or recourse debt can be substantial. For example, an "insolvent" borrower, able to avail itself of the insolvency exception to CODI (see §10.24), might be disinclined to engage in a deed in lieu transaction if the result will be taxable gain or loss under IRC §1001, which is not subject to the insolvency exception (or any of the other exceptions under IRC §108).

Similarly, an insolvent borrower owning property subject to a recourse loan may be incentivized to seek a low valuation of real property transferred to the lender in order to increase the portion of the bifurcated transaction triggering CODI. Of course, the lender may have adverse incentives, including non-tax reasons such as for generally accepted accounting principles (GAAP) reporting purposes, to place a high value on the foreclosed property. As a result, it is important that a borrower, when the property value is an issue, obtain a well-supported third party valuation for income tax reporting purposes. This could be extremely relevant, for instance, at times when the market values of property are uncertain. A government auditor reviewing the past income tax reporting of a transaction will have the advantage of the clarity of vision that comes with hindsight. In such a situation, a taxpayer will want to have the strongest support for its position possible. Even if the taxpayer does not ultimately meet its burden to show that the value it reported was correct and the audit results in an adjustment, an independent valuation may mean the difference between the government imposing or not imposing a penalty.

For the lender receiving real property in a deed in lieu transaction, it does not matter whether the debt is recourse or nonrecourse. In either case the transaction is treated as an exchange of the debt instrument for real property and gives rise to gain or loss. IRC §1001. The character of the gain or loss as capital or ordinary to the lender will depend on the lender's particular facts and circumstances, as will the ability of the lender to deduct any taxable loss suffered. See generally IRC §§1221-1223, 165-166. If the lender has recourse to the borrower and is later able to collect on any deficiency, the lender will have ordinary income to the extent it received the benefit of any deduction previously taken. IRC §111.

If the lender receives the borrower's property in an involuntary foreclosure, the tax consequences are much less clear and depend on the particular facts and circumstances of the transaction. See, *e.g.,* Reg §1.166-6.

The tax consequences may also be different if the lender was originally the seller of the property and the borrower's mortgage obligation to the lender is with respect to the property it acquired. In that case, although there are exceptions, no gain or loss is recognized by the lender on acquisition of the real property by a deed in lieu, and the lender's ability to otherwise claim a worthless debt loss is similarly circumscribed. See IRC §1038.

EXAMPLE: Borrower has income: A borrower owes $500 on a note secured by depreciable real property worth $400. The borrower's adjusted basis in the property is $350, and the property has been held for 5 years as a "capital

asset" within the meaning of IRC §1221. The borrower voluntarily surrenders the property to the lender by a negotiated deed in lieu of foreclosure. Because there is no foreclosure proceeding, no deficiency judgment is obtained. See §§7.5-7.6. If the mortgage is nonrecourse, the outstanding debt amount becomes the deemed sales price. Accordingly, the borrower has a capital gain of $150 (the difference between the amount owed, $500, and the adjusted basis in the property of $350). If the mortgage is recourse, the resulting capital gain is $50 (the difference between the deemed sales price—the $400 fair market value of the property—and the adjusted basis in the property of $350). The excess of the debt principal discharged in the deed in lieu transaction ($500) over the fair market value of the property ($400) results in CODI of $100. Unless the borrower can avail itself of an exception to CODI, it will report the $100 as ordinary income for the year it surrenders the property.

EXAMPLE: Lender has loss: In the immediately preceding example, assume the lender is considered, for income tax purposes, to be in the business of lending and holds the borrower's note as inventory. The lender had originally loaned $500 to the borrower and so, immediately prior to the deed in lieu transaction, the lender has a $500 adjusted basis in the borrower's note. The borrower subsequently voluntarily surrenders the real property to the lender by a deed in lieu of foreclosure. There is no deficiency judgment. If the mortgage is nonrecourse, the lender receives $400 of real property in exchange for a note with an adjusted basis of $500. The lender, therefore, has a $100 tax loss. The loss is ordinary. IRC §1221(a)(1). The lender will deduct the loss. If the debt is considered recourse, the result is the same.

WARNING: The preceding discussion is introductory in nature and is meant to highlight certain income tax issues that commonly arise in the context of foreclosure or deed in lieu transactions between an individual original borrower and an unrelated individual original lender. Both lenders and borrowers should proactively seek tax advice from competent income tax counsel about the impact of any foreclosure or deed in lieu transaction. The body of income tax law that applies in this area is particularly complex, and the IRC and the applicable Treasury Regulations are subject to substantial interplay with other statutory provisions not discussed here. Also, the substantive statutory provisions of the IRC are subject to extensive federal judicial income tax common law. This discussion has not touched on many other substantial issues, including those arising in transactions involving business entities, related persons or entities, equity for debt transactions, or transactions involving successor borrowers or lenders. Also, this part only discusses federal income tax law. State and federal income tax laws can diverge (such as the income tax provisions of California law that specifically require incorporation of federal law), particularly if federal legislation has been recently enacted.

FURTHER READING: The diligent non-tax practitioner who wishes to study in greater detail the issues contained in this section and §10.24 may wish to begin by consulting the following materials:

- Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (7th ed 2006).
- Garlock, Federal Income Taxation of Debt Instruments (5th ed 2007).
- McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners (4th ed 2009).
- Robinson, Federal Income Taxation of Real Estate (6th ed 2007).

CAUTION: The IRS's website contains further, nontechnical information related to the tax topics discussed in this chapter. Go to www.irs.gov. Although the information on that website is often helpful, much of it is of a general nature. The IRS website should almost never be used as the sole source of reference on any tax matter and should never take the place of careful, thoughtful consideration by competent tax counsel.

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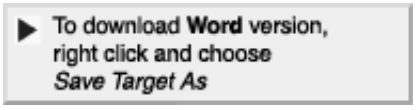
§10.31 d. Deed in Lieu of Foreclosure Agreement

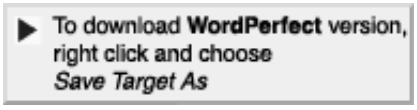
A lender generally wants the terms and conditions of a deed in lieu of foreclosure agreement to be similar to those contained in a purchase and sale agreement (*e.g.,* representations and warranties regarding the physical and economic condition of the property). Borrowers (and guarantors, indemnitors, or others secondarily liable on the loan) generally are unwilling to incur more liability in connection with the transfer of the property pursuant to such an agreement than they would incur in connection with a sale pursuant to a foreclosure of its deed of trust (which is, essentially, an "as-is" sale). From the borrower's perspective, each term of the agreement should be analyzed and negotiated from this standpoint to the extent practicable in light of the borrower's reasons for entering into the transaction as opposed to permitting the property to be sold at foreclosure.

When the deed in lieu is recorded, the discharge of the borrower's obligations under the loan will effect a discharge of guarantors and others secondarily liable on the loan, except to the extent such obligations provide that they survive such discharge. However, counsel representing guarantors, indemnitors, and others secondarily liable on the loan will want to address these matters explicitly in the deed in lieu of foreclosure agreement and obtain full releases of their obligations, or at least releases consistent with their surviving liability (if any) after a nonjudicial foreclosure sale.

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§10.31A e. Form: Deed in Lieu Agreement





DEED IN LIEU OF FORECLOSURE AGREEMENT

THIS DEED IN LIEU OF FORECLOSURE AGREEMENT (Agreement) is made as of _ _[*date*]_ _, by and among _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Borrower); _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Guarantor); and _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Lender), with respect to the following:

RECITALS

A. Borrower owns fee simple title to the real property located at _ _[*address*]_ _, California, and more particularly described on the attached Exhibit _ _[*specify*]_ _ (Land), and the buildings, fixtures, and other improvements located on the Land commonly known as "_ _[*name*]_ _" and generally consisting of _ _[*describe principal improvements*]_ _ (collectively, Improvements).

B. Lender made a loan to Borrower in the original principal amount of $_ _[*amount*]_ _ that is secured by, among other things, the Property (Loan). The Loan was made pursuant to, and is evidenced and secured by, the agreements, instruments, and documents identified on Exhibit _ _[*specify*]_ _ (collectively, Loan Documents). All initially capitalized terms not otherwise defined in this Agreement shall have the meanings given them in the Loan Documents.

C. As of _ _[*date*]_ _, the total outstanding principal balance of the Loan was $_ _[*amount*]_ _, and the total accrued and unpaid regular (*i.e.,* nondefault rate) interest thereon was $_ _[*amount*]_ _. In addition, late charges of $_ _[*amount*]_ _ and additional amounts, including default interest and attorney fees, are now due and owing.

D. As a result of, among other things, _ _[*describe default*]_ _, Borrower is in default under the Loan Documents (collectively, Borrower's Default). As a result of the Borrower's Default, the Loan has been accelerated and the total outstanding principal balance of the Loan, together with all accrued and unpaid interest thereon, is now due and owing.

E. In order to avoid the financial hardship and damage to reputation that would result from Lender exercising its rights and remedies under the Loan Documents as a result of the Borrower's Default, Borrower desires to resolve the Borrower's Default by conveying the "Property" (as defined in Section _ _[*e.g., 1*]_ _) to Lender, or another entity appointed by Lender (Buyer), in consideration of Lender's not foreclosing its security interest in the Property or exercising any of its other rights or remedies against Borrower.

F. The fair market value of the Property does not exceed the total outstanding unpaid principal of, interest accrued and unpaid on, and other outstanding indebtedness due and owing under the Loan Documents.

G. Lender desires to accept, or cause Buyer to accept, the conveyance of the Property pursuant to this Agreement to avoid the necessity of litigation, foreclosure, and the delays associated therewith and to avoid the delays associated with any statutory redemption rights that Borrower would otherwise have with respect to the Property. Lender acknowledges that the provisions of this Agreement directly benefit Lender in this regard.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Borrower, Guarantor, and Lender agree as follows:

1. TRANSFER OF PROPERTY. Borrower agrees to sell, grant, transfer, assign, and convey to Lender (or Buyer), and Lender agrees to acquire, or cause Buyer to acquire, from Borrower, absolutely and free of any

right of redemption or other right or interest of Borrower or anyone claiming by, through, or under Borrower, the following real and personal property (collectively, Property):

1.1. *Real Estate.* Good, valid, indefeasible, and marketable fee simple title to the Land; the Improvements; all of Borrower's right, title, and interest in and to any easements, rights, tenements, and appurtenances belonging or appertaining to the Land and Improvements; and all of Borrower's right, title, and interest in and to any streets, alleys, or public right-of-ways adjacent to the Land and Improvements, before or after vacation thereof (collectively, Real Estate).

1.2. *Leases.* All of Borrower's right, title, and interest as lessor or lessee in all leases, licenses, and other agreements to occupy the Real Estate, together with all rents and other sums due, accrued, or to become due under each such lease, license, and agreement; all rents that are received and allocable to periods following the "Closing Date" (as defined in Section _ _[*e.g., 2.1*]_ _); all guaranties by third parties of the tenants' obligations under such leases; and any lease security and other deposits (collectively, Leases).

1.3. *Plans and Specifications; Warranties.* All of Borrower's right, title, and interest in and to all plans and specifications relating to the Improvements (collectively, Plans and Specifications) and all unexpired claims, warranties, and guarantees, if any, received in connection with the construction or equipping of the Real Estate, if and to the extent assignable (collectively, Warranties).

1.4. *Assigned Contracts.* All of Borrower's right, title, and interest in and to the service, supply, and maintenance contracts and equipment leases listed on Exhibit _ _[*specify*]_ _ (collectively, Assigned Contracts).

1.5. *Licenses and Permits.* All of Borrower's right, title, and interest in and to the licenses, permits, certificates of occupancy, and franchises (including those listed on Exhibit _ _[*specify*]_ _) issued by any federal, state, county, or other governmental authority relating to the use, maintenance, or operation of the Real Estate and running to, or in favor of, Borrower and/or the Real Estate, if and to the extent assignable (collectively, Licenses and Permits).

1.6. *Personal Property.* All of Borrower's right, title, and interest in and to other tangible and intangible personal property, equipment, and supplies located at, or used in connection with the development, leasing, management, use, and/or operation of, the Real Estate, including the items listed on Exhibit _ _[*specify*]_ _ and logos, trade styles, trade names, brochures, manuals, lists of prospective tenants, advertising material, assignable utility contracts, and assignable telephone numbers, but specifically excluding tangible personal property owned by tenants under the Leases, Borrower's managing agent, utility service providers, and any items of tangible personal property owned by Borrower listed on Exhibit _ _[*specify*]_ _ and denoted as "Excluded."

2. CLOSING.

2.1. *Closing.* Provided all terms and conditions contained in this Agreement have been timely satisfied, the closing of the transaction contemplated by this Agreement (Closing) shall take place on _ _[*date*]_ _ (Closing Date) through an escrow with _ _[*name of title company*]_ _ (Title Company), or on such other date or such other place as may be mutually agreed on by Borrower and Lender. The parties shall have the right to inspect all documents before, at the time of, and after their deposit in the escrow. To consummate the Closing, the parties will abide by the general escrow instructions on the attached Exhibit _ _[*specify*]_ _ (Escrow Instructions), provided, however, that this Agreement shall not be merged into the Escrow Instructions and the Escrow Instructions shall be deemed auxiliary to this Agreement. As between the parties to this Agreement, on failure of the escrow or otherwise, the provisions of this Agreement shall control.

2.2. *No Liability for Failure to Close.* The parties acknowledge and agree that if the Closing fails to occur for any reason whatsoever, including the failure to perform any of the pre-Closing obligations under this Agreement, then such failure shall not constitute a default or breach under this Agreement and no party shall have any liability to any other party to this Agreement as a result of such failure.

2.3. *Closing Deliveries and Actions.* The following deliveries and/or actions shall be effected through the escrow established for the Closing. These deliveries and actions shall be deemed to be taken simultaneously, and no one of which shall be deemed completed until all of such deliveries and actions have been completed.

2.3.1. *Transfer Documents.* The following documentation for the transfer of the Property shall be duly authorized, properly executed, acknowledged (if applicable), and/or delivered:

2.3.1.1. *Deed*. Borrower shall execute (such execution to be acknowledged by a notary public) and deliver to Title Company a Deed in Lieu of Foreclosure in the form of Exhibit _ _[*specify*]_ _.

2.3.1.2. *Bill of Sale.* Borrower shall execute and deliver to Title Company a Bill of Sale in the form of Exhibit _ _[*specify*]_ _.

2.3.1.3. *Assignment and Assumption Agreement.* Borrower shall execute and deliver, and Lender will execute and deliver (or cause Buyer to execute and deliver), to Title Company an Assignment and Assumption Agreement in the form of Exhibit _ _[*specify*]_ _.

2.3.1.4. *Non-Foreign Status Certificate.* Borrower shall execute and deliver to Title Company a Non-Foreign Status Certificate in the form of Exhibit _ _[*specify*]_ _.

2.3.1.5. *Rent Roll Certificate.* Borrower shall execute and deliver to Title Company a Rent Roll Certificate in the form of Exhibit _ _[*specify*]_ _, including a schedule of the Leases. The rent roll shall be in substantially the same form as the rent roll provided to Lender before the date of this Agreement.

2.3.1.6. *Tenant Letters.* Borrower shall execute and deliver to Title Company letters to the tenants of the Property in the form of Exhibit _ _[*specify*]_ _.

2.3.1.7. *Estoppel Certificates.* Estoppel certificates shall be executed by each nonresidential tenant of the Property in the form required under the applicable Leases.

2.3.1.8. *Transfer Declarations.* Borrower shall complete, execute, and deliver to Title Company all applicable state, county, and municipal transfer or exemption declarations. If the declarations have been properly completed, Lender (or Buyer) shall execute such declarations if legally required.

2.3.2. *Title Documents.* The following title, transfer, and original documentation and other matters shall be duly authorized, properly executed, acknowledged (if applicable), and/or delivered:

2.3.2.1. *Title Policy.* The "Title Policy" (as defined in Section _ _[*e.g., 3.1*]_ _), or a "marked up" commitment to issue the Title Policy, shall be delivered to Lender (or Buyer).

2.3.2.2. *Loan Policy Endorsements.* The "Loan Policy Endorsements" (as defined in Section _ _[*e.g., 3.2*]_ _), or a "marked up" commitment to issue the Loan Policy Endorsements, shall be delivered to Lender.

2.3.2.3. *Title Affidavits and Indemnities.* Borrower shall execute and deliver to Title Company (a) an Owner's Affidavit and Indemnity; (b) an Indemnification Agreement (regarding mechanics' liens); and (c) a GAP undertaking and affidavit reasonably satisfactory to Title Company so as to permit issuance of the Title Policy and Loan Policy Endorsements on the Closing Date.

2.3.2.4. *Searches.* Borrower shall deliver to Lender, or Lender shall have obtained, Uniform Commercial Code financing statement, tax lien, and judgment searches of Borrower and Guarantor dated not earlier than _ _[*date*]_ _, issued by a search company acceptable to Lender confirming the existence of no financing statements filed against the Property (except in connection with the Loan), tax liens (against the Property, Borrower, or Guarantor) or judgments (against the Property, Borrower, or Guarantor) other than the Permitted Exceptions.

2.3.3. *Property Documents.* Borrower shall deliver originals (or, if originals are not available, copies) of the following documents to Lender (or Buyer) to the extent the same are in the possession or control of Borrower: (a) the Leases; (b) the Assigned Contracts; (c) the Licenses and Permits; (d) the Warranties; (e) the Plans and Specifications; and (f) all books, records, bills, invoices, lease files, credit reports, and other documents related to the ownership, operation, management, use, maintenance, or leasing of the Property or, for any such items not physically delivered to Lender (or Buyer) on the Closing Date, a letter from Borrower to Lender (or Buyer) stating where such items are located, and a letter from Borrower to the keeper of such items, directing the keeper to release all such items to Lender (or Buyer).

2.3.4. *Entity Documents.* The following documents shall be delivered to Lender:

2.3.4.1. *Borrower Agreement and Certificates.* A copy of Borrower's _ _[*e.g., operating agreement*]_ _ certified by its manager, a certified copy of Borrower's _ _[*e.g., certificate of formation and certificate of status*]_ _ issued by the _ _[*identify state*]_ _ Secretary of State (dated not earlier than _ _[*date*]_ _), and a _ _[*e.g., certificate of status*]_ _ for Borrower from the California Secretary of State dated not earlier than _ _[*date*]_ _.

2.3.4.2. *Guarantor Agreement and Certificates.* A copy of Guarantor's _ _[*e.g., operating agreement*]_ _ certified by its manager and a certified copy of Guarantor's _ _[*e.g., certificate of formation and certificate of status*]_ _ issued by the _ _[*identify state*]_ _ Secretary of State (dated not earlier than _ _[*date*]_ _).

2.3.4.3. *Consents.* Consents of the members of Borrower and Guarantor authorizing the execution of this Agreement and the execution and delivery of all documents required pursuant to this Agreement.

2.3.5. *Other Deliveries.* The following deliveries shall be made:

2.3.5.1. *Security and Other Deposits.* Borrower shall deliver (with such assignments as Lender shall require) to Lender (or Buyer) all cash and noncash security and other deposits and any interest required by law or agreement to be paid thereon.

2.3.5.2. *Possession.* Borrower shall deliver possession of the Property to Lender (or Buyer), subject to the rights of existing tenants and the Permitted Exceptions.

2.3.5.3. *Keys to Improvements.* Borrower shall deliver to Lender (or Buyer) a key code inventory and all keys to the Real Estate or a letter executed by Borrower to the keeper of the keys directing such keeper to deliver the keys to Lender (or Buyer).

2.3.5.4. *Evidence of Termination.* Borrower shall deliver to Lender (or Buyer) evidence of termination (at no cost to Lender (or Buyer) and free of all liens or claims for liens by reason of the terminated agreements) of all (a) management, brokerage, and leasing commission agreements and (b) service and maintenance contracts that are not Assigned Contracts.

2.3.5.5. *Miscellaneous Waivers.* Borrower shall deliver to Lender (or Buyer) lien waivers and lien releases from each person listed on Exhibit _ _[*specify*]_ _ and any other person who, pursuant to applicable law or agreement, may have a right to a lien on the Property as a result of work or services performed or materials provided to, or for the benefit of, the Property.

2.3.5.6. *Release.* Borrower and Guarantor shall deliver to Lender a General Release in the form of Exhibit _ _[*specify*]_ _.

2.3.5.7. *Covenant Not to Sue.* In consideration for the transfer of the Property from Borrower to Lender (or Buyer), Lender shall deliver to Borrower and Guarantor a Covenant Not to Sue in the form of Exhibit _ _[*specify*]_ _ (Covenant Not to Sue).

2.3.5.8. *Additional Consents.* Borrower shall deliver to Lender any consents from persons whose consent is required by Borrower to consummate the Closing.

2.3.5.9. *Settlement Statement.* Borrower and Lender shall jointly execute and deliver a settlement statement.

2.4. *Expenses of Closing.* Except as set forth on Exhibit _ _[*specify*]_ _, the parties to this Agreement shall pay their own expenses in connection with the Closing.

3. TITLE.

3.1. *Owner's Policy of Title Policy.* Lender (or Buyer) shall receive from Title Company an ALTA Owner's Policy of Title Insurance (Title Policy) dated as of the Closing Date, naming Lender (or Buyer) as the insured,

showing fee simple title to the Real Estate vested in Lender (or Buyer), and subject only to the Loan Documents of record and the other matters set forth on Exhibit _ _[*specify*]_ _ (collectively, Permitted Exceptions).

3.2. *Loan Policy of Title Policy.* Lender shall receive from Title Company the following endorsements to its Loan Policy No. _ _[*specify*]_ _ (which endorsements shall be dated as of the Closing Date): (a) a date-down endorsement showing fee simple title to the Real Estate vested in Buyer and insuring the "Deed of Trust" (as defined in Exhibit _ _[*specify*]_ _) as a first priority encumbrance on the Property, subject only to the Permitted Exceptions, and (b) at Lender's option, a nonmerger endorsement acceptable to Lender (collectively, Loan Policy Endorsements).

3.3. *Borrower Cooperation.* Borrower shall cooperate with Title Company in connection with its issuance of the Title Policy and the Loan Policy Endorsements, including the release and reconveyance at Closing of any security interests, liens, encumbrances, or hypothecations asserted against the Property, other than liens for non-delinquent property taxes and assessments.

4. COVENANTS.

4.1. *Cooperation.* Before the Closing, Borrower will reasonably cooperate, on Lender's request, with Lender, including any management company designated by Lender, to facilitate an orderly transfer of the ownership and management of the Property.

4.2. *Audit.* Before the Closing, Borrower will permit Lender to audit and review Borrower's books and records related to the Property.

4.3. *Rent Collections.* Borrower agrees that in the event Borrower receives any rental payment or other payment from any tenant or other occupant or user of the Property after the Closing, Borrower will deliver to Lender (or Buyer), with proper endorsements, such funds not later than _ _[*e.g., five (5)*]_ _ days after receipt of such funds.

5. REPRESENTATIONS AND WARRANTIES.

5.1. *Lender's Representations and Warranties.* Lender represents and warrants to Borrower and Guarantor as follows: (a) Lender is a _ _[*type of entity*]_ _ that is duly _ _[*formed/organized*]_ _, validly existing, and in good standing under the laws of the State of _ _[*name*]_ _; (b) Lender has the right, power, and authority to execute this Agreement and to perform its obligations under this Agreement; (c) the execution and delivery of this Agreement by Lender and the performance by Lender under this Agreement has been authorized by all necessary _ _[*corporate/partnership/limited liability company*]_ _ action of Lender; (d) the execution, delivery, and performance of this Agreement by Lender does not breach, conflict with, or contravene (i) Lender's operating agreements or certificates; (ii) any agreement, instrument, document, or indenture to which Lender is a party or by which Lender is bound; (iii) any applicable law; or (iv) any judgment, writ, or order directed to Lender or by which Lender may be bound; and (e) Lender has had no direct dealings with any real estate broker, agent, or finder that is entitled to a commission, fee, or other compensation in connection with the conveyance of the Property contemplated by this Agreement.

5.2. *Representations and Warranties of Borrower and Guarantor.* Borrower and Guarantor represent and warrant to Lender as follows:

5.2.1. *Organization and Authority.* Borrower is a _ _[*type of entity*]_ _ that is duly _ _[*formed/organized*]_ _, validly existing, and in good standing under the laws of the State of _ _[*name*]_ _. Guarantor is a _ _[*type of entity*]_ _ that is duly _ _[*formed/organized*]_ _, validly existing, and in good standing under the laws of the State of _ _[*name*]_ _. Borrower and Guarantor have the right, power, and authority to execute this Agreement and to perform their respective obligations under this Agreement. The execution and delivery of this Agreement by Borrower and Guarantor has been authorized by all necessary _ _[*corporate/partnership/limited liability company*]_ _ action of Borrower and Guarantor, respectively. The execution, delivery, and performance of this Agreement by Borrower and Guarantor does not breach, conflict with, or contravene (a) Borrower's or Guarantor's respective operating agreements or certificates; (b) any agreement, instrument, document, or indenture to which Borrower or Guarantor are a party or by which they or the Property is bound; (c) any applicable law; or (d) any judgment, writ, or order directed to Borrower or Guarantor or by which Borrower or Guarantor may be bound.

5.2.2. *Bankruptcy.* Guarantor and Borrower have not filed a petition in any case, action, or proceeding under the Bankruptcy Code or any similar state law. No party has filed a petition in any case, action, or proceeding under the Bankruptcy Code or any similar state law against Borrower or Guarantor that has not been dismissed or vacated. Neither Borrower nor Guarantor have filed an answer or otherwise admitted in writing insolvency or inability to pay their debts, made an assignment for the benefit of creditors, or consented to an appointment of a receiver or trustee of all or a material part of their property. The transaction contemplated in this Agreement is not a preference, voidable transfer, or fraudulent conveyance or otherwise in violation of the Bankruptcy Code or any other similar state or federal law.

5.2.3. *Absence of Litigation.* Neither Borrower nor Guarantor have received any written notice of, nor is there pending or, to the best of Borrower's knowledge, threatened, any litigation or administrative proceeding involving in any manner the Property or the ownership, leasing, operation, management, use, or maintenance of the Property or this transaction.

5.2.4. *Arm's Length Transaction.* Borrower and Guarantor have requested conveyance of title to the Property in lieu of the exercise of Lender's remedies under the Loan Documents and throughout the negotiation, preparation, and execution of this Agreement have been, and will through the Closing be, represented by competent legal counsel of their own choosing. This Agreement was entered into out of the free will of Borrower and Guarantor and pursuant to arm's length negotiations. Borrower and Guarantor believe this Agreement is fair. Lender has not taken advantage of Borrower or Guarantor by threats, intimidation, overreaching, unconscionable conduct, or otherwise, and Borrower and Guarantor are proceeding in this transaction as volunteers in what they perceive to be their own best interest.

5.2.5. *No Broker.* Borrower and Guarantor have had no direct dealings with any real estate broker, agent, or finder that is entitled to commission, fee, or other compensation in connection with the conveyance of the Property contemplated by this Agreement.

5.2.6. *Property Value*. The value of the Property does not exceed the indebtedness owing to Lender under the Loan Documents.

5.2.7. *No Intent to Hinder, Delay, or Defraud.* Borrower is not consummating the transaction contemplated by this Agreement with any intent to hinder, delay, or defraud any party to whom Borrower is now indebted or may hereafter become indebted.

5.3. *Indemnity.* Subject to the Covenant Not to Sue, Borrower and Guarantor, jointly and severally, agree to indemnify, defend, and hold Lender, its accountants, affiliates, agents, attorneys, directors, employees, members, officers, parents, partners, representatives, stockholders, subsidiaries, and their successors and assigns harmless from and against any act, action, agreement, breach, claim, controversy, cost, damage, debt, default, demand, dispute, expense, injury, judgment, liability, loss, malfeasance, misfeasance, obligation, omission, and/or suit of every character, kind, nature, and type (*e.g.,* whether legal or equitable, known or unknown, suspected or unsuspected, contingent or fixed) arising, directly or indirectly, from (a) any breach by Borrower or Guarantor of any representation or warranty contained in this Agreement or in the documents executed and delivered by Borrower or Guarantor pursuant to or in connection with this Agreement or the transactions contemplated by this Agreement (collectively, Borrower Documents), (b) any default by Borrower or Guarantor under the Borrower Documents; and (c) the Property (but only to the extent the same arose before the Closing).

6. NO ASSUMPTION OF OBLIGATIONS TO THIRD PARTIES. Borrower and Guarantor acknowledge and agree that they do not intend that the transfer to Lender (or Buyer) of title to the Property under the terms of this Agreement shall create any obligations or liabilities on the part of Lender (or Buyer) to third parties that have claims against Borrower or Guarantor with respect to the Property that accrued before the Closing. Neither Lender nor Buyer assume, or agree to discharge, any such obligations or liabilities.

7. ABSOLUTE CONVEYANCE. Borrower's conveyance of the Property to Lender (or Buyer) pursuant to this Agreement is an absolute conveyance of all of Borrower's right, title, and interest in and to the Property in fact as well as form and is not intended as a mortgage, deed of trust, or security instrument of any kind, such that Borrower has no further interest (including rights of redemption) or claims in or to the Property.

8. NO MERGER. Notwithstanding Lender's (or Buyer's) acquisition of the Property, the indebtedness

evidenced by the Loan Documents shall not be cancelled on, and all of the Loan Documents shall remain in full force and effect after, the Closing. The interest of Lender (or Buyer) in the Property after the Closing shall not merge with the interest of Lender in the Property under the Loan Documents such that such interests shall be and remain at all times separate and distinct. The lien of the Deed of Trust shall be and remain at all times a valid and continuing lien on the Property unless and until released of record by Lender.

9. APPOINTMENT OF BUYER. Lender reserves the right to appoint Buyer to accept title to the Property at the time of the Closing such that Buyer shall become a third party beneficiary of this Agreement on any such appointment.

10. SURVIVAL. The terms and conditions of this Agreement shall survive the Closing.

11. MISCELLANEOUS.

[*Add miscellaneous provisions similar to those in §10.23A*]

IN WITNESS WHEREOF, Borrower, Guarantor, and Lender have executed this Deed in Lieu of Foreclosure Agreement as of the day and year first above written.

BORROWER:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

GUARANTOR:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

LENDER:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This form agreement provides that the deed in lieu will not become effective until a satisfactory new owner's policy of title insurance is issued to the lender. Although this form calls for an American Land Title Association (ALTA) owner's policy, the scope of owner's title coverage and who pays these costs is often negotiable. The lender will generally want the broader scope of coverage, including one or more special endorsements. When the deed in lieu is on property where there has been recent construction (either partially or fully completed), and if a California Land Title Association (CLTA) owner's policy is specified in the agreement, the lender may wish to include in the agreement the following:

- A provision requiring the borrower to provide an affidavit stating and warranting what, if any, construction bills remain unpaid (or a provision requiring issuance of an appropriate CLTA mechanics' lien endorsement to protect the lender against any subsequently filed mechanics' lien claims based on work done before recordation of the deed in lieu); and

- A provision stating that the lender's discharge of the borrower from the secured debt will not relinquish any indemnity rights that the lender may subsequently have because of design or construction defects in the project existing before the recordation date of the deed in lieu of foreclosure.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.32 f. Form: Deed in Lieu of Foreclosure (Recordable)

§10.32 f. Form: Deed in Lieu of Foreclosure (Recordable)

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

RECORDING REQUESTED BY)
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Space Above for Recorder's Use Only

The Undersigned Grantor Declares:

Grantee _ _[*was/was not*]_ _ the Foreclosing Beneficiary

Consideration $_ _[*amount*]_ _; Amount of Unpaid Debt $_ _[*amount*]_ _

Non-Exempt Amount $_ _[*amount*]_ _

Documentary Transfer Tax $_ _[*amount*]_ _; _ _[*City Transfer Tax $_ _[amount*]_ _]_ _

[__] computed on the consideration or full value of property conveyed, OR

[__] computed on the consideration or full value less value of liens and/or encumbrances remaining at time of sale

[__] unincorporated area

[__] City of _ _[*name*]_ _

DEED IN LIEU OF FORECLOSURE

FOR A VALUABLE CONSIDERATION, receipt of which is hereby acknowledged, _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Grantor), hereby GRANTS to _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Grantee), the real property in the City of _ _[*name*]_ _, County of _ _[*name*]_ _, State of California, described as (Property):

SEE LEGAL DESCRIPTION ATTACHED HERETO AS EXHIBIT _ _[*specify*]_ _.

This Deed is an absolute conveyance. Grantor has sold the Property to Grantee for a fair and adequate consideration, such consideration being reasonably equivalent value and, in addition to the consideration recited above, being

[*Add one of the following alternatives*]

[*Alternative 1: Full satisfaction of obligations secured by deed of trust]*

full satisfaction of all obligations secured by that certain Deed of Trust recorded in the Official Records of _ _[*name*]_ _ County, California, on _ _[*date*]_ _, as Instrument No. _ _[*specify*]_ _.

[*Alternative 2: Agreement not to foreclose]*

the agreement by an affiliate of Grantee (Beneficiary) that is the beneficiary under that certain Deed of Trust recorded in the Official Records of _ _[*name*]_ _ County, California, on _ _[*date*]_ _, as Instrument No. _ _[*specify*]_ _ (Deed of Trust), to not foreclose on the Deed of Trust.

[*Alternative 3: Covenant Not to Sue]*

the agreement by Grantee to enter into that Covenant Not to Sue _ _[*between/among*]_ _ Grantee and _ _[*names of parties*]_ _ or that certain _ _[*describe release document*]_ _ made by Grantee in favor of _ _[*names of parties*]_ _.

[*Continue*]

Grantor and Grantee acknowledge and agree that the beneficial interest of Beneficiary in the Property pursuant to the Deed of Trust shall not merge with the fee interest of Grantee in the Property pursuant to this Deed in Lieu of Foreclosure and that such interests shall be and remain at all times separate and distinct.

Grantor declares that this conveyance is freely and fairly made and that there are no agreements, oral or written, other than this Deed in Lieu of Foreclosure and the Estoppel Affidavit, attached as Exhibit _ _[*specify*]_ _, between Grantor and Grantee with respect to the Property.

GRANTOR:

Date: _ _ _ _ _ _ _ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

EXHIBIT _ _ TO DEED IN LIEU OF FORECLOSURE

ESTOPPEL AFFIDAVIT

STATE OF CALIFORNIA) SS.
COUNTY OF _____)
)

Date: _ _ _ _ _ _

_ _[*Name*]_ _ **(Affiant), being first duly sworn, for** _ _[*himself/herself*]_ _**, deposes and says:**

That _ _[*he/she*]_ _ **is the** _ _[*title*]_ _ **of** _ _[*name*]_ _**, a** _ _[*type of entity*]_ _ **(Grantor), which made, executed, and delivered that certain Deed in Lieu of Foreclosure to** _ _[*name*]_ _**, a** _ _[*type of entity*]_ _ **(Grantee), on** _ _[*date*]_ _ **(Deed), conveying the real property in the City of** _ _[*name*]_ _**, County of** _ _[*name*]_ _**, State of California, described as (Property):**

SEE LEGAL DESCRIPTION ATTACHED HERETO AS EXHIBIT _ _[*specify*]_ _.

That Affiant makes this Estoppel Affidavit for, and on behalf of, Grantor pursuant to a resolution of its Board of Directors;

That the Deed is intended to be, and is, an absolute conveyance of fee title of the Property to Grantee and was not, and is not now, intended as a mortgage, trust conveyance, or security of any kind;

That it was the intention of Grantor, as grantor in the Deed, to convey, and by the Deed did convey, to Grantee all its right, title, and interest absolutely in and to the Property;

That possession of the Property has been surrendered to Grantee;

That, in the execution and delivery of the Deed, Grantor was not acting under any misapprehension with regard to the effect of the Deed, acted freely and voluntarily, and was not acting under coercion or duress;

That the consideration for the Deed was, and is, payment to Grantor of the sum of $_ _[*amount*]_ _ by Grantee and the full cancellation of all of Grantor's debts, obligations, costs, and charges secured by that certain Deed of Trust recorded in the Official Records of _ _[*name*]_ _ County, California, on _ _[*date*]_ _, as Instrument No. _ _[*specify*]_ _ or _ _[*e.g., the agreement by Grantee to not foreclose on the Deed of Trust*]_ _ or _ _[*e.g., the agreement by Grantee to enter into Covenant Not to Sue or release document*]_ _ (collectively, Consideration);

That at the time of the execution and delivery of the Deed, Affiant, as an officer of Grantor, believed, and now believes, that the Consideration represents the fair value of the Property;

That this Estoppel Affidavit is made for the protection and benefit of Grantee and its successors and assigns, and all other parties hereafter dealing with, or who may hereafter acquire an interest in, the Property, and particularly for the benefit of _ _[*name*]_ _, which is about to insure title to the Property in reliance thereon, and any other title company that may hereafter insure title to the Property;

That Affiant will testify, declare, depose, or certify before any competent tribunal, office, or person, in any case now pending or that may hereafter be instituted, to the truth of the particular facts set forth in this Estoppel Affidavit; and

That Affiant has executed this Estoppel Affidavit as an individual and also for and on behalf of Grantor, pursuant to authority of the Board of Directors of Grantor.

AFFIANT:

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

State of California)
County of _ _[*name of county*]_ _ **)**

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

SECRETARY CERTIFICATE

I, _ _[*name*]_ _**, being the duly elected and acting Secretary of** _ _[*name*]_ _**, a** _ _[*type of entity*]_ _

(Company), do hereby certify that the below is a true and correct copy of a resolution duly and regularly passed at a special meeting of the Board of Directors of Company on _ _[*date*]_ _.

RESOLVED that _ _[*name*]_ _, as the _ _[*title*]_ _ of Company, be, and _ _[*he/she*]_ _ is hereby, authorized and directed to execute the Estoppel Affidavit, a copy of which is attached hereto (Affidavit), and that the facts stated in the Affidavit are hereby declared to be true, correct, and complete in all material respects.

I further certify that such meeting was duly and regularly held, that there was present during all of such meeting a quorum, and that such resolution was unanimously passed and has not been modified or rescinded.

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

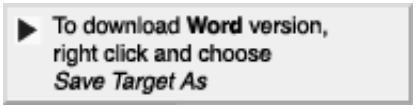
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its Secretary

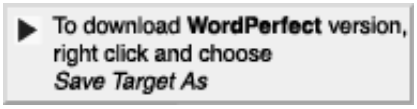
Comment: This deed refers to a covenant not to sue. For that form, see §10.32A. The Non-Exempt Amount (listed in the grantor declarations on page 1), if any, is determined as provided under Rev & T C §11926. The recitals in this deed, commonly referred to as "estoppel" recitals (because their purpose is to estop the borrower from later contending that the deed in lieu is something other than what it purports on its face to be), are usually required in a deed in lieu by title insurers before they will issue a new owner's policy to the lender based on this deed. See California Title Insurance Practice §8.49 (2d ed Cal CEB 1997). If the borrower is receiving any monetary consideration for the deed in lieu other than discharge from the secured debt, that fact or the amount of the consideration should also be included in the recital. The form of this deed should be provided to the title company for review and approval as early as possible and should be revised to incorporate the title company's requirements (or the parties can request that the title company provide an acceptable form at the outset of the deed in lieu transaction).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.32A g. Form: Covenant Not to Sue

§10.32A g. Form: Covenant Not to Sue





COVENANT NOT TO SUE

THIS COVENANT NOT TO SUE (Covenant) is made as of _ _[*date*]_ _ by and among _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Borrower); _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Guarantor); and _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Lender), with respect to the following:

RECITALS

A. Lender made a loan to Borrower in the original principal amount of $_ _[*amount*]_ _ **(Loan) pursuant to the agreements, instruments, and documents identified on Exhibit _ _[*specify*]_ _ (collectively, Loan Documents). All initially capitalized terms not otherwise defined in this Covenant shall have the meanings given thereto in the Loan Documents.**

B. One or more Events of Default have occurred under the Loan Documents (collectively, Default) that entitle Lender to exercise its rights and remedies under the Loan Documents, including accelerating the Loan.

C. Pursuant to that certain Deed in Lieu of Foreclosure Agreement dated as of _ _[*date*]_ _, executed by Borrower, Guarantor, and Lender (Agreement), Borrower has agreed to convey the Property to an entity appointed by Lender (Buyer) as consideration for Lender not foreclosing its security interest in the Property or exercising any of its other rights or remedies under the Loan Documents against Borrower or Guarantor as a result of the Default.

D. In connection with the closing of the transaction contemplated by the Agreement, Lender has agreed not to sue Borrower and Guarantor in connection with the Loan or under the Loan Documents on the terms, and subject to the conditions, set forth in this Covenant.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Lender agrees as follows:

1. *Covenant Not to Sue*. Subject to Sections _ _[*e.g., 2, 3, 4*]_ _, Lender, for itself and its affiliates, agents, directors, employees, members, officers, parents, partners, stockholders, and subsidiaries, and their respective successors and assigns, forever covenants not to sue Borrower or Guarantor, or their respective accountants, affiliates, agents, attorneys, directors, employees, members, officers, parents, partners, representatives, stockholders, or subsidiaries, or their respective successors and assigns, regardless of whether such suit would be in law, in equity, or otherwise, in connection with the Loan or the Loan Documents, provided, however, that (a) the Loan and the Loan Documents are not cancelled, discharged, terminated, or deemed paid; (b) Lender reserves all of its rights and remedies under the Loan Documents and applicable law in, to, and against the collateral described in the Loan Documents (including the Property), including the right to continue or commence any action (including a judicial or nonjudicial foreclosure action) that Lender considers necessary or desirable to protect or enforce its rights in and to such collateral and may maintain or join Borrower as a party thereto for such purpose (although Lender covenants not to enforce any *in personam* judgment obtained by Lender against Borrower in any such action); and (c) Lender reserves the right to implead Borrower and Guarantor in any action in which a claim is made against Lender in connection with the Loan, under the Loan Documents, or with respect to the collateral described therein (including the Property), including Lender's right to contribution and indemnity against Borrower and Guarantor in any such action.

2. *Reinstatement.* If any court of competent jurisdiction shall at any time cancel, void, nullify, rescind, or set aside any payment or transfer made to Lender pursuant to the Agreement for any reason whatsoever and shall

require, whether by order, judgment, declaration, or otherwise, Lender to repay or retransfer all or any part thereof to Borrower or Guarantor or to any trustee, receiver, or custodian thereof, then, notwithstanding any rule of law or equity or agreement of the parties to the contrary, and without any notice or action by Lender or any other party, (a) all documents and instruments executed and delivered pursuant to the Agreement, including this Covenant, shall be void *ab initio;* (b) the Loan Documents shall continue in full force and effect with regard to the individual liability of Borrower and Guarantor; and (c) Lender shall be entitled to enforce its rights and remedies with respect to all obligations and liabilities of Borrower and Guarantor owed or owing to Lender as though this Covenant had not been executed, whether under the Agreement, the Loan Documents, or otherwise.

3. *Certain Obligations Not Affected.* This Covenant shall not in any manner release, discharge, impair, or otherwise affect the obligations of Borrower or Guarantor under the "Environmental Indemnity" (as defined in Exhibit _ _[*specify*]_ _), the Agreement, or any of the documents or instruments executed and delivered pursuant to the Agreement, and Lender reserves each and every claim, cause of action, and all other rights and remedies Lender may now or hereafter have thereunder or with respect thereto.

4. *No Covenant Not to Sue Third Parties.* This Covenant shall not in any manner release or discharge any other party that is or may be liable to Lender in connection with the Loan, the Loan Documents, the Property, or otherwise, and Lender reserves each and every claim, cause of action, and all other rights and remedies Lender may now or hereafter have against any such third party with respect thereto (including any such claim, cause of action, or other rights against any tenant of the Property).

[Add miscellaneous provisions similar to those in §10.23A]

IN WITNESS WHEREOF, Borrower, Guarantor, and Lender have executed this Covenant Not to Sue as of the day and year first above written.

BORROWER:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

GUARANTOR:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

LENDER:

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: In consideration for the transfer of the property from the borrower to the lender (or buyer) under a deed in lieu, a borrower might negotiate from the lender a covenant not to sue in favor of the borrower and guarantor. See Paragraph 2.3.5.7 of form in §10.31.

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2. Construction Loan Workouts

a. When Lender Takes Title During Construction

§10.33 (1) Borrower Assists Lender in Completion

There may be circumstances incident to a defaulted construction loan that would make it mutually advantageous for the parties to enter into a workout agreement under which the lender acquires title to the property (by nonjudicial foreclosure (see chap 2) or by deed in lieu (see chap 7)) and commits to completing construction and marketing the project and under which the borrower renders services to the lender in accomplishing these objectives for an agreed-on compensation (which could be contingent on the project's making a profit). On using receiver to complete project, see §§10.16, 10.19, 10.36, 10.43.

Because nonjudicial foreclosure ordinarily precludes the borrower from entitlement to any postforeclosure profit realized by the lender in reselling the property (see *Smith v Allen* (1968) 68 C2d 93, 65 CR 153), the prospect for successfully negotiating such a workout will depend on whether the lender perceives some special benefit in keeping the borrower involved in the project. For example, the lender may believe that under the particular circumstances, because of the borrower's expertise or talents, the borrower's active assistance in completing construction or in marketing the project is essential if the lender is to maximize the chances for recouping its investment. Disputes between the parties may threaten the lender with costly litigation and potential liability, therefore commending such a workout as a way to settle the disputes. The lender may see a workout simply as a way to keep the borrower from filing for bankruptcy, which would have the effects of staying the lender's foreclosure and seriously delaying its ability to finish construction and market the project. On liability and insurance considerations, see §10.34.

CAUTION: Managing mid-construction workouts that involve the borrower is very difficult because it entails interaction with third parties such as government entities or contractors and sophisticated evaluation of risk and reward. Workout departments should be a profit center, but lenders have a history of selling at the lowest price because they are not able or willing to fund clean-up and staging costs and do not respond timely to sales offers. The receivership process (see §§10.19, 10.36; see also chap 6) may offer a more creative alternative than continued affiliation with the borrower.

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§10.34 (2) Liability and Insurance Considerations

A construction lender that takes title to the property after default may face serious negative consequences. Regardless of whether the property is a commercial building or a residential complex, the lender may face subsequent lawsuits for defective construction that results in personal or property damage if the lender held title for a period of time, and particularly if the lender performed any completion work or remedial or repair tasks while holding title. Defective construction may manifest itself in a variety of ways. For example, a lawyer representing a personal injury claimant who was injured when a portion of the building was displaced and fell on him would likely file suit against all owners who held title at any time during construction of the premises. See California Construction Contracts, Defects, and Litigation §13.1 (Cal CEB 2008). Additionally, the date of defective construction that causes injury or damage may be difficult if not impossible to precisely establish.

Construction defect claims by subsequent purchasers can also result in liability to the lender whether in a commercial or residential context. The lender could be strictly liable after assuming and concluding construction and then selling a residential property, whether single-family homes or high-rise condominiums. See Const Contracts and Defect §11.33. The requirements involved in monitoring and engaging in such construction is beyond the scope of this chapter; however, it is critical that the lender obtain specific insurance that covers construction defects. Lenders typically do not carry such insurance because they are not directly involved in construction projects. In the case of a residential project, it is also necessary to acquire and carry coverage as a "tail" policy for at least 10 years from completion to ensure that the maximum statute of repose under CCP §337.15 is covered. For further discussion regarding the role of insurance in construction, see Const Contracts and Defect, chap 12.

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§10.35 (3) Completion by Single-Purpose Entity

After taking title, a lender may decide to complete and sell the project through the use of a separate subsidiary, typically by forming a single-purpose entity for construction and sale of the project. Liability protection through a single-purpose entity can be accomplished if it is adequately capitalized and insured during construction and if, after sale and disbursing the net sales proceeds back to the lender (or buyer as the case may be), there is sufficient insurance that remains in place until the expiration of the applicable statute of repose, which may extend for as long as 10 years. See CCP §337.15.

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§10.36 b. When Receiver Takes Possession and Completes Project

Lenders may prefer to avoid any indicia of a joint venture with the borrower (see §10.33) because of the potential conflicts involved in accounting for profits and the management of the workout with a borrower who already has failed once. It may be more advantageous for the lender not to take title or possession directly and to instead request as part of the workout a stipulation for the appointment of a receiver to manage the project's completion and sale. See §§10.19, 10.45-10.50. The cost of this process must be assessed according to the magnitude and nature of the project and must be weighed against the potential benefits.

NOTE: In a stipulated receivership, title remains in the name of the borrower until a sale or foreclosure. The receiver is an officer of the court protecting the lender's security and, in theory, the borrower's equity after loan payoff. See CCP §§564-570.

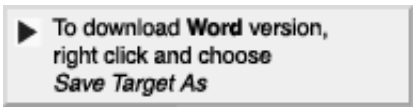
A lender must make an early decision on whether to take responsibility for the asset management and development of the property. The borrower is ordinarily in that business, which requires different skill sets, and the lender is usually not. Also, after the lender takes direct control of the project, it becomes the "deep pocket" for local governmental agencies' fees and requirements, which can affect the economic viability of the project. The lender may be further obligated to homeowners associations, co-owners in common interest developments, purchasers of the ultimate project or portions thereof, and other potential claimants.

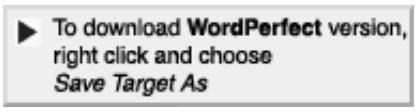
The potential of liability for construction defects also requires the lender to obtain additional (and generally costly) insurance with tail coverage. See §10.34. Lenders must also be sensitive to being the "deep pocket" when completing the project. As a party in the chain of construction, a lender may face liability for defective construction that occurred on its "watch." Since the timing of many areas of construction is difficult to establish, a lender will at a minimum be drawn into litigation. See §10.34.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.37 c. Checklist: Issues to Consider in Drafting Workout

§10.37 c. Checklist: Issues to Consider in Drafting Workout





Each problem construction loan presents its own special set of issues and challenges. Therefore, each workout agreement must be carefully customized to deal with all current problems relating to the project and to try to anticipate all contingencies that may beset the workout as it is implemented. Although the contract provisions that may be necessary or desirable to protect each party's interest can vary widely in each situation, the following issues commonly arise in negotiating and drafting a workout agreement.

- (1) Whether the lender will take title, and if so, whether by a deed in lieu or by nonjudicial foreclosure, and if the latter, the extent of the lender's obligations to bid at such sale.
- (2) The extent of the lender's obligations to complete construction and implement a marketing program, and whether the lender will install a receiver or take assignments or assume any existing construction or marketing contracts.
- (3) The preparation and handling of a line item budget and a mechanism to approve construction draws, and the review and comparison of active and budgeted expenses.
- (4) The handling of any unpaid bills arising from the borrower's construction of the project to date, including agreements for disposition of any undisbursed funds in the construction loan account and for handling any pending and threatened mechanics' lien and stop notice litigation.
- (5) The extent of the borrower's obligations to render services in implementing the proposed workout and the amount of compensation to be paid for those services.
- (6) Whether the lender will exonerate, or retain rights against, the borrower's guarantors and any others who could obtain reimbursement or indemnity from the borrower in connection with the project.
- (7) The substance of any agreements relating to the price and other terms for which the lender may sell the project or individual lots or units in the project.
- (8) The substance of any obligations of the lender to provide financing to a buyer of the project or buyers of individual lots or units in the project or, if there are existing third party lender commitments for such purposes, the assignment of such commitments to the lender.
- (9) The substance of the parties' agreements for disposition of the proceeds and profits from selling the project, including definitions of the relevant concepts involved and any provisions for interest, fees, or other compensation payable to the lender.
- (10) The effect on the workout agreement of any subsequent court order that prevents or delays the lender's acquiring title to the project or that prevents or impairs the lender's ability to complete construction or to market the project.
- (11) What provisions are included for releasing the lender from liability to the borrower for the lender's past acts in connection with the loan transaction.
- (12) Additional insurance for construction defects. See §10.34.

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d. Construction Workout Agreement: Selected Clauses

§10.38 (1) Form: Provision for Lender to Bid at Foreclosure Sale

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Lender will duly schedule a trustee sale under its deed of trust on or before _ _[*date*]_ _. At the sale, Lender will make a beneficiary's credit bid in the amount of the total indebtedness secured thereby as of the date of sale (the "Secured Debt"). Borrower agrees that as of the date of this agreement the following is a true and correct statement of the total indebtedness secured by the deed of trust and the particular items of indebtedness:

[*List each item of indebtedness and its dollar amount*]

Lender will not be obligated to make any bid at the trustee sale in excess of the Secured Debt. If anyone other than Lender is the successful bidder at the trustee sale for a price in excess of the Secured Debt, this agreement, including all of Lender's remaining obligations under it, shall terminate.

Comment: If the workout is premised on the lender's acquiring title to the mortgaged property, the agreement should obligate the lender to proceed with its foreclosure. If it is agreed that nonjudicial foreclosure of the lender's deed of trust will be the method for acquiring title, the extent of the lender's obligation to bid at the trustee sale should be defined. Because the lender may not "credit-bid" at the sale in excess of the amount of the secured debt, the lender will want to limit its obligation to that amount. See CC §2924h(b). In calculating the amount of the secured debt for this purpose, consideration should be given to any unapplied credits with respect to the loan then held by the lender (such as impounds or undisbursed construction loan proceeds).

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§10.39 (2) Form: Provision for Handling Unpaid Construction Bills

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Borrower represents and warrants to Lender that there are no undisputed unpaid bills or disputed monetary claims for labor, material, or equipment furnished to date to the construction project on the Property, except for:

[*List unpaid bills and disputed claims*]

The parties intend that the undisbursed funds in the construction loan account for the loan (the "Fund"), which are held by Lender, shall constitute a source from which such disputed unpaid bills and disputed claims (the "Claims") shall or may be paid, subject to the following conditions: After _ _[*Lender/Special-Purpose Entity*]_ _ acquires title to the Property, _ _[*Lender/Special-Purpose Entity*]_ _ shall pay those Claims that _ _[*Lender/Special-Purpose Entity*]_ _, in its sole discretion, is satisfied are due and owing in the amount claimed; in this connection, Borrower shall furnish to _ _[*Lender/Special-Purpose Entity*]_ _ any documents and information as may be reasonably requested by _ _[*Lender/Special-Purpose Entity*]_ _ to enable it to determine the merits of the Claims. As to each Claim that remains disputed, or as to the merits of which _ _[*Lender/Special-Purpose Entity*]_ _ is dissatisfied, _ _[*Lender/Special-Purpose Entity*]_ _ in its sole discretion may seek to compromise such Claims or may seek to have them determined through litigation (which _ _[*Lender/Special-Purpose Entity*]_ _ may prosecute or defend in the name of the Borrower); and as such Claims are compromised by _ _[*Lender/Special-Purpose Entity*]_ _ or determined by court judgment, as the case may be, Lender may or shall pay them in accordance therewith from the Fund. Borrower will cooperate with _ _[*Lender/Special-Purpose Entity*]_ _ in its efforts to negotiate and effect any such compromises and in its conducting, defending, or settling any such litigation. References in this agreement to any litigation proceeding or to any order or judgment rendered in connection therewith will be deemed to include any arbitration or other binding dispute resolution proceedings that may be conducted in lieu of judicial litigation pursuant to contract, agreement of the parties, or court order, and to any awards, orders, and judgments rendered in connection therewith.

Any sums remaining in the Fund after payment of the Claims shall be disbursed as follows: first, to reimburse _ _[*Lender/Special-Purpose Entity*]_ _ for its attorney fees and other expenses incurred in compromising and litigating the Claims; and second, to _ _[*e.g., future costs of construction, marketing, and sale of the project*]_ _. The foregoing agreements are made solely for the benefit of the parties to this agreement, and no third parties, including any of the owners or holders of the Claims, shall acquire or have any right or interest in the Fund or any right of action against the Lender by reason of the foregoing agreements on the Fund and the Claims.

Comment: One of the main inducements for the borrower to enter into a workout agreement is to facilitate and effect payment of any unpaid construction bills on the project. Undisbursed funds in the construction loan account are an obvious source of funds for doing so. If the lender wishes to retain or earmark for use in the workout any funds left in the account after it has been used to pay such unpaid bills and the lender's expenditures, then the lender should obtain the borrower's agreement that the lender may underbid the secured debt at the trustee sale by at least the anticipated maximum amount of the remainder. Alternatively, the lender could credit its loan with the funds left in the construction loan account before acquiring title to the mortgaged property and agree, as part of the workout, to pay for any prior unpaid construction bills up to a specified maximum. An advantage of recordation of the construction lender's deed of trust before commencement of construction is to protect the lender from mechanics' liens of contractors, subcontractors, and suppliers. See §§12.155-12.159. In a lender's foreclosure, mechanics' liens that are junior to the construction loan are eliminated. See §§2.99, 9.54, 9.64. If the lender took adequate steps before making the loan to ensure its priority over potential mechanics' liens, after a foreclosure by a credit bid the lender has no incentive to pay off those unpaid construction bills that accrued before the workout. On construction lenders' priority rights in relation to mechanics' liens, see California Mechanics' Liens and Related Construction Remedies, chap 11 (3d ed Cal CEB 1998).

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§10.40 (3) Form: Provision Defining Borrower's Role in Workout

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After Lender's acquisition of title to the Property and during the term of this agreement, Borrower shall render the following consultative and other services to Lender, as requested by Lender and under the direct supervision and control of Lender, in connection with completion of the construction project currently in progress on the Property and marketing the _ _[*lots/units*]_ _ to third party buyers:

(1) Assist Lender in committing existing contractors and suppliers to the construction project to continue to perform the remainder of their contracts, in recruiting new contractors or suppliers for the project, and in supervising those contractors' work and in reviewing and approving their requests for payment;

(2) Assist Lender in compromising any unpaid construction bills and other disputed monetary claims against the Property arising from the construction, and in prosecuting or defending any litigation arising from the construction; and

(3) Assist Lender to develop a marketing program for the lots (or units) in the Property and to coordinate and supervise the promotion, advertising, and sale of the Property.

Borrower shall diligently devote as much of its time and effort to rendering the above-described services as may be reasonably necessary and required to accomplish the stated objectives, for which Borrower shall receive no compensation other than that provided in this agreement. In rendering these services, it is understood that Borrower is and will be acting as an independent contractor and not as a joint venturer of, or in any associative capacity whatsoever with, Lender or as one having any right, title, interest, or equity whatsoever in the Property or any portion of it.

Comment: The borrower's precise obligations in implementing the workout will vary depending on what has to be done and what capabilities and expertise the borrower possesses. Especially when the borrower's compensation is to be a share of the project's profit or is contingent on the existence of profits, the lender should insist on a provision characterizing their workout relationship as that of owner (lender) and independent contractor (borrower). Despite that characterization, any relationship with a profit-sharing provision might be viewed, from a third party standpoint, as a joint venture, which increases the risk of liability for the lender to third parties. Consequently, getting the borrower out of the project and having a receiver or a special-purpose entity manage project completion should be considered, especially if cost effective. See §§10.33-10.36.

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§10.41 (4) Form: Provision for Determining Proceeds and Profits of Workout

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"Realized proceeds of sale" shall mean the revenues received by Lender after all sales of _ _[*lots/units*]_ _ in the Property that are completed by Lender within _ _[*number*]_ _ months after Lender has acquired title to the Property as contemplated by this agreement. Such revenues shall include not only cash received on completion of all sales but also the principal amount of any purchase money deed of trust loans made by Lender to buyers in order to facilitate those sales (but not including payments received by Lender on the loans).

Realized proceeds of sale as defined above shall be paid to Lender until Lender has received the total of the following amounts:

(1) The amount for which the Property was purchased by Lender at the trustee sale under the deed of trust securing the loan;

(2) The amount of all expenses of ownership and sale of the Property incurred by Lender as defined below; and

(3) Interest calculated monthly at the rate of _ _[*e.g., 8 percent*]_ _ per annum on the total amounts of (1) and (2) above, then unpaid, the interest to be computed on the amount of (1) above from the date of the trustee sale and to be computed on amounts of (2) above from the dates of payments of the respective expenses so incurred.

For purposes of (2) above, expenses of ownership and sale of the Property include any and all costs and expenses incurred by Lender in connection with the ownership, development, design, marketing, and sale of the Property and include, but shall not be deemed to be limited to, repair and completion of offsite and onsite improvements, supervision in connection with those improvements, furnishing and maintaining model homes, landscaping, utilities, guard services, advertising and other sale stimulants, broker and sales commissions, fire insurance, taxes, title insurance, escrow fees and other expenses of sale, payment of prior unpaid construction bills (whether disputed or undisputed), payment of other monetary claims and liens against the Property (or any lots or units on it) in order to make it marketable to buyers, and any attorney fees and other consultant fees and costs incurred in connection therewith or in connection with any litigation affecting the Property after Lender acquires title to it. Expenses of ownership and sale shall not include Lender's general overhead expenses.

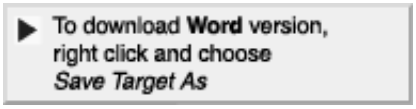
Amounts of realized proceeds of sale in excess of the amounts described in (1), (2), and (3) above, if any, shall be paid and disbursed as follows: _ _[*e.g., 30 percent*]_ _ to Borrower as compensation for Borrower's services to be rendered in connection with completion of construction and marketing of the Property following Lender's acquisition of title to the Property; and the remainder to Lender. Borrower acknowledges that this agreement is entered into by Borrower in full recognition that there may be no realized proceeds of sale, as above defined, in excess of the amounts provided to be paid to Lender.

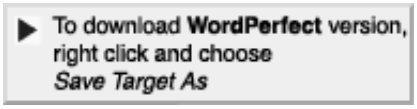
Comment: When the borrower's compensation is to be measured by a share of any project profits, the lender will invariably want to obtain an agreed-on termination date for the workout as of which revenues, expenses, and profits would be determined (even if the project is not completely sold by that time). Usually, the borrower will not resist agreeing to a termination date, particularly if the lender's investment will accrue interest during the workout, because any material delay in selling the project would probably eliminate the borrower's profit. See Comment to form in §10.40 and discussion in §§10.33-10.36.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.42 (5) Form: Provision Regarding Effect of Future Litigation on Workout

§10.42 (5) Form: Provision Regarding Effect of Future Litigation on Workout





This agreement shall terminate and cease to have any force or effect if (1) any court order is issued that (a) restrains or enjoins the nonjudicial foreclosure of Lender's deed of trust or (b) restrains or enjoins Lender from performing any act or thing that Lender is obligated or permitted to do under this agreement with respect to the Property or the Fund, and (2) such injunctive or restraining order is not dissolved within _ _[*e.g., 60 days*]_ _ after its issuance. This agreement shall also terminate and cease to have any force or effect if the trustee sale by which Lender shall have purchased the Property is invalidated for any reason.

Comment: Problem construction loans often result in lawsuits between the parties or by concerned third parties against the parties. The workout agreement should thus consider the possibility of litigation that results in provisional relief or other orders disabling the parties, particularly the lender, from proceeding with the workout.

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IV. REMEDIES: LENDER'S CONSIDERATIONS

§10.43 A. Enforcement of Assignment of Rents Through Receivership

As will almost always be the case, the loan documents will contain an assignment of the rents generated by the real property security, either through an assignment of rents provision in the deed of trust or by a separate assignment of rents agreement delivered to the lender. One of the first issues the lender must address, once it has been determined that a workout will not occur and that foreclosure will be pursued, is whether to enforce the assignment of rents while the default and foreclosure are pending. Current CC §2938 and CCP §564, effective January 1, 1997, comprehensively amended and clarified California law governing assignments of rents and their enforcement. Although prior law, which was inconsistent and unsettled on the issues of perfection and enforcement, may still apply to assignments of rents made prior to January 1, 1997, the amendments substantially clarified the rules for assignments of rents made after that date and should be reviewed even in connection with the enforcement of pre-1997 assignments. See chap 6 for comprehensive discussion and sample forms for enforcement of assignments of rents.

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§10.44 B. Necessity for Lender's Underbid at Foreclosure Sale

When a receiver has been appointed to collect rents as additional security for repayment of the debt owed to a lender, the lender is entitled to such rents only to the extent that the debt is unpaid. See *Eastland Sav. & Loan Ass'n v Thornhill & Bruce, Inc.* (1968) 260 CA2d 259, 66 CR 901. See also §§2.61, 2.82, 2.107, 6.46. Accordingly, if the secured debt has been satisfied, either by the amount bid at a trustee sale or otherwise, the lender will cease to be entitled to rents held by the receiver.

Even if the lender has failed to underbid with regard to the unpaid principal balance and interest, there may be unpaid late charges, attorney fees, or other monetary obligations of the debtor, which can support the lender's entitlement to rents collected by a receiver.

See discussion of underbidding in §§2.87, 10.63-10.64.

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§10.45 C. Enforcement of Construction Lender's Right to Complete Construction by Taking Possession Through Receiver

A loan default may occur while the borrower is in the process of constructing improvements on the real property under a construction loan agreement with the lender. Thus the financial outcome of the loan transaction from the lender's perspective may largely depend on the lender's ability to complete the improvements. Under the authority of CC §2927, many construction loan agreements and workouts contain provisions authorizing the lender or a receiver to complete improvements in the event of a default. See discussion of lender's right to obtain receiver to complete construction and forms involved in doing so in §§10.19, 10.36, 10.46-10.50.

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§10.46 1. Right to Obtain Court-Appointed Receiver to Complete Improvements

Because a typical lender lacks the expertise to complete construction of unfinished improvements, and because of the potential for lender liability claims in the event construction is not completed according to the original plans and specifications and within the originally allocated time period (see §§10.19, 10.36), a lender is unlikely to want to become a mortgagee in possession of an incomplete construction project and will more likely seek to have a receiver complete the project. The right of the lender to obtain appointment of a receiver to complete improvements usually depends on one of two factors:

(1) Whether the mortgage loan contract, including any ancillary construction loan agreement, authorizes the appointment of a receiver for this purpose; and

(2) Whether completion of the improvements pending completion of foreclosure is necessary to preserve or protect the value of the real property security.

Generally, a receiver may, with court permission, do anything with the assets of the receivership estate that the owner could have done. *Pacific Ry. v Wade* (1891) 91 C 449, 455, 27 P 768. Accordingly, although there are no cases specifically on point, there seems to be no reason a receiver could not be appointed to complete improvements on real property hypothecated as security for a loan when the loan contract so authorizes. But without this authorization, the lender probably must establish that completion of construction is necessary to protect and preserve the security. CCP §564(b)(2). See *Raynor v Drew* (1887) 72 C 307, 311, 13 P 866. See also §6.15.

Typical loan documents detail the powers and rights of the lender to take over the project and complete it after a default of the borrower. However, few lenders exercise these powers and rights directly. The presence of these powers and rights (see §10.47), combined with a well-drafted receivership order (see §10.48), should enable the receiver to complete the project without having to seek court authority for other issues that arise during the course of a construction project.

Almost invariably, the receiver will have to borrow money to complete the improvements. Usually, the only source of funds is the lender, who can be authorized by the court to lend money to the receiver in consideration of the receiver's issuance of a receiver's certificate. The extension of credit by the lender to the receiver can be made the equivalent of a secured advance to the underlying loan. See form certificate in §10.49.

For additional lender strategies, especially if mechanics' lien and stop notice claims arise from the construction project, see California Mechanics' Liens and Related Construction Remedies, chaps 10-11 (3d ed Cal CEB 1998).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/10 Workouts of Problem Loans/ §10.47 2. Form: Clause in Construction (Building) Loan Agreement Authorizing Lender or Receiver to Complete Improvements

§10.47 2. Form: Clause in Construction (Building) Loan Agreement Authorizing Lender or Receiver to Complete Improvements

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1. Should work cease on the Improvements, or for any reason whatsoever not progress continuously in accordance with the construction schedule approved by Lender, as determined by Lender in its sole discretion, then Lender may at its option and in its sole discretion, without notice, declare Borrower to be in default under this agreement. On declaration of default or on Lender's declaration of any other default in Borrower's obligations under the loan agreement, the deed of trust, or the other loan documents, Lender is authorized either by itself or by its agents or by a receiver appointed by a court of competent jurisdiction (hereinafter collectively referred to as "Lender") to enter into and on and take and hold possession of any portion or all of the real property or the Improvements, whether real or personal, and exclude Borrower and all other persons therefrom. Thereupon Lender may do one or more of the following acts:

(a) Use, operate, manage, control, insure, maintain, repair, restore, and otherwise deal with all and every part of the real property or the Improvements, and conduct business thereat.

(b) Take possession of all materials, supplies, tools, equipment, construction facilities, and appliances located on or about the real property or the Improvements and perform any and all work and labor necessary to complete the construction of the Improvements or to operate and maintain the project in accordance with the plans and specifications approved by Lender and any agreements relating to the real property and the Improvements existing at the time Lender enters into possession. All sums expended in so doing, whether or not in excess of the maximum amount of the loan, together with interest on such total amount at the default rate set forth in the note, shall be repaid by Borrower to Lender on demand and shall be secured by the loan documents.

(c) Employ security guards to protect the project.

(d) Make alterations, additions, renewals, replacements, and improvements thereto and if required by the plans and specifications or any agreements relating to the real property or the Improvements.

(e) Exercise all rights and powers of Borrower with respect thereto and pursuant to or under the plans and specifications or any agreements relating to the real property or the Improvements, whether in the name of Borrower or otherwise, including the right to make, cancel, enforce, or modify the plans and specifications or any other such agreements, obtain and evict tenants and other persons, and demand, sue for, collect, and receive all earnings, revenues, rents, issues, profits, and other income (Receipts) from the project, and every part thereof.

(f) Apply the Receipts to the payment of the Indebtedness evidenced and secured by the loan documents in accordance with this loan agreement, after deducting therefrom all expenses (including attorney fees and costs and expenses) incurred in connection with the aforesaid operations and all amounts to pay the taxes, assessments, insurance, and other charges in connection with the project, as well as just compensation for the services of Lender and its counsel, agents, and employees in connection with exercising the foregoing rights and remedies.

2. Borrower hereby authorizes, ratifies, and approves all that Lender and its agent and employees may do by virtue of the actions permitted in the above paragraph 1 and its sub-paragraphs.

3. Borrower irrevocably appoints, designates, empowers, and authorizes Lender as Borrower's agent, which agency is coupled with an interest, and is therefore irrevocable, to sign and file for record any notices of completion, notices of cessation of labor, or any other notice or written document that Lender may deem necessary to file or record to protect its interests.

4. Additionally, Borrower specifically agrees that Lender may, in its sole discretion, apply, *ex parte* and without notice to any person, for the appointment of a custodian, receiver, liquidator, or conservator of the project, without regard for the adequacy of the security for the indebtedness evidenced and secured by the loan documents.

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§10.48 3. Form: Provision in Order Appointing Receiver Authorizing Completion of Improvements

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The Court finds that this is a proper case for the appointment of a receiver, that the appointment of a receiver to exercise all the powers and authorities hereinafter granted to the receiver is necessary to protect and preserve the real property security and other security for plaintiff's subject loan to defendant, that plaintiff has no adequate legal remedy at law regarding the security, and that, unless such relief is granted as requested, plaintiff may be greatly and irreparably injured; good cause appearing therefor,

IT IS ORDERED that:

1. _ _[*Name*]_ _ is appointed as receiver in this action;

2. The receiver shall enter into possession of, and hold, occupy, preserve, and protect the real property legally described in plaintiff's complaint in this action and all personal property located in and on the real property and may perform such acts and do such things as are reasonable and necessary for such purposes, including without limitation the exercise of each and every one of the powers and rights accorded to Lender under the loan documents in connection with the completion of the Improvements;

3. Provided that the receiver can borrow sufficient funds to defray the costs of the following described construction work, and subject to prior approval and further order of the court, the receiver shall:

(a) Proceed to have done all or a portion of the work necessary to complete construction of the Improvements in the process of being constructed on the real property, as described in the plaintiff's complaint in this action, and do all things necessary and incidental to completion;

(b) Assume or enter into construction and other contracts for furnishing services, work, labor, and materials to complete the project; and

(c) Issue receiver's certificates to evidence the borrowing of funds to defray the costs of completion.

4. Within 30 days after the date of this Order, the receiver, on ten (10) days' notice by the receiver to all parties appearing in this action, shall personally appear before this court and report his or her findings to the court on the following matters:

(a) The extent of completion and physical condition of such partially completed Improvements and their susceptibility to deterioration or damage if work necessary to complete their construction is not commenced within a reasonable time;

(b) The estimated cost to complete such Improvements;

(c) The construction contracts available to the receiver to complete the project; and

(d) Whether, and to what extent, the receiver can borrow funds to defray the costs of completion.

Comment: When a receiver is appointed to complete improvements, the order of appointment should specifically authorize the receiver to do each of the acts required for that task, including borrowing money to pay for the costs of the required labor and material, entering into construction and other contracts, and issuing receivership certificates to evidence the indebtedness arising from the borrowing. This form primarily addresses the receiver's obligations and rights regarding completion of construction. There are additional aspects of a receivership that are better understood if they are either specified in the initial order making the appointment or stated to be subject to further order of the court,

including (1) the formula for calculating the receiver's compensation, (2) when and from what funds the receiver is paid for its fees and expenses, (3) a schedule for periodic accounting reports, and (4) whether the receiver has the authority to hire an attorney at its own expense or at the expense of the funds held by the lender. Some of these aspects are addressed in Judicial Council forms and the attorney-drafted forms in chap 6, which were designed for the appointment of a receiver to enforce an assignment of rents clause; they would have to be modified or rewritten for use in an order appointing a receiver to complete improvements.

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§10.49 4. Form: Receiver's Certificate for a Borrowing From Lender

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RECEIVER'S CERTIFICATE NO. _ _ _ _ _ _

$_ _[*dollar amount*]_ _, at _ _[*city*]_ _, California

_ _[*Date*]_ _

_ _[*Name*]_ _, the duly appointed, qualified, and acting Receiver in the above-titled action, promises to pay to the order of Plaintiff the sum of _ _[*spell out dollar amount*]_ _ Dollars ($_ _[*numerical dollar amount*]_ _), with interest at _ _[*interest rate*]_ _ percent per annum (which sum to the extent unpaid is hereinafter called "unpaid principal").

Unpaid principal and interest shall be payable by Receiver only from the proceeds of the within receivership, and, to the extent those proceeds are insufficient to fully pay the same (which insufficiency of proceeds is hereinafter called "the certificate deficiency"), Receiver shall have no personal liability for the certificate deficiency.

Portions of unpaid principal and interest may at any time and from time to time be repaid by Receiver to Plaintiff during the period of this receivership, provided that at the time of such payments Receiver holds cash (or cash equivalents) in a sum exceeding the accounts then payable and other current liabilities of Receiver.

The indebtedness evidenced by this Certificate shall be subject and subordinate to all administrative and operating expenses of this receivership. The amount of unpaid principal and unpaid interest of any certificate deficiency, however, shall be and constitute a part of the indebtedness secured by Plaintiff's deed of trust described in plaintiff's complaint on file in this action.

The obligations of Receiver hereunder are being incurred pursuant to the Court's "Order Authorizing Borrowing by Receiver," dated _ _[*date*]_ _.

Comment: A receiver's certificate is evidence of indebtedness by which a receiver becomes obliged to pay a debt out of the receivership estate and without personal liability. Court authorization is required to enable a receiver to issue receiver's certificates; the court giving such authorization may, in its discretion, provide that the certificates shall have priority over other liens on the receivership estate. *Title Ins. & Trust Co. v California Dev. Co.* (1915) 171 C 227, 231, 152 P 564; *Dorn & McKee v Crank* (1892) 96 C 381, 382, 31 P 528.

When the receiver borrows from the lender, there is likely to be no difficulty in obtaining the court's approval for interest to be charged on such borrowing at least at the existing loan contract rate. Unless the order specifies that the unpaid borrowing will be secured by the lender's deed of trust, the lender will have no security for its repayment and no other legal recourse for collection if the receivership fails to produce sufficient proceeds (after payment of all administrative expenses) to pay it.

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§10.50 5. Responsibilities for Payment of Net Deficit Operations of Receiver

Although receivership expenses are normally borne by the receivership estate, if the estate proceeds are insufficient, a question arises about who may be liable for those expenses.

The law on the issue appears to be conflicting. In *Meili v Crane* (1929) 102 CA 144, 146, 282 P 960, it was held that the parties for whose benefit the receivership was created would *not* be liable for receivership expenses when estate proceeds were insufficient, as long as the receiver was regularly appointed.

Other cases, including *Stanton v Pratt* (1941) 18 C2d 599, 603, 116 P2d 609, and *Ephraim v Pacific Bank* (1900) 129 C 589, 592, 62 P 177, indicate that the party for whose benefit the receivership was created may be liable for such expenses. In *Stanton*, the court said (18 C2d at 603):

> [T]he receiver looks primarily to the fund of which he was made the custodian for reimbursement of his expenses and for payment of his compensation. It was there said that if the fund be insufficient, he may then look to the parties at whose instance he was appointed. It may also transpire that liability to pay the expenses and fees of a receivership rests upon any or all of the parties for whose benefit the receivership was created.

Moreover, whatever the receivership law may be, a prudent receiver, when undertaking an assignment in which it is questionable whether the receivership estate will be sufficient to defray the expenses of administration, will require that the party for whose benefit the receiver was appointed agree in writing to pay for any shortfall.

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§10.51 D. Legal Actions by Construction Lender Against Borrower and Third Parties

The construction lender may have several other possible legal actions against the borrower and against third parties, including insurers. Some actions will also be available to a non-construction lender under certain circumstances. These possible actions are discussed in §§10.52-10.62. See also §§2.118-2.129. For further discussion, see California Mechanics' Liens and Related Construction Remedies, chap 11 (3d ed Cal CEB 1998).

Setoff of a borrower's deposit account is improper if the lender is on express or inquiry notice that the funds on deposit are funds intended for progress payments to subcontractors, unless the lender has a prior perfected security interest in the account. *Chang v Redding Bank of Commerce* (1994) 29 CA4th 673, 35 CR2d 64. Inquiry notice may generally be based on knowledge of the borrower's business. This principle seems particularly relevant to construction loans to owner-developers and to situations in which the lender finances both the owner and the general contractor. Note that such a setoff may also be subject to attack as a violation of CCP §726 (see §§4.6, 4.19), the consequences of which may be quite serious and may include loss of the security, loss of the debt, or both.

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§10.52 1. Actions on Personal Guaranties of Payment

The promissory note (or other written contract) may be accompanied by a personal guaranty to repay the loan. If so, when the borrower defaults on the note, the lender may proceed directly against the guarantor for a money judgment (assuming that the guaranty itself is not secured by real property; in that event, the lender must exhaust the security first or risk violating CCP §726; see *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, discussed in §§4.19, 4.27-4.28, 9.90-9.98).

Proceeding directly against the guarantor, however, is risky unless the lender has obtained applicable and adequate waivers of the guarantor's rights (see §§9.110-9.112). For example, if the deed of trust secures a recourse loan (as opposed to a purchase money or completely nonrecourse loan) and the lender did not obtain the necessary waivers, the lender risks exonerating the guarantor if it first completes a nonjudicial foreclosure. In that event, CCP §580d would bar both the lender and the guarantor from obtaining a deficiency judgment against the borrower. See chap 5. As a result, the lender's election to complete the nonjudicial foreclosure would prejudice the guarantor's rights and thereby exonerate it. See *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64. To preserve the guarantor's rights against the borrower, the lender must either foreclose judicially against the borrower or proceed first against the guarantor for a money judgment.

The *Gradsky* rationale does not, however, apply when the deed of trust secures a purchase money note (*Bauman v Castle* (1971) 15 CA3d 990, 93 CR 565), because in a purchase money situation, CCP §580b bars recovery of a deficiency judgment against the borrower (see chap 5). Thus, the fact that the lender has chosen to bring a nonjudicial foreclosure does not destroy any right of subrogation that the guarantor would otherwise have had against the borrower. The same principles apply to any fully nonrecourse loan. For extensive discussion of *Gradsky* principles, see chaps 5, 9. See also California Real Estate Finance Practice: Strategies and Forms, chap 6 (Cal CEB 2000).

In addition to avoiding the *Gradsky* estoppel defense, when enforcing guaranties, lenders must be cognizant of the other guarantor rights. See CC §§2787-2856. These defenses are waivable (CC §2856), and prior to instituting any action against a guarantor, the lender should review the waivers obtained from the guarantor to ensure that no steps are taken that may result in a partial or full exoneration of the guarantor. See §§9.110-9.112.

For example, in *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790, guarantors of nonrecourse construction loans argued that their guaranty obligations were more burdensome than the principal obligation and therefore unenforceable under CC §2809. Following *Bloom v Bender* (1957) 48 C2d 793, 313 P2d 568, the court concluded that this defense was waived, despite the absence of express waiver language, because the loan documents clearly evidenced the guarantors' understanding that their obligations "were completely separate from, and not affected by, the security provisions in the notes." *River Bank,* 38 CA4th at 1416. In so holding, the court rejected the express waiver requirements of *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420. See §9.111.

The *River Bank* court did, however, find that the "sham guaranty" defense may apply when the lender had structured the transaction to avoid the antideficiency protections afforded borrowers by requiring that a new entity be created to be the "borrower" and that the originally intended borrower become the "guarantor." 38 CA4th at 1420. See §§9.107-9.109 for further discussion of sham guaranties and other guarantor defenses. See also *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 1309, 37 CR3d 83, for discussion of the distinctions between guaranties and other forms of third party credit support.

Hidden guaranties are another concern that lenders must keep in mind. Hidden guaranties most commonly arise when a lender does not recognize that one or more of the putative borrowers is, as a matter of law, a guarantor. The statutory definition of a "guarantor" is "one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor." CC §2787; *Josephian v Lion* (1924) 66 CA 650, 660, 227 P 204; *Matthews v Hinton* (1965) 234 CA2d 736, 44 CR 692. Further, for a party to establish that it is a guarantor, it is not necessary for that party to show that the lender accepted it as a guarantor. CC §2832; *Wexler v McLucas* (1975) 48 CA3d Supp 9, 121 CR 453. See *Mead v Sanwa Bank Cal.* (1998) 61 CA4th 561, 71 CR2d 625 (execution of deed of trust by both borrower and guarantor does not shift burden of proof to guarantor to disprove lender's allegation that all trustors were

principal obligors). Accordingly, whenever multiple "borrowers" are involved in a transaction, the lender should evaluate whether any of the borrowers are guarantors. If so, and if guarantor waivers were not obtained (as is generally the case with unrecognized guaranties), the lender must carefully plan its enforcement steps to avoid exonerating the guarantor. See §9.94.

In general, although financial guaranties are referred to as "personal" guaranties, they are not personal with respect to the party to whom the guaranty is given and thus can be assigned without the guarantor's consent. *Champion Home Builders Co. v Sipes* (1990) 219 CA3d 1415, 269 CR 75.

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§10.53 2. Actions on Personal Guaranties of Completion

The construction lender may also choose to file an action on any personal guaranty of completion of the proposed improvements financed by the construction loan if the defaulting borrower has not completed them. See, *e.g., Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135 CR 802.

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§10.54 3. Actions in Tort

The lender may sue the borrower in tort for any tortious acts, such as diverting construction loan funds or committing waste or other tortious impairment of the security. See §§10.55-10.58.

WARNING: If a lender is foreclosing on the real property security and intends to pursue the borrower on a tort theory, proper bidding at the foreclosure is critical. For example, if the lender makes a full credit bid (see §2.84), it will limit its chances of collecting damages from the borrower. *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352; *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557; *Nippon Credit Bank v 1333 N. Cal. Blvd.* (2001) 86 CA4th 486, 103 CR2d 421. See §§2.84-2.87.

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§10.55 a. Fraud

When a borrower has misappropriated loan funds or submitted fraudulent disbursement requests, the lender should consider an action for damages based on fraud. *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135 CR 802. In addition to damages, the lender's other possible remedies in such an action might include an equitable lien or a constructive trust. If any of the lender's own employees were involved in the fraud, the lender should also consider claims on any fidelity bonds covering those employees. Fraud in the inducement may be evidenced by a diversion of construction loan funds or by other evidence. See, *e.g., Kass v Weber* (1968) 261 CA2d 417, 67 CR 876; *Stenzel v Kronick* (1928) 94 CA 327, 271 P 211. In this regard, it should be noted that the official California Judicial Council forms make the pleading requirements for all fraud actions in the state courts far less onerous than they were under such older cases as *Scafidi v Western Loan & Bldg. Co.* (1946) 72 CA2d 550, 165 P2d 260, or *Mason v Drug, Inc.* (1939) 31 CA2d 697, 88 P2d 929.

Actions for fraud are not expressly barred by CCP §580b. Also, CCP §726(h) expressly permits, with certain exceptions, an action for fraud despite the antideficiency statutes, CCP §§580a-580b and 580d. Under Fin C §§779 and 7460, lenders are also permitted, in certain situations, to sue for fraud. A lender's right to sue for fraud has been recognized in many reported cases. See *Guild Mortgage Co. v Heller* (1987) 193 CA3d 1505, 239 CR 59 (antideficiency statutes do not preclude action for fraud in inducement of loan); *Bell v Roy* (1986) 187 CA3d 694, 232 CR 83 (CCP §580b does not bar action to recover purchase money debt when debtor profits from scheme that causes beneficiary's deed of trust to become worthless); *Manson v Reed* (1986) 186 CA3d 1493, 231 CR 446 (CCP §580b does not bar suit when contract was fraudulently induced); *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co., supra* (CCP §§580b and 580d do not bar fraud action after trustee sale).

In *Lassar & Gross Int'l, Inc. v Dunham* (1987) 196 CA3d 496, 241 CR 854, the court permitted the purchaser of a second deed of trust to maintain an action following a trustee sale for fraud despite CCP §§580b and 580d. The court distinguished *First Fed. Sav. & Loan Ass'n v Lehman* (1984) 159 CA3d 537, 205 CR 600, saying there is a difference between a purchase money institutional lender that has taken a first deed of trust and one that purchased an existing second deed of trust. Among other differences, holders of first deeds of trust generally appraise the property and give themselves an equity cushion.

WARNING: If a lender makes a full credit bid, it will have no damages because the debt will be considered to have been paid in full. See §§2.86, 2.120, 10.54, 10.63.

If the lender acquires the property at the foreclosure, the lender may have additional claims based on its status as the owner as distinct from its status as a lender. In *Sumitomo Bank v Taurus Developers, Inc.* (1986) 185 CA3d 211, 217, 229 CR 719, the lender could not state a tort cause of action against the borrower because the lender had made a full credit bid. But since the lender had purchased the property at its foreclosure sale and was now the owner of the property, it could state a cause of action for negligent construction against the borrower that had built the condominium project at issue. 185 CA3d at 223. Although a lender that made a full credit bid will have no damages, when the lender is also the owner, claims that any owner would have should not be barred by a full credit bid.

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§10.56 b. Waste

Evidence of waste will support an action for damages suffered because of the waste. CC §2929. "Waste" consists of material acts or omissions of a possessor of land, which are actionable by anyone having an interest in the same land for the protection of the latter's reasonable expectation. *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557. In addition to damages, the lender may obtain injunctive relief in the same action to prevent future waste. *Jensen v Shadburne* (1956) 145 CA2d 624, 302 P2d 824. Waste may occur through a possessor's inaction as well as through affirmative behavior. This is particularly true when the improvements have been left exposed to the elements or to vandalism or when farmland is left unattended for long periods of time. See, *e.g., Hickman v Mulder* (1976) 58 CA3d 900, 130 CR 304.

The purchase money antideficiency provisions of CCP §580b do not bar an action by a lender for waste that was deliberate and in bad faith. *Cornelison v Kornbluth, supra* (dictum); *Nippon Credit Bank v 1333 N. Cal. Blvd.* (2001) 86 CA4th 486, 103 CR2d 421. See *Mills v Sdrawde Titleholders, Inc. (In re Mills)* (9th Cir 1988) 841 F2d 902. See also §2.119.

WARNING: Any successful bid at the foreclosure sale may result in the lender having little or no damages. Since the lender only has the right to have its debt repaid, to the extent that occurs, either by credit bid or a third party bid, the lender has suffered no damages. See discussion of *Cornelison v Kornbluth, supra,* in §§2.86, 2.119-2.120, 5.58. See also *Nippon Credit Bank v 1333 N. Cal. Blvd., supra*.

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§10.57 c. Dischargeability in Bankruptcy

Debts for fraud (11 USC §523(a)(4)) and for "willful and malicious injury" to property (11 USC §523(a)(6)) are not dischargeable in bankruptcy. Although debts for waste are usually dischargeable, they are not if the act of committing waste was willful and malicious. See *Aetna Life & Cas. Co. v Purk (In re Purk)* (1983) 28 BR 234. The lender should consider whether 11 USC §523 provides any other course of action that would result in a nondischargeable judgment debt.

Under the Bankruptcy Reform Act of 1994 (Pub L 103-394, 108 Stat 4106), postpetition condominium association dues are nondischargeable if the debtor occupied, or received rental income from, the unit during the assessment period. 11 USC §523(a)(16). See §11.45 for discussion of possible grounds to object to discharge of a real estate secured loan.

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§10.58 4. Third Persons' Tortious Impairment of Security

Although the doctrine of strict liability appears inapplicable (*United States Fin. v Sullivan* (1974) 37 CA3d 5, 17, 112 CR 18), the lender's standing to sue third persons (such as contractors and design professionals) for intentional or negligent impairment of the lender's security interest has long been recognized (*American Sav. & Loan Ass'n v Leeds* (1968) 68 C2d 611, 614 n2, 68 CR 453; *United States Fin. v Sullivan* (1974) 37 CA3d 5, 12, 112 CR 18; *Los Angeles Trust & Sav. Bank v Bortenstein* (1920) 47 CA 421, 190 P 850). In *United States Fin.,* the holder of a first deed of trust successfully sued various third party professionals (including a developer, a soils engineer, and a construction contractor) for negligence in connection with the construction of a residential tract after settling caused foundation failure and other damages. The lender-trustee was allowed to sue even though it had not first judicially foreclosed and obtained a deficiency judgment against the owner. See *Gentry Constr. Co. v Superior Court* (1989) 212 CA3d 177, 260 CR 421 (commercial plaintiff may maintain action for comparative equitable indemnity based on doctrine of strict liability).

If, however, the lender makes a full credit bid at a foreclosure sale, the debt will be extinguished and the lender will have no further recourse against the debtor or third parties. In *Duarte v Lake Gregory Land & Water Co.* (1974) 39 CA3d 101, 113 CR 893, the lender's rights under a deed of trust, and the clause assigning any damage awards, were extinguished because the lender bid the full balance due on the note.

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5. Contract Actions By or Against Issuers of Take-Out or Standby Commitments

§10.59 a. Standing to Sue

Major construction projects usually entail long-term lenders making loan commitments to the borrower that are designed to protect the interests of short-term construction lenders. Such long-term financing after completion of construction may be made to the borrower if the property is to be operated as income-producing or to third party buyers if the completed project is built to be sold off in units.

To minimize the risks inherent in construction financing, the construction lender typically requires its borrower to obtain a "take-out" commitment for new long-term financing from another lender (to be funded after completion of construction) or a "standby" commitment (under which another lender will agree to buy the construction lender's loan after completion of construction). In such instances, the borrower may be required to assign such a loan commitment to the construction lender. Sometimes, however, such arrangements take the form of a "three-way" agreement to be signed by the borrower and both lenders (a tri-party agreement). Similarly, a loan commitment issued to the borrower may express the parties' intent that the contract be made for the construction lender's benefit. Under such a commitment, the construction lender may sue for its breach as a third party beneficiary under CC §1559. A third party beneficiary need not be identified as such (or at all) in the contract as long as it can show that it is a person, or one of a class of persons, for whose benefit the loan commitment was made. See *Rexroth & Rexroth, Inc. v General Cas. Co.* (1966) 242 CA2d 363, 372, 51 CR 505. However, unless the permanent loan commitment expressly states that it is being made for the construction lender's benefit, it is doubtful that, under CC §1559, the construction lender would be able to directly enforce such a commitment as a third party beneficiary.

See generally Dewey, *Organizational Due Diligence in Real Estate Secured Loan Transactions: The Role of Lender's Counsel,* 16 Prob & Prop 10 (2002); Coscarelli, *The Construction Loan Agreement: Six Provisions Important to Lender's Counsel,* ABA Prob & Prop (2001) (http://www.abanet.org/rppt/publications/magazine/2001/01jf/jf01coscarelli.html); Shadur, *Avoiding Lender Liability at the Loan Commitment Stage,* 6 Prac Real Est Law 47 (1990); Williamson, *Loan Commitments and Agreements,* 59 Miss LJ 71 (1989). See California Real Estate Finance Practice: Strategies and Forms §6.9 (Cal CEB 2000) for discussion of buy-sell and tri-party agreements and their enforcement.

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§10.60 b. Remedies for Lender's Breach

The old rule of equity that a contract to lend money cannot be specifically enforced has been abolished by statute in California. See CC §§3384, 3390. Nevertheless, damages remain the traditional remedy for breach of a commitment contract, at least when the borrower fails to show that an award of damages would be inadequate under the circumstances (see, *e.g., American Bancshares Mortgage Co. v Empire Home Loans, Inc.* (5th Cir 1978) 568 F2d 1124). Damages may include lost profits (*Kissell Co. v Gressley* (9th Cir 1979) 591 F2d 47). In order to recover, the borrower must be able to show that it has satisfied all the conditions set forth in the loan commitment. See *Towers Charter & Marine Corp. v Cadillac Ins. Co.* (2d Cir 1990) 894 F2d 516 (judgment for lender entered in action for anticipatory breach of loan commitment when borrower had not furnished appraisal called for in loan commitment). Note that commitments to make loans in amounts in excess of $100,000 must be in writing to be enforceable. See CC §1624(a)(7). For further discussion of lender liability in loan commitment disputes, see chap 12. See also California Real Estate Finance Practice: Strategies and Forms, chap 6 (Cal CEB 2000).

The question of adequacy of legal remedy need not present an insuperable obstacle to awards of specific performance of loan commitment contracts because several troublesome questions may arise on how damages can be realistically measured in such contexts, given the commercial uniqueness of a particular loan commitment. See Anno, *Illegality as Basis for Denying Remedy of Specific Performance for Breach of Contract,* 58 ALR5th 387 (1998); Anno, *Promissory Estoppel of Lending Institution Based on Promise to Lend Money,* 18 ALR5th 307 (1994). When damages are not susceptible to accurate measurement (and the contract contains no liquidated damages provision) or do not realistically substitute for the promised performance, the remedy of specific performance is usually available. See California Real Property Remedies and Damages, chap 5 (2d ed Cal CEB 2002). See also Restatement (Second) of Contracts §360 (1981).

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§10.61 6. Actions on Performance Bonds

Typically, a construction lender will require that it be named, along with the borrower, as a beneficiary under a performance bond provided by the contractor. If so, the lender will have direct rights under the performance bond to require that the surety complete the project in accordance with the terms of the bond. Although no authority seems to be directly on point, a construction lender may even be able to show that it is a third party beneficiary of a performance bond under CC §1559. See, *e.g., Gordy v United Pac. Ins. Group* (1966) 243 CA2d 445, 52 CR 438; *C. O. Sparks, Inc. v Pacific Coast Paving Co.* (1958) 159 CA2d 513, 324 P2d 293. Even if the lender is not expressly named as a beneficiary in the bonding contract, it might be able to recover on the bond if the lender can show that it is one of a class of persons for whose benefit the contract was made. See *Rexroth & Rexroth, Inc. v General Cas. Co.* (1966) 242 CA2d 363, 372, 51 CR 505. The court's holding in *Commercial Standard Ins. Co. v Bank of America* (1976) 57 CA3d 241, 248, 129 CR 91, suggests that the construction lender is an intended third party beneficiary under such a bond; the bonding company was permitted to sue the lender for negligence in its disbursement of construction loan funds. Because the bonding company's damages were purely economic, the lender's "duty" in negligence must have been premised on the bonding company's status as a third party beneficiary under the lender's contract with the borrower. See *DeVoto v Pacific Fid. Life Ins. Co.* (9th Cir 1980) 618 F2d 1340, 1349 n8 (analyzing California cases on recovery of negligently caused economic loss as having involved factual situations "roughly similar" to those found in third party beneficiary cases). See also Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment,* 37 Stan L Rev 1513 (1985).

Assuming that the construction lender can show that it has standing to sue as a third party beneficiary under the bond, the lender's damages recoverable from the bonding company may include attorney fees incurred in litigation against the borrower. See *Boliver v Surety Co.* (1977) 72 CA3d Supp 22, 30, 140 CR 259.

WARNING: A lender must exercise caution in making a claim under completion or payment bonds. In so doing, the lender may step into the shoes of the owner and assume the owner's obligation to the contractors and become obligated to pay all sums due to the contractors, which may be a considerable sum depending on the status of construction. See *Commercial Standard Ins. Co. v Bank of America* (1976) 57 CA3d 241, 129 CR 91.

For further discussion on lender recovery under construction bonds, see California Mechanics' Liens and Related Construction Remedies, chaps 2, 10-11 (3d ed Cal CEB 1998).

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§10.62 7. Lender's Actions Against Title Insurer

The lender usually obtains title insurance in the form of a lender's policy insuring the validity and priority of the lender's deed of trust. Problem loans often give rise to lien priority disputes with junior lienors and mechanics' lien claimants. At the time a lender makes a claim for defense and indemnity under such a policy, issues may arise concerning the policy's validity or continued existence or concerning the extent of policy coverage for the claims. If coverage is unreasonably refused, the insurer may be liable to the lender-insured under a number of different theories. See California Title Insurance Practice, chaps 11-13 (2d ed Cal CEB 1997).

The decision in *Cale v Transamerica Title Ins.* (1990) 225 CA3d 422, 275 CR 107, illustrates that the protection afforded by title insurance may be significantly weaker than an insured lender might expect. In *Cale,* the insured lender discovered the existence of senior liens that were not disclosed by the title insurance policy. The title insurer first took the position that the insured had not suffered any damages covered by the policy because a foreclosure sale might make enough money to satisfy all the liens. After the insured lender acquired the property at a nonjudicial foreclosure sale, subject to the undisclosed liens, the title insurer continued to maintain that the insured had suffered no damages because a resale of the property might still satisfy all the liens, including the insured's indebtedness. When the insured sued the title insurer for breach of contract, the court agreed with the title insurer and granted summary judgment against the insured, finding that the insured had suffered no actual loss as of the time summary judgment was granted. But see *Karl v Commonwealth Land Title Ins. Co.* (1993) 20 CA4th 972, 24 CR2d 912 (loss under lender's policy measured at time of foreclosure sale; whether insured realized profit at resale with concessionary financing not relevant). For further discussion of the *Cale* and *Karl* decisions, see Title Ins §§6.43, 6.64, 6.67, 8.43-8.45, 11.10-11.14.

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E. Underbidding by Lender at Foreclosure Sale

§10.63 1. Potential Importance

There are numerous practical reasons why a foreclosing lender should consider underbidding (*i.e.,* bidding an amount less than the secured debt) at the trustee sale. Because a full credit bid extinguishes the lender's lien under CC §2910, the lender who does not underbid has very limited options for postsale damage actions. See §§2.80-2.87. In addition, to the extent that the debt has been satisfied by the successful bid, the lender cannot recover rents or insurance proceeds (*Track Mortgage Group, Inc. v Crusader Ins. Co.* (2002) 98 CA4th 857, 120 CR2d 228) or realize on other security for the loan (*Eastland Sav. & Loan Ass'n v Thornhill & Bruce, Inc.* (1968) 260 CA2d 259, 66 CR 901). See also §§10.44, 10.63.

When the loan agreement contains a so-called dragnet clause (a clause providing that the deed of trust will also secure other existing and future obligations of the borrower to the lender), underbidding may serve to increase the secured debt on another deed of trust loan to the same borrower—a particularly salutary purpose when that loan has a high loan-to-value ratio. See *Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549. But see *National Enters., Inc. v Woods* (2001) 94 CA4th 1217, 115 CR2d 37 (distinguishing *Union Bank v Wendland, supra,* questioning application of doctrine of merger to situations involving multiple deeds of trust and limiting application of dragnet clauses by strictly construing language of such clauses).

An underbid also preserves claims that the lender may have against persons secondarily liable (*e.g.,* guarantors) for repayment of the loan or for breaches by the borrower. See *White v Seitzman* (1964) 230 CA2d 756, 765, 41 CR 359. (But see *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64, discussed in §10.52, which ruled that a lender may not pursue the guarantor after foreclosure by a trustee sale unless the guarantor waived its subrogation rights against the borrower, which would otherwise be destroyed because CCP §580d would bar further recovery against the borrower. This is commonly referred to as the "*Gradsky* estoppel" defense, which arises from the indirect application of CCP §580d. See CC §2856.) The amount underbid may also be used as an offset in the lender's favor for any monetary liability that the lender might have incurred to the borrower relative to the loan transaction or, indeed, any other dealings between them. See *Nevin v Salk* (1975) 45 CA3d 331, 119 CR 370.

Finally, underbidding may also preserve claims under a lender's title insurance policies, which customarily provide that liability under the policy terminates on full payment of the insured loan. See *Paramount Props. Co. v Transamerica Title Ins. Co.* (1970) 1 C3d 562, 83 CR 394.

WARNING: For income tax purposes, absent clear and convincing proof to the contrary, the sales price of real property sold at a foreclosure sale is presumed to be its fair market value. Treas Reg §1.166-6(b)(2); *Community Bank v Commissioner* (9th Cir 1987) 819 F2d 940. On potential tax advantages of lender's underbidding at foreclosure sale, see §2.116-2.117.

Underbidding is not required for the lender to pursue certain postsale claims. In *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, the court allowed an action for fraud against third party nonborrowers who fraudulently induced the lender to make the loan even though the lender had made a full credit bid for the property at a trustee sale. In *Kolodge v Boyd* (2001) 88 CA4th 349, 105 CR2d 749, the lender purchased the property at a nonjudicial foreclosure sale and sued the appraiser who had made the foreclosure appraisal of the property, alleging negligence and negligent misrepresentation. The court held that even if a lender makes a full credit bid, the full credit bid rule announced in *Alliance* allows subsequent tort claims against third party appraisers who are not borrowers or successors in interest, provided the lender establishes that it reasonably relied on the misrepresentations of the value of the property when it entered its bid at the foreclosure sale. 88 CA4th at 377.

The court of appeal in *First Commercial Mortgage Co. v Reece* (2001) 89 CA4th 731, 108 CR2d 23, acknowledged that *Alliance* recognized that a full credit bid does not bar a claim by the repurchasing lender damaged by the repurchase of the foreclosed property when the loan was made and sold based on an inflated appraisal and false information. But see *Evans v California Trailer Court, Inc.* (1994) 28 CA4th 540, 33 CR2d 646 (lender who holds two

deeds of trust secured by same property and enters full credit bid at nonjudicial foreclosure of its senior obligation may not seek enforcement of other debt as "sold-out" junior, but is not barred from pursuing fraud and bad faith waste claims against borrower to extent of unsatisfied junior obligation). See also chap 5 regarding the effect of CCP §580d on a sold-out junior and the result when foreclosing lender holds both senior and junior trust deeds.

For discussion of bidding strategies at nonjudicial foreclosure sales, see §§2.80-2.87; Hansen, *Wielding the Two-Edged Sword: What Every Attorney Needs to Know About Real Property Secured Transactions* (2 parts), 22 CEB Real Prop L Rep 159 (July, Aug. 1999). For further discussion of postsale damage actions, see §§2.118-2.129.

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§10.64 2. Underbidding and Injunction Bonds

A lender's damage remedy is limited when pursuing relief against an injunction bond posted by a defaulting borrower to enjoin foreclosure (see chap 7) pending litigation against the lender. For example, in *Surety Sav. & Loan Ass'n v National Auto. & Cas. Ins. Co.* (1970) 8 CA3d 752, 87 CR 572, the lender, after the court ultimately decided that the borrower was not entitled to an injunction, successfully sued the borrower's surety for damages suffered as a result of the preliminary injunction. The lender attempted to prove damages resulting from a decline in the property's fair market value. The court of appeal held that "[a] decline in the market value of the security is material to a determination of damage only to the extent the decline affects the adequacy of the security to satisfy the obligation secured." 8 CA3d at 757. Damages owing to market value decline are measured as the difference between the amount of the obligation secured and the amount received from any foreclosure sale that actually occurs (rather than the difference between the amount of the obligation and the fair market value of the property at the time of the sale).

Because of this limitation on the damages, the lender's underbidding will not preserve its ability to recover any proven damages against a surety for an improvidently issued injunction.

California courts have evidently not decided the question whether California's antideficiency legislation may bar the lender's rights to recover from a borrower any damages suffered because of a wrongfully obtained injunction. (Because a surety under an injunction bond is not an obligor on the *secured loan,* it would seem not to be afforded protection under such statutes.) When an injunction is obtained through malice and without probable cause, a tort action for abuse of process arises. *Asevado v Orr* (1893) 100 C 293, 298, 34 P 777. Such actions should not necessarily be barred by CCP §580b or §580d. See *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557 (actions for tortious waste not barred by antideficiency provisions of CCP §580b). However, abuse of process (unlike waste) does not directly impair the lender's security. Thus, cases such as *Schumacher v Gaines* (1971) 18 CA3d 994, 96 CR 223, permitting an action for bad faith waste despite §580b, may not apply when a lender attempts to recover from a defaulting borrower who has raised the antideficiency statutes as an affirmative defense.

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V. REMEDIES: BORROWER'S CONSIDERATIONS

A. Reinstatement of Accelerated Loan

§10.65 1. Requirements of CC §2924c

In certain situations, borrowers may be able to use the right of reinstatement under CC §2924c(a)(1) to "de-accelerate" a loan. See §§2.51-2.61, 2.72. When a borrower has failed to make required monetary payments that are less than the full amount of the loan (*e.g.,* monthly principal and interest payments, taxes, insurance premiums), and the lender has accelerated the loan based on that failure, the borrower nevertheless has the right to reinstate the loan by paying only the amount in arrearage. CC §2924c(a)(1). The right of reinstatement continues until 5 business days before the date of the trustee sale (CC §2924c(e); see §§2.53-2.54), but the reinstatement period may be extended by contract (*Bank of America, N.A. v La Jolla Group II* (2005) 129 CA4th 706, 28 CR3d 825). Even if the beneficiary has made no advances on defaults that constitute recurring obligations (see §2.58), the beneficiary may require, before reinstatement, that the trustor provide written evidence that the amounts due on recurring obligations have been paid.

In effect, loan reinstatement requires payment of, among other things, all arrearages specified in the notice of default —possibly including claimed deficiencies in any construction loan account—and all sums becoming payable between the date on which the notice of default is recorded and the time of reinstatement. When the accelerated loan is a junior encumbrance, the reinstating borrower might also have to add any taxes and insurance premiums that were paid by the senior lender and added to the amount of the senior loan so as to avoid impairing the junior lien's security through enlargement of the senior lien. *Manning v Queen* (1968) 263 CA2d 672, 69 CR 734. If the junior lender has cured monetary defaults under the senior loan, as permitted by the terms of the junior loan, these amounts could also be added to the amount necessary to reinstate the junior loan.

Within 21 days of reinstatement, the beneficiary must deliver a notice of rescission to the trustee, which, after payment of all allowable fees and costs, the trustee must record within 30 days after receiving it. CC §2924c(a)(2).

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§10.66 2. Reinstatement Rights and Nonmonetary Defaults

Civil Code §2924c affords reinstatement rights only for defaults resulting from failures "to pay." Hence, it is arguable that nonmonetary defaults (such as those resulting from transfers that violate due-on-transfer clauses) are not governed by §2924c. In this respect, due-on-transfer clauses function differently from acceleration for nonpayment clauses. Under a due-on-transfer clause, the default is not the transfer itself; it is the borrower's failure to pay the entire debt as accelerated *because of the transfer*. Thus, it probably can be cured only by payment of the entire debt. In such a context, "reinstatement" is arguably meaningless. On enforcing due-on-transfer clauses, see chap 8.

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§10.67 3. Borrower Excused From Tendering Reinstatement

Situations may arise in which the borrower in default will be excused from performance (including tendering reinstatement) by virtue of the lender's conduct. For example, in *System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 98 CR 735, a judgment setting aside a trustee sale was affirmed when the evidence supported a finding that the lender's notice of default was defective because it did not specify whether the payment due was principal or interest and so "did not state the nature of the breach in such terms as would enable the debtor to determine what payment would have to be made in order to cure the breach and obtain reinstatement of the obligation." 21 CA3d at 153. In addition, the court ruled that the borrower was excused from performance by virtue of the lender's prior breach and that the lender was estopped from asserting any default by the borrower.

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B. Partial Releases While in Default

§10.68 1. Release Not Conditioned on Absence of Default

For property that is to be developed and sold in increments (*e.g.,* a residential subdivision), the deed of trust may contain a "partial release" clause, providing for the lender's release of the lien on a portion of the real property security in consideration for payment of a portion of unpaid principal. Whether defaulting borrowers will be able to successfully invoke such a clause during periods when they are in default depends on whether the deed of trust conditions the right to partial releases on the absence of default. For discussion of these clauses, see California Real Property Sales Transactions §9.100 (4th ed Cal CEB 2007). When the partial release is not conditioned on the absence of default, the borrower is entitled to a partial release despite the default, or at least to a return of his or her prior payments if no reconveyance is made. *Eldridge v Burns* (1978) 76 CA3d 396, 411, 142 CR 845.

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§10.69 2. Release Conditioned on Absence of Default

The borrower's rights are less clear when the particular release clause expressly conditions release on the absence of default. In such instances, the weight of authority, in California as elsewhere, seems to be that although no right to reconveyance can accrue while the borrower is in default, a default does not impair whatever rights have already accrued. *Conley v Poway Land & Inv. Co.* (1965) 232 CA2d 22, 28, 42 CR 636. However, the cases turn principally on the language of individual deeds of trust and not on independently existing equitable considerations. There appears to be no authority on the question whether a release clause, which purports to impair release rights accruing before default, is enforceable. However, dictum in *Conley,* based on an early New York case, suggests that literal enforcement of such a release clause does not work an inequitable forfeiture. 232 CA2d at 26.

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§10.70 3. Borrower's Remedies for Wrongful Refusal to Allow a Partial Reconveyance

When a lender wrongfully refuses to allow a partial reconveyance, the borrower may bring an action against the lender for specific performance of the release clause. Junior lienors are probably necessary parties in such actions under CCP §389. In any event, a borrower who seeks specific performance of a release clause against lenders should join all junior lienors, if only to avoid their later claims that the earlier judgment ordering partial release did not discharge a sufficient amount of the senior debt. *Blood v Munn* (1909) 155 C 228, 100 P 694 (bankrupt mortgagors, whose property was released from mortgage against their will on bankruptcy trustee's payment of $425 to mortgagee, were entitled to have released property's full value credited on mortgage debt).

In addition to decrees of specific performance, judgments for damages may also be obtained under appropriate circumstances, as when the borrower suffers lost profits because of the lender's wrongful retention of the security. See *Kissell Co. v Gressley* (9th Cir 1979) 591 F2d 47, 50.

The Subdivided Lands Act (Bus & P C §§11000-11200) requires that any lien encumbering an entire subdivision contain a release clause so the purchasers of the lots can take title free from the encumbrance. While noncompliance with the Act renders the purchase agreement voidable at the purchaser's option, the right to rescission does not extend to subsequent purchasers. *Drake v Martin* (1994) 30 CA4th 984, 992, 36 CR2d 704.

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§10.71 C. Borrower's Action to Enjoin Trustee Sale

Considerations in seeking a preliminary or permanent injunction to enjoin a trustee sale are discussed in §10.72, and lis pendens considerations are discussed in §10.73. For complete discussion of procedures for attacking a trustee sale, both to enjoin and to set aside a sale, and pleading forms, see chap 7.

Note that the trustor's right to a one-time, one-business-day postponement of a foreclosure sale, formerly provided under CC §2924g(c)(1), was eliminated. Stats 1992, ch 351, §4. On postponements and bankruptcy stays and their effect on reinstatement, see chaps 2, 11.

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§10.72 1. Obtaining Injunction

A trustor may seek to enjoin a foreclosure sale on a number of grounds, including any of the following:

- The lender has wrongly refused reinstatement;
- No default exists;
- Proper statutory procedures were not followed; or
- The lender is guilty of illegal acts such as predatory lending.

For detailed discussion of the grounds for seeking to enjoin a foreclosure proceeding, see chap 7. For comprehensive discussion of lender liability, see chap 12.

The trustor may seek to enjoin a trustee sale by filing an action or, if the lender has commenced a judicial foreclosure, by filing a cross-complaint in the pending action. In the event of trustee sale, the trustor will usually seek a temporary restraining order (TRO) and preliminary and permanent injunction against foreclosure. See chap 7 for discussion of procedures for obtaining injunction. In a judicial foreclosure, because the lender cannot foreclose until it has obtained a judgment of foreclosure, the trustor will usually seek only a permanent injunction (unless the lender has also commenced a trustee sale, in which case a TRO and a preliminary injunction would likely be needed). If a permanent injunction is awarded, the lender should request that the trustor's continuing performance of the secured obligation be a condition for that injunction.

In order to enjoin a foreclosure sale, generally, the trustor must unconditionally tender all undisputed amounts owed to the lender. In limited circumstances, the trustor is excused from the tender requirement. See §7.41 for detailed discussion of tender requirement.

Should the trustor ultimately lose the action to enjoin the foreclosure, the trustor may be liable to the lender for any damages resulting from the unwarranted injunction. See §7.55 for further discussion of trustor's potential liability.

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§10.73 2. Lis Pendens

The purpose of a lis pendens (also known as a notice of pendency of action) is to put all subsequent purchasers on notice of the plaintiff's claim, thereby protecting that claim from defenses interposed by bona fide purchasers without notice. See *Putnam Sand & Gravel Co. v Albers* (1971) 14 CA3d 722, 92 CR 636. The statute applies to "real property claims," the definition of which is sufficiently broad to permit a lis pendens to be recorded in connection with an action to enjoin a trustee sale. See CCP §405.4. The lis pendens statutes were substantially revised in 1992 to prevent perceived abuse of lis pendens to tie up property and thereby coerce a favorable settlement. See *BGJ Assocs., LLC v Superior Court* (1999) 75 CA4th 952, 89 CR2d 693. Even under the stricter standards of the new statutes, however, as long as interest is claimed in the real property (as opposed to in the proceeds from the sale), the filing of an action to enjoin a trustee sale should still involve a real property claim that would support recordation of a lis pendens. In actions to enjoin trustee sales, unless a lis pendens is immediately recorded, a problem could arise if no preliminary injunction issues, the sale takes place, and a permanent injunction then issues *together with a further order setting aside the trustee sale.* Under those circumstances, a bona fide purchaser at the trustee sale could prevail. To protect a claim in the face of the presumptions afforded to the holder of a trustee's deed (see CC §2924), the borrower should record the lis pendens immediately after filing the action to enjoin.

WARNING: To provide notice to subsequent purchasers and to enjoy the privilege associated with recordation of a lis pendens, the borrower must strictly follow the procedure required for recordation and service of a lis pendens. Note, however, that unless the borrower who fails to obtain a preliminary injunction has also applied for an order setting aside the sale, either in the original complaint or by amendment, consummation of the trustee sale will render the injunction action moot.

See chap 7 for further discussion of using lis pendens in connection with action to enjoin foreclosure sale. For general discussion of lis pendens procedures and expungement of lis pendens before trial, see California Real Property Remedies and Damages, chap 13 (2d ed Cal CEB 2002). See also Bernhardt, *The Lessened Lis Pendens,* 26 CEB Real Prop L Rep 178 (Sept. 2003).

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§10.74 D. Borrower's Pre-Trustee Sale Strategy With Multiple Parcels

Civil Code §2924g(b) states:

> The trustor, if present at the sale, may … unless the deed of trust or mortgage otherwise provides, direct the order in which property shall be sold, when the property consists of several known lots or parcels which may be sold to advantage separately, and the trustee shall follow that direction. After sufficient property has been sold to satisfy the indebtedness, no more can be sold.

The trustor's prerogatives are also extended to its successors in interest under the same deed of trust. See *Whitman v Transtate Title Co.* (1985) 165 CA3d 312, 320, 211 CR 582. Because the borrower may often direct the course of the sale when the security consists of several distinct parcels, it should consider which (if any) are in its best interest to sell first. The borrower should keep in mind that when the aggregate bids reach a desired amount, it then may tender the balance of the secured debt to the trustee, who must reconvey the unsold parcels. Note, however, that the trustor is not entitled to credit for the fair value of the lots sold at a trustee sale. *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29.

See §§2.75, 3.77, 9.87 for further discussion of marshaling of assets by borrower or junior creditor.

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E. Actions Against Lender After Trustee Sale

§10.75 1. Action to Set Aside Trustee Sale

Even if the trustor did not seek to enjoin a trustee sale, the trustor may seek to have that sale set aside. See *Hauger v Gates* (1954) 42 C2d 752, 269 P2d 609. See also §7.56. There are a number of disadvantages for a trustor attacking the sale in a postsale action as compared with seeking to enjoin the sale, such as the presumptions of validity of the sale recited in the trustee's deed, which are conclusive in favor of a bona fide purchaser (BFP). CC §2924. See §§7.60-7.66 for further discussion of disadvantages of postsale attack.

The grounds for setting aside a trustee sale are the same as for enjoining such a sale, unless a BFP bought the property. See §§7.67-7.68. In that event, unless the sale is void, as opposed to merely voidable, a trustor will not be able to set aside the sale and may be limited to money damages. See §§7.67, 7.70.

In order to bring the action, in most situations, the trustor must tender the full amount of the secured debt due and owing. *MCA, Inc. v Universal Diversified Enters. Corp.* (1972) 27 CA3d 170, 176, 103 CR 522; *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 117, 92 CR 851. In the action, the trustor may also seek ancillary relief, including to quiet title, cancel instruments, and recover possession. See §7.69. See chap 7 for general discussion of setting aside trustee sales and form complaint. See §7.41 for discussion of tender as requirement for temporary relief. For further discussion of actions to quiet title or recover possession through ejectment, or for rescission, cancellation of instruments, or damages for fraud, see California Real Property Remedies and Damages (2d ed Cal CEB 2002).

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§10.76 2. Action for Damages for Wrongful Sale

A trustor who cannot or chooses not to set aside the sale may recover monetary damages. Theories of recovery for wrongful foreclosure can include conversion, fraud, breach of contract, and breach of the covenant of good faith and fair dealing, discussed in chapters 7 and 12. In addition, the prevailing party will likely recover attorney fees because most deeds of trust contain attorney fee provisions. See *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57. In appropriate cases, the trustor may also be able to recover lost profits and punitive damages. See *Block v Tobin* (1975) 45 CA3d 214, 220, 119 CR 288.

For discussion of actions for monetary damages see §§7.69-7.70.

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§10.77 3. Third Party Claims Against Lender After Trustee Sale

A lender that wrongfully conducts a trustee sale may also be liable to parties other than the trustor, such as junior lienholders. See §7.57. For example, an irregularly conducted nonjudicial foreclosure sale supports an action both to set aside the sale and for tort damages. See *South Bay Bldg. Enters. v Riviera Lend-Lease, Inc*. (1999) 72 CA4th 1111, 85 CR2d 647. Reversing a directed verdict for the defendant senior beneficiary and reinstating a sold-out junior lienholder's fraud complaint, the court held that although the complaining junior did not prove its allegations that the foreclosing senior had misrepresented to it that the sale would be conducted fairly, evidence at trial did establish a claim for tortious violation of CC §§2924h(g) and 2924k by the following acts:

- An agreement between the trustor and the senior beneficiary to postpone the sale;
- Actual postponements in the face of willing bidders; and
- Collusive overstatement and credit bidding of the senior debt.

See also *FPCI RE-HAB 01 v E&G Invs., Ltd.* (1989) 207 CA3d 1018, 255 CR 157 (beneficiary acting as trustee, who overstated debt to acquire property, tortiously wronged junior lienholder, but junior lienholder failed to prove damages through presence of willing and able competing bidder).

Another junior lienholder action involved a sold-out junior carry-back trust deed holder that sued the trustor, its affiliate who had acquired and foreclosed the senior trust deed, and the original senior lender, alleging a conspiracy to interfere with his contractual rights under the junior trust deed in addition to other tort claims. See *Webber v Inland Empire Invs., Inc.* (1999) 74 CA4th 884, 88 CR2d 594. The appellate court in *Webber* took judicial notice of its prior, unpublished decision that affirmed the trial court's dismissal of the original senior lender on summary judgment, finding that it could lawfully sell its note even if doing so resulted in a default on the junior lien, so long as the senior lender had not deliberately participated in the trustor's conspiracy to conduct a sham foreclosure of the senior lien. See 74 CA4th at 894 n2. Junior lienholders, however, may be barred from bringing certain actions against lenders. In *Le Gault v Erickson* (1999) 70 CA4th 369, 82 CR2d 692, the court found that the junior lienholder did not have standing to contest a trustee sale by a senior lienholder on the basis of a violation of the Subdivision Map Act (Govt C §§66410-66499.37).

Successful third party purchasers at trustee sales may also have claims against lenders, although their success rate in the reported cases is limited. In *Ostayan v Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 92 CR2d 577, the successful bidder sued to set aside a trustee sale held on a junior obligation, claiming that misstatements had been made regarding the senior lien. The court found that neither the lender-beneficiary nor the trustee owed a duty to the bidder to explain the title encumbrances of record. Liability of beneficiary and the trustee is limited to concealment and misrepresentation, the limited warranties inherent in a trustee's deed, and concealed defects in the foreclosed property. But when the trustee followed the beneficiary's instruction and made a presale announcement inadvertently *overstating* the amount of the senior debt by some $100,000, there was no actionable misrepresentation and, in any event, the successful bidder was not harmed by reliance on the statement (since the effect of overstating the senior debt should have been to discourage the bidder rather than inducing higher bidding).

In another bidder case, *Angell v Superior Court* (1999) 73 CA4th 691, 86 CR2d 657, after accepting the plaintiff's bid but before issuing the trustee's deed, the trustee discovered that the lender had mistakenly commenced the foreclosure on only one of the two notes secured by the trust deed and so canceled the sale. The court held that the trustee may properly cancel a sale based on the discovery of an irregularity before the deed has been issued.

Security interests in leaseholds also hold the potential for actions by lessors against lenders. Lenders should be cautious about taking possession and assuming leasehold obligations through a subsidiary, even if temporarily. In a case of first impression to resolve the issue whether foreclosure on a leasehold extinguishes the duties owed to the lessor by an assignee of the lessee who had expressly assumed the lease, the court in *Vallely Invs. v BancAmerica Commercial Corp.* (2001) 88 CA4th 816, 106 CR2d 689, held that the assignee's contractual obligations to the lessor survived foreclosure. The court explained that the plaintiff lessor held a senior reversionary interest in the property and

that there was privity of contract between the lessor as a third party beneficiary and the defendant assignee who had assumed the lease, neither of which was affected by the foreclosure of a junior leasehold mortgage. The lessor's right to enforce the assumption agreement as a third party beneficiary was an incident of the reversion. As such, it could not be eliminated by the foreclosure.

For discussion of additional theories for lender liability claims, see chaps 7, 12.

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11

Enforcing Secured Loans Against Debtors in Bankruptcy

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I. INTRODUCTION

§11.1 A. Scope of Chapter

A lender with a properly perfected security interest in real property possesses two sets of rights: (1) an obligation of the debtor, usually represented by a promissory note, and (2) an interest in the debtor's real property to secure performance of such obligation, usually enforceable by causing the property to be sold and the sale proceeds to be applied toward satisfaction of the debt. See chaps 1-3.

The commencement of a case under Title 11 of the United States Code (the Bankruptcy Code) will affect and may alter the lender's rights. The commencement of a case will usually stay any action to collect the debt or enforce the lender's lien rights, such as foreclosing on the real property. During the case, the collateral may be sold free and clear of the secured lender's lien or used as collateral for further borrowing, provided that there is adequate protection of the secured lender's interests. Finally, the rehabilitative chapters under the Bankruptcy Code (Chapters 11, 12, and 13) may be used to modify the terms of the underlying loan.

On April 20, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23) was signed into law. This act significantly revised both consumer and business provisions of the Bankruptcy Code. With some exceptions, the amendments are effective only for cases filed on or after October 17, 2005, but some affect proceedings occurring either before or after the October date if the bankruptcy was pending on the April (enactment) date. (See Pub L 109-8, §1501, 119 Stat 23. See also Chang & Morales, *New Bankruptcy Law Requires Scrutiny of Applicability Dates,* SF Daily Journal, May 2, 2005, p 7.) This chapter pertains to both the Bankruptcy Code as it existed prior to BAPCPA, since there will be many cases making their way through the courts under the preexisting Code over the next few years, and to the many changes effected under BAPCPA.

NOTE: In 2009 two bills were introduced in the United States Congress to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence: HR 1106, 111th Cong, 1st Sess (2009) and S 61, 111th Cong, 1st Sess (2009). Proposed language also provided additional remedies for violations of TILA or other consumer statutes. Counsel for all parties in interest—debtors, bankruptcy trustees, trustors, beneficiaries, trustees, and foreclosure trustees, as well as such entities as MERS—must be aware of the impact that the passage of such legislation may have on their clients' rights and remedies. The first bill passed in the House in early 2009 and was sent to the Senate, where both bills are apparently stalled. For further information, go to http://www.govtrack.us/congress/bill.xpd?bill=h111-1106 and http://www.govtrack.us/congress/bill.xpd?bill=s111-61.

This chapter is primarily intended to provide the reader with an overview of the bankruptcy process as it applies to the interests of a lender secured by real property, with an emphasis on parties' legal rights as interpreted by decisions in the Ninth Circuit. The discussion is limited to the Bankruptcy Code's effect on private parties' rights under Chapters 7, 11, 12, and 13.

PRACTICE TIP: If debtor's counsel is about to prepare a bankruptcy petition, counsel must explain to the debtor that even though the filing will precipitate the automatic stay and delay foreclosure (see §§11.5-11.7), a creditor's motion for stay relief (see §11.20) is likely. Counsel must prepare to defend the motion from the inception of the bankruptcy (see §11.46).

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§11.2 B. Types of Bankruptcy Relief

The Bankruptcy Code is divided into three chapters of general applicability covering case administration and general provisions affecting creditors and debtors (Chapters 1, 3, and 5) and six chapters applicable in certain specific cases (Chapters 7, 9, 11, 12, 13, and 15).

Chapter 7 provides for liquidation of the debtor's assets by a trustee. 11 USC §§701-727. Chapter 11 provides for reorganization of the debtor's financial affairs. 11 USC §§1101-1146. Individuals and virtually any type of entity other than trusts are eligible for relief under Chapters 7 and 11. 11 USC §109(b), (d); *Toibb v Radloff* (1991) 501 US 157, 115 L Ed 2d 145, 111 S Ct 2197 (individual debtors are eligible for Chapter 11 relief when they do not qualify for Chapter 13 relief). The primary exceptions are banks, savings and loan associations, credit unions, and insurance companies, each of which is subject to separate state or federal liquidation schemes, and certain small business investment companies. BAPCPA (see §11.1) imposes additional hurdles for individuals seeking to file if their debts are primarily consumer debts, especially under Chapter 7 or 13. First, under revised 11 USC §109(h), individuals are generally not eligible for bankruptcy relief unless they receive credit counseling within 180 days prior to filing. In addition, a "means test," based on state median income, added to 11 USC §707 makes it more difficult for individuals with income to file for Chapter 7 relief. See 11 USC §707(b)(2).

Chapter 13 allows individuals to make periodic payments over a period of 3 to 5 years to creditors under the supervision of a trustee. 11 USC §§1301-1330. Such payment plans often provide for less than full payment of creditors. BAPCPA revised 11 USC §1322 to provide that a plan providing for less than full payment of claims must distribute all of the debtor's projected disposable income over the plan period. Only an individual (or an individual and spouse) with regular annual income who owes unsecured debts of less than $336,900 and secured debts of less than $1,010,650 is eligible for relief under Chapter 13. 11 USC §109(e).

Chapter 12 provides family farmers and, under BAPCPA, family fishermen with treatment similar to that available under Chapter 13. 11 USC §§1201-1231. Only family farmers and fishermen with regular annual income are eligible for relief under Chapter 12. 11 USC §109(f). "Family farmer" is defined by 11 USC §101(18) to include an individual or individual and spouse whose debts do not exceed $1,642,500 ($3,554,565 under BAPCPA), provided that (1) not less than 80 percent (50 percent under BAPCPA) of those debts (excluding all debts secured by the debtor's residence) arise out of the farming operation and (2) more than 50 percent of the income of the debtor (or the debtor and spouse, if filing jointly) was derived from farming during the taxable year preceding the taxable year in which the case was filed (under BAPCPA, the taxable year preceding or each of the second and third taxable years preceding the taxable year in which the case commences). 11 USC §101(18)(A). Under certain circumstances, a partnership or corporation that meets these criteria and is owned and operated by a family qualifies for relief under Chapter 12. 11 USC §101(18)(B). "Regular annual income" is defined as annual income that is "sufficiently stable and regular to enable such family farmer to make payments under a plan under Chapter 12 of this title." 11 USC §101(19). "Family fishermen" is defined similarly to "family farmers," but with lower debt and income thresholds, in 11 USC §101(19A).

In Chapter 11, 12, and 13 cases, the debtor in possession is authorized to operate its business unless the bankruptcy court orders otherwise. 11 USC §§1108, 1203, 1304(b). However, in most Chapter 13 cases, the debtor will be an employee of a company rather than the owner of a business. In Chapter 7 cases, the court may authorize the trustee to operate a business if that is in the best interests of the estate. 11 USC §721.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/11 Enforcing Secured Loans Against Debtors in Bankruptcy/§11.3 C. Commencement, Dismissal, Conversion, and Closure

§11.3 C. Commencement, Dismissal, Conversion, and Closure

The debtor may commence a voluntary case under Chapter 7, 11, 12, or 13 by filing a petition for relief. 11 USC §301. A voluntary petition filed by the debtor constitutes the order for relief, and no further action is needed. 11 USC §301. A bankruptcy case may also be commenced under Chapter 7 or 11 against a debtor by the filing of an involuntary petition. 11 USC §303. Cases under Chapters 12 and 13 may not be commenced by filing an involuntary petition. After the filing of an involuntary petition, the court will determine whether to dismiss the case or order relief. The exclusive jurisdiction of the federal courts over bankruptcy under the Bankruptcy Code precludes any state law claims for abuse of process premised on the filing of a "bad faith" bankruptcy petition or other acts taken under the Bankruptcy Code. See *Gonzales v Parks (In re Gonzales)* (9th Cir 1987) 830 F2d 1033; *Choy v Redland Ins. Co.* (2002) 103 CA4th 789, 127 CR2d 94. Remedies for an abusive bankruptcy filing are provided under the Bankruptcy Code. See §§11.24-11.27.

There is no requirement that the debtor be insolvent or unable to pay its debts as they mature before the debtor can file a voluntary petition under any of the chapters. An involuntary petition, however, must allege that the debtor is not generally paying debts as they become due or that a custodian was appointed within the past 120 days to take possession of assets of the debtor for purposes other than enforcing a lien on them. 11 USC §303(h). A lender holding a nonrecourse note is not eligible to file an involuntary Chapter 7 petition, because unlike the other chapters, Chapter 7 does not recognize nonrecourse claims. *CC Britain Equities, LLC v Allen-Main Assocs. Ltd. Partnership (In re Allen-Main Assocs. Ltd. Partnership)* (BAP 2d Cir 1998) 223 BR 59.

Under the law applicable to petitions filed before the effective date of BAPCPA (see §11.1), a bankruptcy case could be dismissed or converted to Chapter 7 for "cause," including (1) unreasonable delay by the debtor that prejudices creditors; (2) failure to timely propose a plan; (3) inability to effectuate or denial of confirmation of a proposed plan; (4) inability to effectuate, material default under, or revocation of a confirmed plan; (5) nonpayment of fees; or (6) failure to file required information with the court. 11 USC §§707(a), 1112(b), 1208(c), 1307(c). "Cause" also includes the filing of a bankruptcy case in bad faith. *Marsch v Marsch (In re Marsch)* (9th Cir 1994) 36 F3d 825 (affirming dismissal based on filing used solely as litigation tactic by solvent debtor). Under new standards adopted under BAPCPA, the debtor's bad faith is presumed in many instances. See §§11.6, 11.25.

In Chapter 7 cases, before the passage of BAPCPA, dismissal or, with the debtor's consent, conversion to Chapter 11 or Chapter 13 was appropriate if granting relief under Chapter 7 to a debtor with primarily consumer debts would be a "substantial abuse" of Chapter 7. 11 USC §707(b). Under BAPCPA, §707(b) requires only "abuse" and presumes that "abuse" exists if the debtor's monthly income, after deduction for certain standardized expenses over a 60-month period, is not less than the lesser of $10,950 or 25 percent of the debtor's unsecured debt (not to exceed $6575).

PRACTICE TIP: These requirements, the so-called "means test," were thought to greatly restrict the availability of Chapter 7 relief to debtors with any significant earning capacity. In practice, however, its impact in California has been minimal because the test permits debtors to deduct their actual monthly mortgage obligations from income under 11 USC §707(b)(2)(A)(i), (iii). Moreover, under 11 USC §707(b)(1), the means test does not apply to many high-income individuals because it does not apply to debtors whose debts are not primarily consumer debts (defined in 11 USC §101(8)).

BAPCPA also expands the definition of "cause" for conversion or dismissal of Chapter 11 cases in 11 USC §1112(b)(4). Notable additions include the following:

- Failure to maintain appropriate insurance;
- Unauthorized use of cash collateral;
- Gross mismanagement of the estate;
- Failure to attend meetings of creditors or a scheduled examination of the debtor;
- Failure to comply with reporting requirements, court orders, or requests for information from the United States Trustee; and

- Nonpayment of fees or taxes.

If cause is established, the court must convert or dismiss a Chapter 11 case unless the court determines that it is in the best interests of creditors to appoint a trustee or examiner in Chapter 11. See 11 USC §§1104(a)(3), 1112(b)(1). The court must also convert or dismiss the case on request of a party in interest showing cause, unless the debtor or another party in interest objects and establishes that there is a reasonable probability of confirming a plan within a reasonable period of time and that the complained-of acts or omissions (other than substantial continuing loss to or diminution of the estate) are reasonably justified and curable within a reasonable time fixed by the court. 11 USC §1112(b)(2). Absent the consent of the moving party or some other compelling circumstance, the court must hear a motion to dismiss or convert within 30 days after the motion is filed and must issue a ruling within 15 days after commencement of the hearing. 11 USC §1112(b)(3).

The legal effect of conversion or dismissal of a bankruptcy case is set forth in 11 USC §§348-349, 362(c)(2)(B). Generally, if a case is converted, the automatic stay remains in effect until a stay relief order is issued. An order granting stay relief does not become effective until 14 days after its entry. Fed R Bankr P 4001(a)(3). If a case is dismissed, the automatic stay expires. A judgment on dismissal is effective when entered. See Fed R Bankr P 9021.

After a bankruptcy estate is fully administered, the bankruptcy case should be closed, although it may later be reopened for cause. 11 USC §350.

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§11.4 D. Distinctions Among Debtors, Debtors in Possession, Trustees, and Committees

A Chapter 7 filing results in the automatic appointment of a trustee, who is charged with promptly liquidating the assets of the bankruptcy estate. But a trustee may operate a business if that would be in the best interests of the bankruptcy estate. See 11 USC §§701-727. As a result, the secured lender will often square off with the trustee rather than the debtor in a Chapter 7 case.

In Chapters 11, 12, and 13, the debtor as "debtor in possession" is authorized to operate the business (most Chapter 13 cases do not involve an operating business), retain control of the estate assets during the bankruptcy case, and exercise all the powers of a trustee. See 11 USC §§1107-1108, 1203, 1303-1304. Thus, in these cases, a secured lender usually interacts with the debtor. However, a trustee can be appointed in a Chapter 11 case for cause, including fraud, gross mismanagement, or conflict of interest. 11 USC §1104. BAPCPA (see §11.1) expands §1104 to include, among other things, failure to maintain appropriate insurance, unauthorized use of cash collateral, and failure to file a plan and disclosure statement within the time required. 11 USC §§1104, 1112. In a Chapter 12 case, a debtor may also be removed as debtor in possession for cause and, if that occurs, the Chapter 12 standing trustee, whose main function is usually distribution of payments to creditors under a confirmed plan, assumes control of the assets. 11 USC §§1202(b)(5), 1204. When a trustee is appointed in a Chapter 11 or Chapter 12 case, he or she becomes the decision-maker with whom the secured lender interacts. In Chapter 13 cases, there is no provision for appointment of a trustee to take control of the assets from the debtor, but the case can be converted to Chapter 7, resulting in the automatic appointment of a trustee. 11 USC §1307.

Creditors' committees are commonly appointed in Chapter 11 cases. See 11 USC §1102. A creditors' committee can also be appointed in Chapter 7 cases, but this does not usually occur unless it is a larger case with significant assets. See 11 USC §705. Creditors' committees represent the interests of unsecured creditors and will usually side with a debtor in possession or trustee in its dealings with a secured lender.

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II. AUTOMATIC STAY

A. Overview of Automatic Stay

§11.5 1. Before BAPCPA (2005 Amendments)

The filing of a voluntary or involuntary bankruptcy petition generally results in the imposition of the automatic bankruptcy stay without need for a hearing or court order. 11 USC §362(a). The automatic stay enjoins most creditor efforts to immediately recover property or take other legal action. Federal courts, not state courts, have the final authority to determine the scope and applicability of the automatic stay created by §362. *Gruntz v County of Los Angeles (In re Gruntz)* (9th Cir 2000) 202 F3d 1074, 1083.

The stay applies equally to "all entities," which includes individuals, partnerships, corporations, estates, trusts, and governmental units. 11 USC §101(15), (41). The stay blocks a broad range of judicial and nonjudicial actions against the debtor, the debtor's property, and property of the bankruptcy estate (see §§11.7-11.16) including litigation, lien enforcement, and self-help remedies of creditors. The expansive nature of the stay is meant to provide a temporary "breathing spell" so that the trustee or debtor can conduct an orderly liquidation or reorganization for the benefit of all creditors.

PRACTICE TIP: The automatic stay does not prevent lien enforcement when a debtor is liable on the debt but does not have any interest in the encumbered real property. *Saratoga Group, Ltd. v Peoples Nat'l Bank (In re Geris)* (4th Cir 1992) 973 F2d 318 (debtor was guarantor).

The commencement of a bankruptcy case also automatically creates an estate comprised of essentially all the debtor's legal and equitable interests in property. 11 USC §541. The automatic stay of acts against property of the bankruptcy estate terminates when the property is no longer part of the estate. 11 USC §362(c)(1). Property abandoned from the estate pursuant to 11 USC §554 becomes property of the debtor, but enforcement of a lien against such property continues to be stayed until the debtor receives a discharge. 11 USC §362(a)(5).

The automatic stay terminates with respect to other actions and property of the debtor on the earlier of (1) closure or dismissal of the case or (2) grant or denial of a discharge of debts in a Chapter 7 case involving an individual or in any case under Chapter 9, 11, 12, or 13. See 11 USC §362(c)(2). The discharge is not effective in Chapter 12 or Chapter 13 cases until the debtor completes plan payments. 11 USC §§362(c), 1228, 1328. In a Chapter 11 case, however, a discharge may be granted or denied at the time of plan confirmation. 11 USC §1141. Under BAPCPA (see §11.1), an individual Chapter 11 debtor receives a discharge after plan payments are completed, although the court may grant a discharge if the debtor has distributed partial payments equaling the amount that creditors would have received in a Chapter 7 case. 11 USC §1141(d)(5). If a discharge is granted, a separate discharge injunction arises, enjoining judicial or nonjudicial acts to collect a discharged debt as a personal liability of the debtor. 11 USC §524.

Before the stay terminates against abandoned property of the estate or terminates by virtue of a closure or dismissal of the case (or before an automatic termination under 11 USC §362(c)(3)(A), as amended by BAPCPA), a creditor may obtain a court order allowing relief from stay to proceed against specific property. See §§11.20-11.55.

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§11.6 2. After BAPCPA (2005 Amendments)

Except as otherwise stated in §11.5 or §11.6, the discussion about the automatic stay in §11.5 applies to cases filed after the effective date of BAPCPA (see §11.1).

To address the problem of successive filings, BAPCPA significantly limits applicability of the automatic stay if an individual debtor had one or more cases pending in the bankruptcy court in the prior year. These limits apply to both single and joint cases filed by married individuals and to voluntary and involuntary petitions, and they address two scenarios. (See 11 USC 362(c). See also §11.11, citing specific amendments that limit the application of the automatic stay in enforcement of real property liens and secured lending situations.)

(1) **After dismissal of another prior bankruptcy case:** BAPCPA provides for early termination of the stay for individuals filing Chapter 7, 11, and 13 cases who had another case dismissed within the preceding year (other than a case refiled under a Chapter other than Chapter 7 after dismissal under 11 USC §707(b)). 11 USC §362(c)(3). Section 362(c)(3)(A) provides that the stay "with respect to any action taken with respect to a debt or property securing such debt or with respect to any lease shall terminate with respect to the debtor on the 30th day after the filing of the later case."

However, on a noticed motion by an interested party, and provided the hearing is completed within the 30-day period following the filing of the later case, the court may extend the stay period against any or all creditors and on such conditions or limitations as the court may impose. 11 USC §362(c)(3)(B). The moving party must demonstrate that the later case was filed in good faith regarding the creditors to be stayed. 11 USC §362(c)(3)(B)-(C). See ND Cal Local Bankr R 4001-2.

(2) **After dismissal of more than one prior bankruptcy case:** BAPCPA imposes a still harsher rule if the debtor had two or more cases in any Chapter dismissed in the prior year (other than a case refiled under 11 USC §707(b)). In that situation the automatic stay does not go into effect on the filing of the new case at all, and, on request of a party in interest, "the court shall promptly enter an order confirming that no stay is in effect." 11 USC §362(c)(4)(A). See *Nelson v George Wong Pension Trust (In re Nelson)* (BAP 9th Cir 2008) 391 BR 437 (concluded that stay did not arise on debtors' third filing of bankruptcy petition within 1 year of the first and dismissed debtors' adversary proceeding brought against foreclosing lender for stay violation).

PRACTICE TIP: A foreclosing lender or a buyer may find it useful to obtain a "comfort order" confirming that the stay is not in effect to assure the trustee that proceeding with a foreclosure is appropriate or to facilitate obtaining title insurance. In addition to the authorization for such an order under §362(c)(4)(A)(ii), §362(j) authorizes such orders for any termination of the stay under §362(c) generally.

A party in interest may, within 30 days after the filing of the new case, and after notice and a hearing, request that the court enter an order that the automatic stay take effect against any or all creditors, subject to such conditions or limitations as the court may impose. 11 USC §362(c)(4)(B). As in §362(c)(3)(B)-(C), such relief may only be granted if the moving party demonstrates that the new case was filed in good faith regarding the creditors to be stayed. 11 USC §362(c)(4)(B), (D). If the court does order the automatic stay to take effect, the stay is effective only on entry of the order. 11 USC §362(c)(4)(C).

Proving good faith under §362(c)(3)-(4) may be a difficult task. Both of those sections create a presumption, rebuttable only by "clear and convincing evidence," that a case has been filed in bad faith regarding all creditors in any of the following circumstances:

- More than one previous case was pending in the preceding year;
- A previous case was dismissed within the preceding year after the debtor failed to (1) file or amend without substantial excuse the petition or other documents required by the Bankruptcy Code (*e.g.,* schedules of assets and liabilities) or the court; (2) provide adequate protection ordered by the court; or (3) perform under the terms of a confirmed plan; or
- There has been no substantial change in the financial or personal affairs of the debtor since the dismissal of the

prior case or any other reasons to conclude that the new case will be concluded with a discharge (if a Chapter 7 case) or a confirmed plan (if a Chapter 11 or 13 case).

Under BAPCPA, creditors are entitled to a presumption of the debtor's bad faith if the creditor filed a stay relief motion in the prior case and, as of the dismissal of that case, the motion was still pending or had been resolved by terminating, conditioning, or limiting the stay against actions by the creditor. 11 USC §362(c)(3)(C)(ii), (c)(4)(D)(ii). The bad faith presumption under amended §362(c)(3) does not apply, however, to situations in which dismissal of an individual debtor's prior case was based on creation of a "debt repayment plan." 11 USC §362(i).

PRACTICE TIP: Individual debtors and their counsel should consider attempting to craft a dismissal based on a good faith debt repayment plan, given the severe consequences of successive bankruptcy cases. There appears to be some leeway in structuring such a plan because it is not defined by the Bankruptcy Code. Lenders should be alert to requests for dismissal based on unilateral or unrealistic repayment plans.

BAPCPA also significantly reduces applicability of the automatic stay in "small business cases." 11 USC §362(n). However, the amendments define such cases to include only individuals or businesses "engaged in commercial or business activities" and excludes those debtors "whose primary activity is the business of owning or operating real property or activities incidental thereto" or whose debts are more than $2,190,000. 11 USC §101(51C)-(51D).

On BAPCPA's effect on automatic stay in "single asset real estate cases," see §11.32.

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B. Scope of Automatic Stay

§11.7 1. Acts to Create, Perfect, or Enforce Lien

The automatic stay expressly enjoins acts to create, perfect, or enforce (1) "any lien against property of the estate" and (2) "against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case." 11 USC §362(a)(4)-(5). The term "lien" is expansively defined under 11 USC §101(36)-(37), (51), (53) to include security interests, statutory liens, judicial liens, and other charges against, or interests in, property to secure payment of a debt. The automatic stay also prohibits the "enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case." 11 USC §362(a)(2). The automatic stay clearly restrains not only an actual foreclosure sale but also

- the publication, recordation, or service of a notice of trustee sale (nonjudicial foreclosure), except a notice of postponement (see §11.8);
- a notice of default and election to sell; and
- the commencement or continued prosecution of a judicial foreclosure action or an action to have a receiver appointed to collect rents, issues, and profits.

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a. Exceptions: Foreclosure Sales

§11.8 (1) Postponing Sale

A foreclosing party does not violate the automatic stay by giving notice that a sale, noticed prior to commencement of the bankruptcy case, has been postponed from time to time, whether before or after plan confirmation. *Mason-McDuffie Mortgage Corp. v Peters (In re Peters)* (9th Cir 1996) 101 F3d 618; *First Nat'l Bank v Roach (In re Roach)* (9th Cir 1981) 660 F2d 1316. See also *Nghiem v Ghazvini (In re Nghiem)* (BAP 9th Cir 2001) 264 BR 557, aff'd (9th Cir 2002) 53 Fed Appx 489 (unpublished opinion) (oral postponement of foreclosure sale under CC §2924g does not violate stay, provided that underlying bankruptcy case is dismissed before postponed sale date). It has also been held that publishing notice of a foreclosure sale on the same day as the bankruptcy filing does not violate the stay. *Tully v World Sav. & Loan Ass'n* (1997) 56 CA4th 654, 65 CR2d 545.

Because Fed R Bankr P 4001(a)(3) provides that an order granting stay relief to allow foreclosure does not become effective until 14 days after its entry, a postponed foreclosure sale cannot commence until after the 14-day period expires, unless the bankruptcy court reduces or eliminates that period. Note that the usual 7-day waiting period under California law does not apply to stay relief motions in bankruptcy. See CC §2924g(e), discussed in chap 2.

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§11.9 (2) Recordation of Trustee's Deed to Effect Prepetition Sale

If the borrower files a bankruptcy petition after a nonjudicial foreclosure sale but before the trustee's deed is recorded, an exception to the automatic stay should exist for recordation of the deed within 15 calendar days of the sale. The bankruptcy appellate panel in *Bebensee-Wong v FNMA* (*In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820, applying 11 USC §§362(b)(3) and 546(b), held that such recordation is valid because it relates back to 8 a.m. on the day of the sale, or the next business day following the 15th day if the county recorder is closed on the 15th day, and the sale is treated as final on the sale date under CC §2924h(c). See also *In re Stork* (Bankr ND Cal 1997) 212 BR 970 (trustee's deed recorded 16 days after sale and postbankruptcy filing, but court annulled stay to confirm sale because 11 USC §549(c) protected good faith purchaser who recorded before debtor recorded notice of bankruptcy petition); *Blatnick v Sanders* (*In re Sanders)* (Bankr SD Cal 1996) 198 BR 326 (sale held on same day as, but few hours after, bankruptcy filing not validated by recordation under CC §2924h, but stay annulled because of debtor's bad faith); *Davisson v Engles* (*In re Engles)* (Bankr SD Cal 1996) 193 BR 23 (stay relief granted to purchaser at prepetition foreclosure sale to record trustee's deed because bare legal title remaining was of no value to estate; debtor had failed to record notice of petition, so argument that purchaser had not timely complied with CC §2924h(c) was hypothetical).

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§11.10 b. Other Exceptions

Arguably, a bankruptcy petition filed in contravention of an order barring the debtor from filing additional bankruptcy petitions for 180 days is without effect. The Ninth Circuit reached that conclusion in a case involving a postpetition foreclosure conducted after such a filing, but the published decision was withdrawn and is no longer citable. *Umali v Dhanani (In re Umali)* (9th Cir 2003) 345 F3d 818, withdrawn (9th Cir 2004) 382 F3d 1158.

The United States Supreme Court has held that a bank's "administrative hold" of the debtor's deposit account pending a hearing on the bank's stay relief motion does not violate the automatic stay. *Citizens Bank v Strumpf* (1995) 516 US 16, 133 L Ed 2d 258, 116 S Ct 286. For transactions subject to California mortgage law, such a "freeze" may nonetheless be subject to attack as a violation of the one-action rule of CCP §726. See §§4.12-4.22.

Several miscellaneous exceptions to the automatic stay regarding governmental liens can impact real estate collateral. Most notable is the exception allowed for creation or perfection of a statutory lien for state ad valorem property taxes that come due postbankruptcy. 11 USC §362(b)(18). Thus, accrual of unpaid property taxes secured by a senior lien under state law can erode a private lender's security.

Other exceptions have less wide-ranging impact. See 11 USC §362(b)(8) (Secretary of Housing and Urban Development may commence action to foreclose on certain mortgages and deeds of trust); 11 USC §362(b)(4) (acts taken by governmental units in exercise of their police or regulatory power); *U.S. v Klein (In re Chapman)* (BAP 9th Cir 2001) 264 BR 565 (government not barred from seeking forfeiture of debtor's house used to grow and distribute marijuana because such action is exercise of its police power); *Javens v City of Hazel Park (In re Javens)* (6th Cir 1997) 107 F3d 359 (stay does not prevent demolishing debtor's real property for code violations involving public health and safety). But see *Maricopa County v PMI-DVW Real Estate Holdings* (*In re PMI-DVW Real Estate Holdings)* (Bankr D Ariz 1999) 240 BR 24 (no exception for condemnation action to acquire real estate for road because no showing of specific public health, safety, or welfare issues).

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§11.11 c. Exceptions Under BAPCPA

Two changes in BAPCPA (see §11.1) codify evolving case law dealing with abusive repeat filings:

- **Prior order granting stay relief regarding real property.** The automatic stay does not apply "to any act to enforce any lien against or security interest in real property" for 2 years after entry of an order lifting the automatic stay regarding the property in any prior bankruptcy case under 11 USC §362(d)(4)—provided, however, that the debtor may move for relief from the prior order based on changed circumstances or other good cause. 11 USC §362(b)(20). The relief order extending the automatic stay must be recorded with the county recorder. 11 USC §362(d)(4). These changes track case law authorizing "in rem" stay relief. See §11.25.
- **Ineligible debtor.** The automatic stay does not apply "to any act to enforce any lien against or security interest in real property" if the debtor is ineligible under 11 USC §109(g) (barring eligibility for individuals and family farmers with bankruptcy cases dismissed within the prior 180 days by the court for willful misbehavior or voluntarily after a stay relief motion was filed; see §11.25) or if the present case is filed in violation of an order in a prior bankruptcy case that prohibits the debtor from filing another bankruptcy. 11 USC §362(b)(21). See §11.10. See also §11.6.

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2. Tolling of Redemption and Reinstatement Periods

§11.12 a. Redemption

The automatic stay protects a debtor's preforeclosure equity of redemption because that right continues until the foreclosure sale actually commences (see §2.73); if the sale is stayed, the equity of redemption is tolled along with the actual sale (see *In re Capital Mortgage & Loan, Inc.* (Bankr ED Cal 1983) 35 BR 967, 971).

Whether the automatic stay tolls the running of the period for postsale statutory redemption (following a judicial foreclosure) is undecided. (On postsale redemption, see §§3.8, 3.90-3.101.) In that context, the lien has been extinguished by the judicial foreclosure. Because expiration of the redemption period extinguishes the debtor's right to buy the property back from the foreclosure sale purchaser (see §§3.92, 3.101), arguably there is no real act for the stay to prohibit. However, at the expiration of the redemption period, the foreclosure sale purchaser must take some action to obtain title, typically the exchange of the certificate obtained at the sale for a deed to the property. See §§3.85, 3.101. This deferral of the taking of title until after the redemption period expired formed the basis of a Ninth Circuit decision holding, under prior bankruptcy law, that the automatic stay tolled the redemption period. See *Hamblen v Federal Sav. & Loan Ins. Corp. (In re Thomas J. Grosso Inv.)* (9th Cir 1972) 457 F2d 168. See also *In re Capital Mortgage & Loan, Inc., supra* (bankruptcy filing tolls periods within which debtor must reinstate or redeem loan). More recent cases have held that the automatic stay does not toll the running of the postforeclosure redemption period. See, *e.g., Johnson v First Nat'l Bank* (8th Cir 1983) 719 F2d 270, 276 (considering Minnesota redemption law). Until the Ninth Circuit decides this question under current bankruptcy law, taking into consideration California redemption law, creditors should proceed with a judicial foreclosure cautiously.

NOTE: The postsale redemption period is extended for up to 60 days after the entry of the order for relief (*i.e.,* the commencement of the bankruptcy case) by 11 USC §108(b) when the redemption period has not expired prior to the filing of the petition. See *Johnson v First Nat'l Bank, supra; In re Santa Fe Dev. & Mortgage Corp.* (BAP 9th Cir 1981) 16 BR 165 (dealing with extension of time to exercise option to purchase).

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§11.13 b. Reinstatement

Under CC §2924c(e), the reinstatement period in nonjudicial foreclosure proceedings expires 5 business days before a sale and is automatically revived whenever the sale is continued for more than 5 business days. See §§2.51-2.61. Thus, as is most common, when the bankruptcy petition is filed before the sale is noticed, the automatic stay will toll the running of the reinstatement period by prohibiting publication of a notice of sale that establishes a sale date. See §11.7. As for a sale that has already been noticed at the time the petition is filed, the automatic stay will prevent the sale from taking place as scheduled and will also result in a tolling of the reinstatement period if the sale is continued for more than 5 business days. On California law that triggers new notice of sale and revives reinstatement right after sale is postponed for more than period of 1 year, see §§2.54-2.55, 2.88-2.96.

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§11.14 3. Foreclosure by Senior Lienholder When Debtor's Only Interest Is Junior Lien

A bankruptcy filing by the holder of a junior lien should automatically stay the foreclosure action of a senior lienholder. The junior lien is property of the holder's bankruptcy estate under 11 USC §541, and foreclosure by a senior lienholder would terminate the junior lien in violation of the automatic stay. See *In re Capital Mortgage & Loan, Inc.* (Bankr ED Cal 1983) 35 BR 967. See also *Monumental Life Ins. Co. v Bibo, Inc.* (*In re Bibo, Inc.)* (BAP 9th Cir 1996) 200 BR 348, vacated (9th Cir 1998) 139 F3d 659 (appeal mooted by payoff of junior lien); *Fidelity Mortgage Investors v Camelia Builders, Inc.* (2d Cir 1976) 550 F2d 47 (Bankruptcy Act decision); *Florida Inst. of Technol. v Carpenter* (*In re Westec Corp.)* (5th Cir 1972) 460 F2d 1139 (Bankruptcy Act decision). Affording protection to a junior lien is also consistent with cases protecting the estate's interest as a lessee (*Roslyn Sav. Bank v Comcoach Corp.* (*In re Comcoach Corp.)* (2d Cir 1983) 698 F2d 571) and as one of several co-owners of the collateral (*Harsh Inv. Corp. v Bialac* (*In re Bialac)* (9th Cir 1983) 712 F2d 426).

On the effect of the automatic stay on reinstatement rights of junior creditors in bankruptcy, the authorities are split. Compare *California Thrift & Loan Ass'n v Downey Sav. & Loan Ass'n (In re Eagles)* (BAP 9th Cir 1984) 36 BR 97 (automatic stay protection to borrower-debtor's reinstatement rights under prior California law does not extend to junior lienholder-debtor's reinstatement rights) with *In re Capital Mortgage & Loan, Inc., supra* (bankruptcy filing tolls periods within which junior lienholder-debtor must reinstate or redeem loan).

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§11.15 4. Postforeclosure Eviction

The purchaser at a foreclosure sale may sometimes need to bring an unlawful detainer action to evict a borrower who refuses to vacate. If the purchaser obtains an unlawful detainer judgment and writ of possession before the bankruptcy filing, the automatic stay arguably should not prevent eviction, because the borrower has no remaining legal or equitable interest in the property and eviction will not impact the bankruptcy estate. CCP §715.050; *Marquand v Smith* (*In re Smith)* (Bankr CD Cal 1989) 105 BR 50; *Lee v Baca* (1999) 73 CA4th 1116, 86 CR2d 913, cert denied (2000) 529 US 1020, 146 L Ed 2d 314, 120 S Ct 1422. But see *Westside Apts., LLC v Butler* (*In re Butler)* (Bankr CD Cal 2002) 271 BR 867 (holding that §715.050 is unconstitutional; landlord must file stay relief motion even if unlawful detainer judgment entered and writ of possession issued before tenant filed for bankruptcy).

WARNING: The *Butler* court cautioned that future creditors seeking to rely on *Smith, Baca*, or §715.050 "for purposes of making an end run around obtaining relief from the automatic stay run the risk of liability for violating the automatic stay." 271 BR at 876.

BAPCPA (see §11.1) may impact a court's analysis of this issue: The automatic stay no longer blocks eviction or unlawful detainer proceedings by a "lessor" against a debtor involving "residential property in which the debtor resides as a tenant under a lease or rental agreement" if the lessor has obtained a judgment for possession before the bankruptcy case is filed. 11 USC §362(b)(22). A holdover resident arguably falls within this exception as a form of holdover tenant. See §2.100. Note, however, that this exception does not apply until 30 days after the petition is filed and that the debtor has an opportunity to extend the automatic stay if the entire monetary default is cured within the 30 days. 11 USC §362(*l*).

PRACTICE TIP: Many judges post guidelines that permit shortened-notice motions for relief from stay against holdover tenants. See, *e.g.,* Judge Tchaikovsky's or Judge Morgan's guidelines for stay relief motions at website for Northern District of California Bankruptcy Court: http://www.canb.uscourts.gov/judges/judges-menu (click on name of judge and then on "Procedures" link).

On tenant bankruptcy generally and on the effect of BAPCPA on residential tenant evictions, see California Landlord-Tenant Practice, chap 14 (2d ed Cal CEB 1997). On eviction after foreclosure, see Landlord-Tenant §§8.68A-8.68E, 14.21.

PRACTICE TIP: If a stay relief motion is needed to proceed with foreclosure, counsel should consider including in the motion a request for leave to pursue an eviction action following foreclosure, as necessary, and include appropriate language in the proposed order. See Landlord-Tenant §14.64.

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§11.16 5. Acts to Recover Claim Against Debtor or Debtor's Property

The Bankruptcy Code allows the debtor to retain certain property, such as exempt property and property acquired after case commencement. 11 USC §§522, 541(b). Property may also revert back to the debtor if the trustee abandons an asset. 11 USC §554. In addition to protecting property of the estate, the automatic stay prevents (1) acts to create, perfect, or enforce a lien securing a prepetition claim against property of the debtor, (2) acts to collect, assess, or recover a prepetition claim against the debtor individually, and (3) acts to set off any debt that arose prepetition. 11 USC §362(a)(5)-(7). Therefore, unless the stay terminates earlier (see §11.5), a secured lender will need to seek relief from the automatic stay even if the collateral has been abandoned to the debtor or is retained by the debtor as exempt property.

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C. Violation of Automatic Stay

§11.17 1. Acts Violating Stay Are Void

The Ninth Circuit has held that acts taken in violation of the automatic stay are void ab initio and without effect. *Far Out Prods., Inc. v Oskar* (9th Cir 2001) 247 F3d 986; *Schwartz v U.S.* (*In re Schwartz)* (9th Cir 1992) 954 F2d 569, 571. The automatic stay of 11 USC §362 does not apply, however, to sales of assets by the debtor. Such sales may be subject to avoidance under 11 USC §549 and therefore may be voidable but are not void ab initio. *Burkart v Coleman* (*In re Tippett)* (9th Cir 2008) 542 F3d 684 (trustee did not obtain avoidance under §549 because court applied defense in favor of bona fide purchaser). However, 11 USC §362 clearly applies to creditor actions (see *Burkart v Coleman, supra*); thus a foreclosure sale that violates the stay will be void. *Phoenix Bond & Indem. Co. v Shamblin (In re Shamblin)* (9th Cir 1989) 890 F2d 123 (tax sale). Not surprisingly, a lender's claim for costs of a void foreclosure sale held in violation of the automatic stay have been disallowed. *Pro Fin., Inc. v Spriggs (In re Spriggs)* (BAP 10th Cir 1998) 219 BR 909, aff'd (10th Cir 1998) 166 F3d 348 (unpublished opinion).

Bankruptcy courts do, however, have discretion to annul the automatic stay retroactively to validate otherwise void past actions. 11 USC §362(d); *Schwartz v U.S., supra; Aheong v Mellon Mortgage Co. (In re Aheong)* (BAP 9th Cir 2002) 276 BR 233 (court has jurisdiction to issue order annulling automatic stay after dismissal of Chapter 13 case). A bankruptcy court must balance the equities on a case-by-case basis to determine whether retroactive annulment is justified. *National Envt'l Waste Corp. v City of Riverside (In re Nat'l Envt'l Waste Corp.)* (9th Cir 1997) 129 F3d 1052 (annulment allowed when debtor did not challenge contract termination until after confirmation of plan that accepted validity of termination). In deciding whether to grant retroactive relief from the stay, courts may focus on (1) whether the creditor was aware of the bankruptcy petition and (2) whether the debtor engaged in unreasonable or inequitable conduct or whether prejudice to the creditor would result. See, *e.g*., *Stinson v Bi-Rite Restaurant Supply, Inc. (In re Stinson)* (BAP 9th Cir 2003) 295 BR 109, 116, aff'd in part and rev'd in part on other grounds in *Stinson v Cook Perkiss & Lew* (9th Cir 2005) 128 Fed Appx 30, 2005 US App Lexis 5449.

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§11.18 2. Rights of Third Party Purchaser at Void Sale

Prior to BAPCPA (see §11.1), courts were divided on whether 11 USC §549(c) created an implied exception to the automatic stay that would protect a good faith third party purchaser at a foreclosure sale held in violation of the stay. See §7.91. Section 549 empowers a trustee to avoid an unauthorized postpetition transfer of estate property. However, an exception to this avoidance power exists for a good faith purchaser of real property that pays fair equivalent value and purchases without knowledge of the commencement of the bankruptcy case. 11 USC §549(c). The exception is not available if a copy of the bankruptcy petition has been recorded before the sale with the county recorder for the county in which the property is located. 11 USC §549(c).

The Ninth Circuit ruled that §549(c) did not create an exception protecting a bona fide purchaser at a foreclosure sale held in violation of the automatic stay. In *40235 Washington St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, 1081, the court held that §549 governed avoidance actions by the trustee, not transfers that are already void under the automatic stay. A second Ninth Circuit case also held that bona fide purchaser status alone was not cause for retroactive annulment of the stay, but it stated that a buyer could obtain relief if the equities allowed for retroactive annulment of the automatic stay. See *Fjeldsted v Lien (In re Fjeldsted)* (BAP 9th Cir 2003) 293 BR 12, which suggested 12 nonexclusive factors that might be considered in determining whether such relief is warranted (293 BR at 25):

(1) Number of case filings;

(2) Whether a repeat filing case is intended to delay and hinder creditors;

(3) Extent of prejudice to creditor and third parties if annulment not granted, including harm to a bona fide purchaser;

(4) Overall good faith of the debtor;

(5) Whether creditors knew of the automatic stay;

(6) Whether the debtor is complying with the Bankruptcy Code and Rules;

(7) Ease of restoring parties to the status quo ante;

(8) Costs of annulment to the debtor and creditor;

(9) How quickly creditor moved for annulment or how quickly debtor moved to set aside the sale;

(10) Whether, after learning of the bankruptcy, creditor continued to take steps in violation of the stay or whether it moved expeditiously to obtain relief;

(11) Whether annulment will cause irreparable injury to the debtor; and

(12) Whether annulment will promote judicial economy or other efficiencies.

See Bernhardt & Stillman, *Balancing the Automatic Stay,* 26 CEB Real Prop L Rep 144 (July 2003).

BAPCPA resolves the divided case law by creating a statutory exception to the automatic stay for transfers that are not avoidable under 11 USC §§544 and 549. See 11 USC §362(b)(24). This change should protect good faith buyers purchasing at a void foreclosure sale. In that situation, however, the foreclosing lender's damage exposure may increase if the property cannot be returned to the debtor.

PRACTICE TIP: Counsel for a debtor facing foreclosure should promptly record a copy of the bankruptcy petition and deliver to the lender and its counsel a notice of the automatic stay. A Judicial Council form (Notice of Stay of Proceedings, Judicial Council Form CM-180) is set out in California Landlord-Tenant Practice §14.57 (2d ed Cal CEB 1997). This will discourage violation of the stay and reduce the risk of litigation with third party purchasers at a sale held in violation of the stay.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/11 Enforcing Secured Loans Against Debtors in Bankruptcy/§11.19 3. Statutory Damages and Contempt Sanctions

§11.19 3. Statutory Damages and Contempt Sanctions

An individual debtor injured by a willful violation of the automatic stay shall recover actual damages including attorney fees and, in appropriate circumstances, may recover sanctions or punitive damages from the offending party. 11 USC §362(k) (formerly numbered as §362(h)). See §11.1. See also *Eskanos & Adler, P.C. v Leetien* (9th Cir 2002) 309 F3d 1210. "Willfulness" is established if (1) the creditor knew of the automatic stay and (2) the actions violating the stay were intentional. *Associated Credit Servs., Inc. v Campion (In re Campion)* (BAP 9th Cir 2003) 294 BR 313, 316. Egregious, intentional misconduct or a showing of reckless or callous disregard for the law or rights of others is required to award punitive damages for a willful violation. *Goichman v Bloom (In re Bloom)* (9th Cir 1989) 875 F2d 224; *Stinson v Bi-Rite Restaurant Supply, Inc. (In re Stinson)* (BAP 9th Cir 2003) 295 BR 109, aff'd in part and rev'd in part on other grounds in *Stinson v Cook Perkiss & Lew* (9th Cir 2005) 128 Fed Appx 30, 2005 US App Lexis 5449. In awarding attorney fees for a stay violation, the court has discretion to determine the number of hours reasonably expended and the proper hourly rate. *Dawson v Washington Mut. Bank, F.A. (In re Dawson)* (9th Cir 2004) 390 F3d 1139, 1152.

The Ninth Circuit also ruled in *Dawson* that emotional distress damages are recoverable for a violation of the automatic stay even if the injured party has not suffered financial damage. However, such an award is warranted only if an individual (1) suffered significant harm, (2) can clearly establish the harm suffered, and (3) can demonstrate a causal connection between the harm and the stay violation. The harm may be shown through corroborating medical evidence, testimony from non-experts such as family members, or evidence of such egregious or unreasonable behavior by the violator that harm may be readily apparent from the circumstances even without other corroborative evidence. 390 F3d at 1149. Other circuits have developed varying rules. See *Aiello v Providian Fin. Corp.* (7th Cir 2001) 239 F3d 876 (purely emotional damages recoverable if financial injury also exists); *U.S. v Rivera Torres (In re Rivera Torres)* (BAP 1st Cir 2004) 309 BR 643 (emotional distress claims even without financial injury allowable under 11 USC §105 as long as debtor establishes emotional distress was caused by violation of automatic stay or discharge injunction).

Some courts have allowed bankruptcy trustees and corporate debtors to obtain relief under 11 USC §362(k). In the Ninth Circuit, damages under §362(k) are not available to trustees or corporate entities, but such parties may recover civil contempt sanctions for violations of the stay under 11 USC §105. *Knupfer v Lindblade (In re Dyer)* (9th Cir 2003) 322 F3d 1178; *Havelock v Taxel (In re Pace)* (9th Cir 1995) 67 F3d 187, 193. Other circuits have liberally construed the power of the courts to award civil contempt damages under §105. See, *e.g.*, *U.S. v Rivera Torres, supra*.

NOTE: Creditors as well as debtors have standing to recover damages under 11 USC §362(k)(1) if they are seeking to protect the bankruptcy estate. *In re International Forex, Inc.* (Bankr SD Cal 2000) 247 BR 284 (creditors awarded attorney fees and punitive damages against corporate debtor's officer and his attorney for willful violation of stay).

Harmonizing inconsistent Ninth Circuit precedent, *Knupfer v Lindblade, supra,* details the limits of the contempt power that bankruptcy courts may exercise. Under §105, a court has civil contempt authority and may assess compensatory sanctions, but not "serious punitive" (*i.e.,* criminal contempt) sanctions, when a creditor with knowledge of the automatic stay takes intentional action that violates the stay. 322 F3d at 1195. "The sanctions associated with civil contempt—that is, compensatory damages, attorneys fees, and the offending creditor's compliance—adequately meet [the goal of enforcing the Bankruptcy Code]." 322 F3d at 1193. In holding that relatively mild, noncompensatory fines may be necessary and appropriate in some situations, the court implied that fines greater than $5000 would amount to impermissible punitive sanctions. *Knupfer* further clarifies that a bankruptcy court's inherent contempt authority may be the basis for sanctioning a violation of the automatic stay if the creditor acts in bad faith or intentionally violates the stay. 322 F3d at 1196. Substantial damages may be awarded to punish violation of the stay as contempt. See *Computer Communications, Inc. v Codex Corp. (In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725 (affirming compensatory contempt award of several million dollars in case filed before the subsection allowing damages for a willful violation was enacted). The primary difference is that actual damages awarded under 11 USC §362(k) are mandatory and damages for civil contempt under 11 USC §105 are discretionary. 824 F2d at 731.

Finally, the contempt power cannot be exercised against government authorities protected by sovereign immunity (*Franchise Tax Bd. v Lapin (In re Lapin)* (BAP 9th Cir 1998) 226 BR 637, 642).

Under 11 USC §362(k), a bankruptcy court must include appellate attorney fees incurred in resisting a nonfrivolous appeal in the damage award. *Beard v Walsh (In re Walsh)* (BAP 9th Cir 1998) 219 BR 873. However, 11 USC §105 does not provide a basis for awarding appellate attorney fees. *Employment Dev. Dep't v Taxel (In re Del Mission Ltd.)* (9th Cir 1996) 98 F3d 1147. Note also that creditors may have standing to seek damages for violation of the automatic stay when they are attempting to protect the interests of the bankruptcy estate. *In re International Forex, Inc., supra* (creditors obtained attorney fees and punitive damages against debtor's officer and his attorney for willfully violating automatic stay).

A party may seek damages under §362(k) or contempt sanctions by motion rather than by a complaint initiating an adversary proceeding. *Fortune & Faal v Zumbrun (In re Zumbrun)* (BAP 9th Cir 1988) 88 BR 250.

NOTE: A party charged with violation of the automatic stay has no right of contribution against other potentially responsible third persons in the bankruptcy court due to the court's lack of subject matter jurisdiction (under 28 USC §1334) over matters that have no effect on the debtor. *Walker v Cadle Co.* (*In re Walker)* (5th Cir 1995) 51 F3d 562, 569.

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III. RELIEF FROM AUTOMATIC STAY

§11.20 A. Relief Available to Creditors

Unlike in typical injunctions, the burden is generally on the enjoined creditor to move for relief from the automatic stay. However, as discussed in §11.6, BAPCPA (see §11.1) requires the debtor (or other party in interest) to take affirmative steps to impose the stay when there have been successive bankruptcy filings by the debtor. Federal courts have the final authority to determine the scope and applicability of the automatic stay; consequently, state courts do not have the power to modify or dissolve the stay. *Gruntz v County of Los Angeles (In re Gruntz)* (9th Cir 2000) 202 F3d 1074, 1083. Parties in interest may request that the bankruptcy court terminate, annul, modify, or condition the stay. 11 USC §362(d). Stay relief is ordinarily granted after a noticed hearing (see §§11.33-11.41, 11.46-11.55), but the parties may also stipulate to relief (see §§11.42-11.45). The bankruptcy courts have power to grant relief retroactively or to annul the stay. See §11.17. For example, a bankruptcy court may annul the stay retroactively to validate a foreclosure sale. See *Fjeldsted v Lien (In re Fjeldsted)* (BAP 9th Cir 2003) 293 BR 12.

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§11.21 B. Enforceability of Prepetition Stay Waivers

Anticipatory agreements waiving the automatic stay if a bankruptcy case is commenced are generally invalid as a restraint against filing bankruptcy in violation of public policy. See, *e.g., In re Jenkins Court Assocs. Ltd. Partnership* (Bankr ED Pa 1995) 181 BR 33 (holding waiver unenforceable). A reported case that summarizes at length the public policy embodied in the automatic stay rules, *In re Pease* (Bankr D Neb 1996) 195 BR 431, 433, held that a prepetition waiver of the automatic stay was unenforceable, per se,

> because (1) the waiver is invalid due to debtors' lack of capacity to act on behalf of the debtor in possession; (2) the waiver is unenforceable under specific provisions of the Bankruptcy Code which limit the effectiveness of certain contractual provisions that take effect upon the filing of a bankruptcy case [citations]; and (3) the Bankruptcy Code extinguishes the private right of freedom to contract around its essential provisions.

There is, however, some authority for the enforcement of prepetition agreements to lift the stay in single asset real estate cases (defined in §11.32). See, *e.g., In re University Commons, LP* (Bankr MD Fla 1996) 200 BR 255 (holding, alternatively, that relief from stay was warranted under terms of prepetition settlement with lender on bad faith grounds); *In re University Commons, LP* (Bankr MD Fla 1996) 204 BR 80 (denying reconsideration motion by debtor and unsecured creditor notwithstanding alleged equity in property and prejudice to interests of unsecured creditors). Such clauses are likely to be scrutinized carefully by the court.

Although the Ninth Circuit has not ruled directly on the enforceability of prepetition waivers of the automatic stay, courts in the Ninth Circuit are generally reluctant to enforce prepetition waivers of bankruptcy benefits. See, *e.g.*, *Hayhoe v Cole (In re Cole)* (9th Cir BAP 1998) 226 BR 647 (refusing to allow state court stipulated judgment to establish nondischargeability of debt because it was impermissible attempt to waive debtor's right to bankruptcy discharge); *Bruder v Peaches Records & Tapes, Inc. (In re Peaches Records & Tapes, Inc.)* (9th Cir BAP 1985) 51 BR 583, 587 n6 (noting that ipso facto clause, allowing contract to terminate on bankruptcy filing, is not enforceable). See also *Bank of China v Huang (In re Huang)* (9th Cir 2002) 275 F3d 1173.

Some lenders negotiate stay relief for future bankruptcies in reorganization plans. Such provisions are not self-executing or enforceable per se. See *Southwest Ga. Bank v Desai (In re Desai)* (Bankr MD Ga 2002) 282 BR 527; *In re Atrium High Point Ltd. Partnership* (Bankr MD NC 1995) 189 BR 599. See further discussion on debtor agreements not to oppose stay relief motions in §7.99.

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C. Grounds for Relief

§11.22 1. Overview

Prior to BAPCPA (see §11.1), the Bankruptcy Code provided three alternative grounds for obtaining relief from the automatic stay. BAPCPA adds the important fourth scenario.

(1) If the creditor establishes "cause," including but not limited to lack of adequate protection of the creditor's interest in the property or the debtor's bad faith. 11 USC §362(d)(1). See §§11.23-11.28.

(2) If the debtor holds insufficient equity in the property and the property is not necessary to an effective reorganization. 11 USC §362(d)(2). See §§11.29-11.31.

(3) In single asset real estate cases, if the debtor has not taken specified steps within 90 days of the petition date. 11 USC §362(d)(3). See §11.32. BAPCPA shortens this time to the earlier of 90 days after the petition date or 30 days after the court determines that the debtor is a single asset real estate concern, whichever is later.

(4) In cases in which creditors are secured by real estate, if the bankruptcy filing was part of a scheme to delay, hinder, and defraud creditors involving either transfer of the real estate without creditor or court consent or multiple bankruptcy filings affecting the property. 11 USC 362(d)(4). See §§11.6, 11.25 on successive filings.

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2. Cause for Stay Relief

§11.23 a. Lack of Adequate Protection

A secured lender can show lack of adequate protection of its interest in real property and related collateral, such as rents, in several ways. Typically, the lack of adequate protection problem facing the lender is postbankruptcy erosion in the value of the collateral as a result of depreciation, declining market values, unpaid real property taxes secured by a senior lien, waste, deferred maintenance, or other similar circumstances. Another common adequate protection problem arises when the debtor or trustee fails to maintain adequate insurance naming the lender as an additional insured.

In response, a debtor or trustee may try to show that the lender is adequately protected. The Bankruptcy Code sets out the following three nonexclusive examples of what can constitute adequate protection (11 USC §361):

(1) Periodic cash payments, to the extent of the decrease in value of the secured party's interest in the property;

(2) Additional or replacement liens, to the extent of the decrease in value of such entity's interest in such property; or

(3) Other relief (other than an administrative expense priority claim) that will result in the realization by such entity of the "indubitable equivalent" of its interest in the property.

Under the first two illustrations, adequate protection is required only to the extent of the decrease in value of a secured creditor's "interest in such property." This interest is the secured party's allowed secured claim, which cannot exceed the value of the property. 11 USC §506(a). Thus, adequate protection against a decline in value may consist of simply making sufficient regular payments to the lender or granting a lien on other property. In the commercial context, a lender may be compelled to accept rental income as adequate protection of its interest. *Metropolitan Life Ins. Co. v Sunnymead Shopping Ctr. (In re Sunnymead Shopping Ctr.)* (BAP 9th Cir 1995) 178 BR 809. But a secured creditor cannot be adequately protected merely by being granted an administrative priority claim in an amount equal to the decline in collateral value. See 11 USC §361(3). The inadequacy of this approach is most glaring in single asset real property cases when, after disposition of the collateral, there will usually be no assets from which to pay administrative priority claims. There may be other means, however, to provide adequate protection. *In re Eureka S. R.R., Inc.* (Bankr ND Cal 1987) 72 BR 813 (nondebtor third party's guaranty was adequate protection of interest of equipment lessor).

PRACTICE TIP: Some creditors will stipulate to an adequate protection order, typically requiring the debtor to cure defaults and make postpetition principal and interest payments in specified amounts. If the debtor thereafter fails to make the payments, the adequate protection order may also permit the creditor to obtain relief from stay within a shorter period of time than ordinarily required.

The existence of an "equity cushion" can also provide adequate protection to a secured creditor. An equity cushion exists if the value of the collateral is greater than the amount of the secured lender's claim plus any senior lien claims secured by the same property. *Pistole v Mellor* (*In re Mellor)* (9th Cir 1984) 734 F2d 1396. Junior liens are disregarded because junior encumbrances do not endanger senior lien claims. A more difficult question is presented in determining how much equity cushion is needed to constitute adequate protection. In *Pistole*, the Ninth Circuit held that an equity cushion of approximately 20 percent above the secured debt sufficed. 734 F2d at 1401. In the Ninth Circuit's view, this was sufficient to ensure that the secured creditor would receive either cash payment (under a plan or through a sale) or property with a value in excess of the secured claim, even though the automatic stay remained in effect. When a substantial equity cushion protects the creditor, the bankruptcy court may deny a stay relief motion even if the debtor is not making postpetition payments on the debt, particularly if the property is necessary to an effective reorganization. *In re Avila* (Bankr ND Cal 2004) 311 BR 81.

The stay might be allowed to continue indefinitely even with no or a negligible equity cushion if the lender is undersecured at the petition date, and therefore not entitled to postpetition interest under 11 USC §506(b), and if the lender's interest in the collateral is not being eroded. *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626. However, if the collateral is depreciating, the lender is entitled to adequate protection payments in an amount equal to the actual reduction in the value of the collateral. 484 US at 377, 98 L Ed

2d at 752.

In many situations, a lender will be able to show that the equity cushion (or its interest in the collateral if there is no equity cushion) is declining over time due to depreciation in the collateral's value or accrual of interest and other charges if the lender is oversecured or if there are oversecured senior liens accruing interest and charges (see §11.94 on postpetition accrual of interest and charges for oversecured creditors). If an equity cushion is being eroded, a court may grant the lender stay relief at a future date based on the anticipated shrinkage of the equity cushion. The debtor or trustee may also be forced to provide adequate evidence of insurance and proof of payment of secured property taxes. This approach gives a debtor or trustee a limited opportunity to sell or refinance the property or to confirm a reorganization plan that provides for treatment of the lender's claim consistent with the Bankruptcy Code.

PRACTICE TIP: Generally, courts will grant the lender stay relief before the equity cushion is completely eroded in order to provide relative certainty that the lender will be paid in full. See *La Jolla Mortgage Fund v Rancho El Cajon Assocs.* (Bankr SD Cal 1982) 18 BR 283, 289. If the lender's interest is eroding and there is no equity cushion, the lender may petition the court for an order requiring the debtor to make payments equal to the reduction in value, citing the reasoning and ruling in *Timbers*.

CAUTION: The calculation of an equity cushion regarding specific collateral for purposes of determining adequate protection under 11 USC §362(d)(1) is not the same as calculating the existence of equity for purposes of 11 USC §362(d)(2). Section 362(d)(2), discussed in §§11.29-11.31, focuses on whether there is any equity in the collateral, and all liens are included in that calculation. *Pistole v Mellor* (*In re Mellor)* (9th Cir 1984) 734 F2d 1396, 1400 n2 (equity, as opposed to equity cushion, is value above all secured claims against property that can be realized from sale of property for benefit of unsecured creditors).

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§11.24 b. Bad Faith

A bankruptcy case filed in "bad faith" may also be cause for stay relief under 11 USC §362(d)(1). See *Idaho Dep't of Lands v Arnold (In re Arnold)* (9th Cir 1986) 806 F2d 937 (affirming denial of stay relief because no clear abuse of bankruptcy process shown); *Trident Assocs. Ltd. Partnership v Metropolitan Life Ins. Co. (In re Trident Assocs. Ltd. Partnership)* (6th Cir 1995) 52 F3d 127 (bad faith found when bankruptcy filing made on eve of foreclosure by newly created debtor after losing motion in state court to enjoin foreclosure). To determine whether a case is filed in bad faith, the trial court should review the "totality of circumstances," including the following factors, rather than focusing solely on the debtor's intent:

- Whether the debtor misrepresented the facts, otherwise unfairly manipulated the Bankruptcy Code, or filed its petition or plan in an inequitable manner;
- The debtor's history of filings and dismissals;
- If the debtor's primary intent was to defeat state court litigation; and
- If the debtor's behavior was egregious.

See *Leavitt v Soto (In re Leavitt)* (9th Cir 1999) 171 F3d 1219, 1224 (affirming dismissal of Chapter 13 petition based on finding that bankruptcy was filed in bad faith).

Given the elasticity of the bad faith doctrine, the conclusion derived from the same facts may vary widely from judge to judge. At one extreme, courts have held that a bankruptcy case filed solely to delay a secured creditor's foreclosure could be bad faith even if the debtor had equity in the property and a reasonable prospect of successful reorganization. *Pacific Rim Invs., LLP v Oriam, LLC* (*In re Pacific Rim Invs., LLP)* (D Colo 2000) 243 BR 768; *In re Colonial Manor Assocs.* (Bankr MD Fla 1989) 103 BR 315. At least one court has rejected the bad faith doctrine as a judicially created, good faith condition for filing a bankruptcy petition that conflicts with the Bankruptcy Code (particularly the provisions governing single asset real estate cases), its legislative history, and case law. *In re Victoria Ltd. Partnership* (Bankr D Mass 1995) 187 BR 54. The Ninth Circuit has not ruled on this issue.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/11 Enforcing Secured Loans Against Debtors in Bankruptcy/§11.25 (1) Successive Filings

§11.25 (1) Successive Filings

One of the most vexing problems for secured lenders is the filing of successive bankruptcy cases to block a foreclosure. For example, a debtor may undertake one or more of the following courses of action after a secured party obtains stay relief but before it can foreclose:

- Dismissal of the bankruptcy case without prejudice, with the filing of a new case on the eve of foreclosure;
- Filing a new case in the same or another district, even without dismissal of the old case;
- Conveyance of the property to a third party, with or without bankruptcy court approval, with a new bankruptcy filed by the third party on the eve of foreclosure, or to a third party that is already a debtor in an existing bankruptcy case; or
- Granting a deed in lieu of foreclosure to a junior lienholder affiliated with the debtor, with the new owner arguing that there is now equity in the property because the junior lien no longer encumbers the property.

The courts have properly refused to impose a blanket prohibition on serial bankruptcy filings. *Johnson v Home State Bank* (1991) 501 US 78, 115 L Ed 2d 66, 111 S Ct 2150 (debtor who was discharged from personal liability on mortgage in Chapter 7 case allowed to file subsequent Chapter 13 case to modify mortgage terms; this procedure is informally called "Chapter 20"); *Elmwood Dev. Co. v General Elect. Pension Trust (In re Elmwood Dev. Co.)* (5th Cir 1992) 964 F2d 508 (serial cases should be tested on individual basis to determine if subsequent bankruptcy is filed in good faith). However, when there is only a short period between the dismissal of a prior bankruptcy case and the filing of a new petition, some courts have placed the burden on the debtor to show that there has been a change in circumstances justifying the new case. See *In re Fuhrman* (Bankr ED Mich 1990) 118 BR 72; *In re Garsal Realty, Inc.* (Bankr ND NY 1989) 98 BR 140. Absent such proof, courts are inclined to give a lender relief. See *Martwick v Agribank, FCB (In re Martwick)* (8th Cir 1995) 60 F3d 482 (no abuse of discretion to deny continuance of relief from stay motion when Chapter 11 petition was filed shortly after entry of Chapter 7 discharge to block lender's sale despite only 4 days' notice and unavailability of debtor's counsel); *In re Rauso* (ED Pa 1997) 212 BR 242 (reopening dismissed Chapter 13 case to authorize lender's foreclosure and bar further filings by debtor who had filed seven Chapter 13 petitions); *Blatnick v Sanders* (*In re Sanders)* (Bankr SD Cal 1996) 198 BR 326 (annulment of stay warranted when Chapter 11 case was filed to block foreclosure sale after debtor obtained Chapter 7 discharge); *In re Huerta* (Bankr CD Cal 1992) 137 BR 356 (second Chapter 13 filing not in good faith); *In re Beswick* (Bankr ND Ill 1989) 98 BR 900 (filing second Chapter 12 case, rather than appealing dismissal of first case, was not in good faith). For further discussion of serial filings, see §11.5.

The BAPCPA (see §11.1) amendments to 11 USC §362(c), discussed in §11.6, address this issue directly and limit the applicability of the stay when there are successive filings by individual debtors. Existing "bad faith" case law will likely remain relevant to cases filed prior to enactment of the new provisions.

Prior to BAPCPA, it was possible for a lender to obtain "in rem" stay relief, effective against any new owner of the property who obtained title through the debtor, if the facts were especially egregious. Such an order was granted in a case involving serial Chapter 13 and Chapter 7 cases filed by a debtor, his wife, and a related party to block a foreclosure. The bankruptcy court held that its in rem stay relief order was valid without notice to the debtor despite due process concerns. *Fernandez v GE Capital Mortgage Servs.* (*In re Fernandez)* (Bankr CD Cal 1997) 212 BR 361, aff'd (BAP 9th Cir 1998) 227 BR 174, aff'd (9th Cir 2000) 208 F3d 220 (unpublished opinion). BAPCPA effectively codifies in rem relief by making the stay generally inapplicable to acts to enforce a lien or security interest in real property for 2 years after a stay relief order is obtained regarding such property. To qualify for this protection, the order must be recorded with the county recorder. 11 USC §§362(b)(20), 362(d)(4). See §11.11.

The Bankruptcy Code also expressly blocks a second bankruptcy filing by an individual or family farmer debtor if the debtor's bankruptcy case is (1) voluntarily dismissed at the request of the debtor after a motion for stay relief is filed or (2) dismissed for willful failure to abide by court orders or to appear before the court in proper prosecution of the case. 11 USC §109(g)(1)-(2). In either of those circumstances, the debtor is not eligible to be a debtor in a new bankruptcy

case for 180 days after the case is dismissed. Section 109(g) is likely to deter attorneys from filing a new case for the proscribed period. A determined debtor, however, might still file a new case in pro per in violation of §109(g). Before BAPCPA, the Ninth Circuit held under such circumstances that the filing does not reinstitute the automatic stay and that a foreclosure sale conducted after such a filing is still valid. See *Umali v Dhanani (In re Umali)* (9th Cir 2003) 345 F3d 818, withdrawn (9th Cir 2004) 382 F3d 1158. This rule is now codified in 11 USC §362(b)(21) under BAPCPA. See §11.11.

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§11.26 (2) New Debtor Syndrome

Another common bad faith scenario is the "new debtor syndrome." In the prototypical case, property is conveyed on the eve of foreclosure to a newly formed or already existing shell entity, and a bankruptcy petition is filed for that entity. Often, the new entity pays no consideration or merely assumes the encumbrances on the property. See, *e.g., United Enters., Ltd. v ACI Sunbow, LLC (In re ACI Sunbow, LLC)* (Bankr SD Cal 1997) 206 BR 213 (court may grant stay relief based on subjective bad faith without finding of objective futility of plan); *California Mortgage Serv. v Yukon Enters. (In re Yukon Enters.)* (Bankr CD Cal 1984) 39 BR 919.

Transferring assets into a shell corporation on the eve of its bankruptcy is not per se bad faith. *Meadowbrook Inv. Group v Thirtieth Place, Inc. (In re Thirtieth Place, Inc.)* (BAP 9th Cir 1983) 30 BR 503. The initial burden to establish bad faith is on the creditor. However, once "a prima facie case is established, the burden shifts to the debtor to demonstrate a good faith business reason for the transfer and the filing." *Duvar Apartments, Inc. v FDIC (In re Duvar Apartments, Inc.)* (BAP 9th Cir 1996) 205 BR 196, 200. Indicia of the new debtor syndrome include the following:

- Transfer of distressed property into a newly created corporation;
- Transfer occurring within a close proximity to the bankruptcy filing;
- Transfer for no consideration;
- Debtor has no assets other than the recently transferred property;
- Debtor has no or minimal unsecured debt;
- Debtor has no employees and no ongoing business; and
- Debtor has no means, other than the transferred property, to service the debt on the property.

BAPCPA (see §11.1) addresses "new debtor syndrome" by authorizing stay relief in cases involving real estate collateral if the bankruptcy filing was part of a scheme to delay, hinder, and defraud creditors involving either transfer of the real estate without creditor or court consent or multiple bankruptcy filings affecting the property. 11 USC §362(d)(4). The combination of this provision and new 11 USC §362(b)(20), which generally makes stay relief for lien enforcement against real property effective for 2 years even if a new case is filed (see §11.25), should markedly reduce potential disruption from abusive new debtor cases.

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§11.27 (3) Other Relief Based on Bad Faith

A case filed in bad faith can be grounds for significant relief beyond modification of the automatic stay. The following are additional forms of relief that have been granted:

- Dismissal of entire bankruptcy case. See *Leavitt v Soto (In re Leavitt)* (9th Cir 1999) 171 F3d 1219, 1224; *Marsch v Marsch (In re Marsch)* (9th Cir 1994) 36 F3d 825 (filing used solely as litigation tactic by solvent debtor).
- Conversion of case from one Chapter to another. See *Molitor v Eidson* (*In re Molitor)* (8th Cir 1996) 76 F3d 218 (three Chapter 13 filings evidenced bad faith, supporting conversion to Chapter 7).
- Barring of further bankruptcy filings indefinitely by order dismissing bankruptcy case with prejudice under 11 USC §349(a). See *Casse v Key Bank Nat'l Ass'n (In re Casse)* (2d Cir 1999) 198 F3d 327 (foreclosure sale not invalidated by fourth bankruptcy filing that was void because of dismissal with prejudice of prior case filed in bad faith).
- Imposition of sanctions against the debtor or its attorney. See *Miller v Cardinale (In re DeVille)* (9th Cir 2004) 361 F3d 539 (compensatory and deterrent sanctions properly awarded based on serial filings); *Dressler v Seeley Co. (In re Silberkraus)* (9th Cir 2003) 336 F3d 864 (bankruptcy filing by solvent debtor as litigation tactic in commercial lease dispute held to be filed in bad faith and for improper purpose); *Marsch v Marsch (In re Marsch)* (9th Cir 1994) 36 F3d 825 (frivolousness and improper purpose must both be examined); *Blake, Barnett, Milman & Bell, Inc. v Chalmers (In re Villa Madrid)* (BAP 9th Cir 1990) 110 BR 919.

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§11.28 c. Other Cause for Stay Relief

Courts have also found other forms of "cause" justifying modification or termination of the stay under 11 USC §362(d)(1). As "cause" is not defined, the particular circumstances of the case will be determinative. See, *e.g.*, *Delaney-Morin v Day (In re Delaney-Morin)* (BAP 9th Cir 2003) 304 BR 365 (postpetition defaults may constitute cause for stay relief); *Margell v Bouquet Invs. (In re Bouquet Invs.)* (Bankr CD Cal 1983) 32 BR 988 (undue burden on secured creditor because of its financial position).

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§11.29 3. Lack of Equity and Property Not Necessary for Effective Reorganization

An alternative ground for stay relief is establishing that (1) the debtor does not have any equity in the collateral and (2) such property is not necessary to an effective reorganization. 11 USC §362(d)(2). The policy underlying §362(d)(2) is to examine whether any useful purpose is served by maintaining the automatic stay. If the debtor has no equity in the property and has little or no chance of successfully reorganizing, no legitimate purpose is served by delaying the secured creditor's enforcement of its rights, even if the creditor's interest in the property is adequately protected for the moment. On the other hand, if there is significant equity in the property, maintaining the stay gives the debtor an opportunity to maximize the value of the property for its unsecured creditors and interest holders, either through orderly liquidation or retention of the property under a confirmed plan. See *In re Avila* (Bankr ND Cal 2004) 311 BR 81.

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§11.30 a. Determining Whether Equity Exists

The process of measuring equity in real property is relatively straightforward in some cases and complicated in others. All liens against the property are added up, and the total is compared to the fair market value of the property, which is usually determined by analyzing appraisal testimony. *Stewart v Gurley* (9th Cir 1984) 745 F2d 1194. On valuation and appraisal standards, see §§11.91, 11.110, 11.126, 11.129. The creditor has the burden of establishing whether the debtor has equity in the property. 11 USC §362(g)(1).

NOTE: Calculation of equity for the purpose of establishing justification for stay relief under 11 USC §362(d)(2) is a separate and distinct analysis from calculation of the amount of the equity or value "cushion" sufficient to afford a secured creditor "adequate protection" of its interest under 11 USC §363(e) if relief from stay is not granted. See §§11.69-11.70. The relative priority of a lienholder moving for stay relief is not relevant to the former analysis, but it is relevant to the latter. If a senior lienholder seeks stay relief, junior liens are normally not considered in evaluating the senior lienholder's equity or value cushion. *Stewart v Gurley, supra*.

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§11.31 b. Necessity of Property for Effective Reorganization

The second prong of the test in 11 USC §362(d)(2), whether the debtor's property is necessary to an effective reorganization, arises in cases commenced under Chapters 11 and 12 and sometimes Chapter 13. The second prong is never an issue in Chapter 7 cases, because Chapter 7 provides only for liquidation.

Chapter 13 is available only to individuals with regular income and limited debts. 11 USC §109(e). As a result, the secured real estate lender's focus in a Chapter 13 case is typically on the individual debtor's residence, although rental properties are sometimes involved. Generally, a debtor's residence should not be critical to a Chapter 13 plan, but if the home or other properties generate rental income, they may be an important part of the proposed plan. See *In re Avila* (Bankr ND Cal 2004) 311 BR 81. Notably, a Chapter 13 debtor is required to file a proposed plan within 15 days of the commencement of the case. Fed R Bankr P 3015(b). This requirement usually leads a lender to first examine whether its proposed treatment under the plan is proper, with the initial contest, if any, being over such treatment rather than stay relief.

For secured real estate lenders in Chapter 11 and Chapter 12 cases, the focus is usually on the importance of commercial real estate to the reorganization of a business operation or family farm. The term "effective reorganization" is not defined in the Bankruptcy Code, and the legislative history is equally unavailing. The Supreme Court has stated that the appropriate test is a determination of whether there is "a reasonable possibility of a successful reorganization within a reasonable time." *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 751, 108 S Ct 626. The debtor has the burden of establishing a reasonable likelihood of successful reorganization. 11 USC §362(g)(2). To satisfy this test, the debtor must present evidence of the plan's contents, state when it will be proposed and brought to fruition, and demonstrate that there is a realistic chance that the plan will be confirmed. See *Western Farm Credit Bank v Teresi (In re Teresi)* (Bankr ED Cal 1991) 134 BR 392.

This burden may be less during the first 120 days of a Chapter 11 case because Congress recognized, in granting the debtor the exclusive right (with limited exceptions) to file a plan during that period, that it may take the full 120 days to formulate a reorganization plan that will likely succeed. See 11 USC §1121(b), (e). If the debtor obtains an extension of the exclusivity period pursuant to 11 USC §1121(d), the burden may not be less; generally, the longer a case is pending, the greater the burden should be on the debtor to prove a reasonable likelihood of reorganizing. Under BAPCPA (see §11.1), the exclusivity period for filing a plan can be extended "for cause," but not for longer than 18 months after the petition date. 11 USC §1121(d).

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§11.32 4. Single Asset Real Estate

In a "single asset real estate" case (see §11.22), a creditor whose claim is secured by an interest in such real estate may obtain relief from the automatic stay unless, within 90 days after the petition date, the debtor either (1) files a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time or (2) begins making monthly payments to the secured creditor in an amount equal to interest at the nondefault contract rate on the portion of the claim secured by the real property. 11 USC §362(d)(3). The 90-day period can be extended for cause by the bankruptcy court. Section 362(d)(3) was added to the Bankruptcy Code in 1994 to prevent debtors with little hope of rehabilitation from using Chapter 11 to delay real estate foreclosures indefinitely. See *Kraatz v Oceanside Mission Assocs. (In re Oceanside Mission Assocs.)* (Bankr SD Cal 1996) 192 BR 232.

Under BAPCPA (see §11.1), the deadline for plan filing or making interest payments is 90 days after the petition date or 30 days after the court determines that the case has been filed by a single asset real estate debtor, whichever is later (11 USC §362(d)(3)). The debtor may use prepetition or postpetition rents to make the required interest payments. 11 USC §362(d)(3)(B)(i). A debtor might argue that these payments should be a lender's sole adequate protection (see §§11.22-11.23), but the statutory language does not expressly prevent other supplemental forms of adequate protection of a lender's interest.

Beyond providing grounds for stay relief, the plan filing deadline in §362(d)(3) effectively fast-tracks a single asset real estate case. The notion is that it should not be difficult to assess the business of a small real estate venture and put forward a plan. (On validity of prepetition agreements to modify stay in single asset cases, see §11.21.)

Before BAPCPA, the Bankruptcy Code defined the term "single asset real estate" as "real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000." 11 USC §101(51B). Courts have differed on how to calculate the debt limit set out in this definition. One view is that the $4 million limit refers to the total amount of all secured claims without regard to the underlying value of the property. *Kraatz v Oceanside Mission Assocs. (In re Oceanside Mission Assocs.)* (Bankr SD Cal 1996) 192 BR 232. The opposing view is that the secured debt cannot exceed the underlying property value. *In re Pensignorkay, Inc.* (Bankr ED Pa 1997) 204 BR 676. This issue disappears in cases governed by BAPCPA, which eliminates the debt limit entirely and excludes family farmers from the definition.

Disputes have also arisen about whether a debtor is a real estate business subject to §362(d)(3). If the debtor generates income from non-real estate businesses, it probably does not satisfy the definition. See, *e.g., Ad Hoc Group of Timber Noteholders v Pacific Lumber Co. (In re Scotia Pac. Co.)* (5th Cir 2007) 508 F3d 214, 217 (timber farm with harvesting business is not a single asset case); *Centofante v CBJ Dev. (In re CBJ Dev.)* (BAP 9th Cir 1996) 202 BR 467 (full-service hotel with bar and restaurant is not single asset real estate venture); *In re Kkemko, Inc*. (Bankr SD Ohio 1995) 181 BR 47 (marina was not single asset real estate venture because of its other income-producing activities). See also *In re McGreals* (Bankr ED Pa 1996) 201 BR 736 (two adjacent parcels, only one of which was developed, were not single asset real estate).

NOTE: Section 362(d)(3) is not the exclusive ground for stay relief in a single asset real estate case. See *Duvar Apartments, Inc. v FDIC (In re Duvar Apartments, Inc.)* (BAP 9th Cir 1996) 205 BR 196 (affirming relief based on bad faith filing). Indeed, bad faith has been a frequent basis for both stay relief and other relief in single asset real estate cases. See, *e.g., State St. Houses, Inc. v N.Y. State Urban Dev. Corp. (In re State St. Houses, Inc.)* (11th Cir 2004) 356 F3d 1345.

PRACTICE TIP: The likelihood of a bad faith finding is greatly heightened if the debtor has filed more than one bankruptcy case or if new debtor syndrome exists. See §§11.24-11.27. Some cases appear to conclude that filing a bankruptcy petition on the eve of a foreclosure sale is indicative of bad faith. That factor alone should not be dispositive, because bankruptcy cases are virtually always prompted by stress arising from creditor action that will

impair or encumber a debtor's assets or operations.

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D. Procedure for Obtaining Relief From Automatic Stay

1. Motion for Relief From Stay

§11.33 a. Creditor's Pleadings

A "request" for relief from the automatic stay under 11 USC §362(d) is treated as a contested matter and initiated by motion. Fed R Bankr P 4001(a)(1), 9014. In the creditor's moving papers, the creditor must demonstrate to the bankruptcy court that it is the "real party in interest" under Fed R Civ P 17. See *In re Kwan Jin Hwang* (Bankr CD Cal 2008) 393 BR 701, rehearing granted and opinion modified at (Bankr CD Cal 2008) 396 BR 757 (summarized in §7.15). See also *In re Jacobson* (Bankr WD Wash 2009) 402 BR 359. Service of the motion must be made on the debtor and its counsel. Fed R Bankr P 4001(a)(1), 7004, 9014. Notice requirements vary with the particular chapter of the Bankruptcy Code involved. In Chapter 7 and 13 cases, the trustee must be served along with any creditors' committee appointed in the case (or its designated agent); in Chapter 11 cases, if no committee exists, notice must be served on the 20 largest unsecured creditors. The court may direct that other creditors (such as junior lienholders) be served. Fed R Bankr P 4001(a)(1).

PRACTICE TIP: Counsel should review the court's docket before any motion is filed to obtain copies of any changes of address and any requests for special notice filed by parties in interest, such as junior lienholders. Too often, motions for stay relief are denied or continued because of a notice problem. If out-of-town counsel will associate local counsel, prepare and file notice of association as required by local rules. See *In re Jacobson, supra*.

Local rules of the bankruptcy court and any guidelines or standing orders issued by a particular judge should be consulted in order to properly format, file, and serve the moving papers. See, *e.g.,* CD Cal Local Bankr R 9013-1(c)-(e) (as incorporated by CD Cal Local Bankr R 4001-1). See also ED Cal Local Bankr R 4001-1, ND Cal Local Bankr R 4001-1, and SD Cal Local Bankr R 4001-2, each having similar rules. In many districts, the courts, by local rule or otherwise, have encouraged the parties to submit all evidence in the form of declarations and sharply limited the use of live testimony. See, *e.g.,* ND Cal Local Bankr R 4001-1; *Adair v Sunwest Bank (In re Adair)* (9th Cir 1992) 965 F2d 777. Local court procedures should enable parties to ascertain beforehand whether live testimony will be given at a hearing. See Fed R Bankr P 9014(e).

WARNING: Because Fed R Bankr P 4001(a)(3) provides that an order granting stay relief is stayed for 14 days after entry of the order unless the court orders otherwise, counsel should request in the moving papers that the 14-day period be shortened or that the order become effective immediately on entry.

The current specialized rules and forms required by a bankruptcy court or a specific judge can usually be found on the courts' websites:

CD Cal: http://www.cacb.uscourts.gov

ED Cal: http://www.caeb.uscourts.gov

ND Cal: http://www.canb.uscourts.gov

SD Cal: http://www.casb.uscourts.gov

On stay relief motion procedures, see Moving for Relief From an Automatic Stay in Bankruptcy (Cal CEB Action Guide September 2006), which has numerous sample forms and strategies for stay relief motions.

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§11.34 b. Responsive Pleadings

As discussed in §§11.35-11.41, a motion for relief from the automatic stay regarding property of the bankruptcy estate is given expedited treatment by the Bankruptcy Code and typically involves a preliminary hearing followed by a final hearing. 11 USC §362(e). The requirements and timetable for a debtor or trustee to file responsive papers varies dramatically from district to district in California. Counsel should consult the local rules to comply with requirements for format, service, and filing. On strategies for opposing stay relief motions, see §§7.15, 7.99-7.106, 11.46-11.48.

The Northern District conducts a preliminary hearing, which is treated like a status conference. ND Cal Local Bankr R 4001-1(c) (preliminary hearing held on at least 15 days' notice). Responsive papers may be filed but are not required. ND Cal Local Bankr R 4001-1(f). By contrast, in the Central and Southern Districts, a stay relief motion is a contested matter that requires an evidentiary hearing (see, *e.g.,* CD Cal Local Bankr R 9013-1(a)(1), (o)(2)(B)), and the opposing party is required to file responsive pleadings within a short period of time. See CD Cal Local Bankr R 9013-1(f) (not later than 14 days before the hearing date); SD Cal Local Bankr R 4001-3 (11 days). In the Eastern District, a stay relief motion must be scheduled for a hearing, and the motion may be set on either 28 or 14 days' notice. See ED Cal Local Bankr R 4001-1, 9014-1(f). If the 28-day period is used, then opposing papers are required 14 days before the hearing. ED Cal Local Bankr R 9014-1(f)(1)(ii). If the moving party elects the 14-day period, the time limits of §362(e) are waived and any opposition must be presented at the hearing, with the court retaining the power to continue the hearing to permit the filing of evidence and briefs. ED Cal Local Bankr R 9014-1(f)(2)(ii)-(iii).

PRACTICE TIP: Valuation of real property collateral is determinative of equity and adequate protection issues in stay relief motions. As a result, disputes about valuation are common. Trustees and debtors should consider employing an appraiser at the outset of a case involving real property collateral. This will allow a better opportunity to prepare and present valuation evidence when faced with the expedited scheduling of stay relief motions. On valuation standards, see §§11.41, 11.91, 11.110, 11.126, 11.129.

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§11.35 c. Preliminary Hearing

The stay automatically terminates 30 days after a motion is made seeking stay relief against property of the bankruptcy estate unless, before the 30 days run, the court continues the stay in effect pending a final determination of whether relief should be granted. A continuance of the stay should be authorized if there is a reasonable likelihood that the debtor (or other party opposing stay relief) will prevail at the final hearing, although continuances by consent of the parties are also common. Continuance of the stay can only be ordered after notice and a hearing. The initial hearing held within the 30-day period can be a preliminary hearing or consolidated with a final hearing. If a final hearing is set, it must be concluded no later than 30 days after the preliminary hearing unless the parties consent to a longer period or the court extends the time based on compelling circumstances. 11 USC §362(e). BAPCPA (see §11.1) provides that the stay automatically terminates in Chapter 7, 11, and 13 individual debtor cases 60 days after the motion is filed unless the court issues a final decision continuing the stay before the 60 days runs or that period is extended by consent of the parties or by the court for good cause described in the findings. 11 USC §362(e)(2).

As noted in §11.34, local procedure often calls for a preliminary hearing on short notice. At the preliminary hearing, the court will determine if the motion is contested. If the motion is not contested, an order granting relief will usually be granted at that time. If the motion is contested, the court will usually sound out the disputed factual and legal issues and any discovery needed by the parties and then set a briefing schedule and a final hearing.

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§11.36 d. Final Hearing

Matters are set for final hearing in stay relief motions involving real property collateral for two primary reasons. First, if there is a substantial dispute regarding the value of the property, the court may wish to hear live testimony to reconcile the discrepancies. Second, the court may wish to allow the debtor or bankruptcy trustee some period of time during which to make a concrete proposal of adequate protection or of a plan of reorganization. However, a court need not hold a hearing on every proposed plan of reorganization before granting stay relief. Rather, the court need only determine whether a successful reorganization is possible within a reasonable time. *Sun Valley Newspapers v Sun World Corp. (In re Sun Valley Newspapers)* (BAP 9th Cir 1994) 171 BR 71.

Courts will sometimes continue hearings on stay relief motions based on representations by the trustee or debtor that a sale or refinancing or other business solution is in process. If pushed by a secured creditor's counsel in these situations, the court may simply deny the motion without prejudice to its being renewed after the debtor has had the opportunity to achieve the business solution.

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§11.37 e. Ex Parte Relief

If necessary to prevent irreparable damage to its collateral before there is an opportunity for notice and a hearing, a lender may seek ex parte stay relief with or without a hearing and without prior notice and before there is opportunity for notice and a hearing. 11 USC §362(f); Fed R Bankr P 4001(a)(2). The facts substantiating such immediate and irreparable harm must be set forth by declaration or in a verified motion, and the lender's counsel must certify her or his efforts to give notice and why notice should not be required. Fed R Bankr P 4001(a)(2). If ex parte relief is obtained, the lender is required to immediately give oral and written notice to the debtor in possession or to the trustee and the debtor, and reinstatement of the stay may be sought on 2 days' notice to the lender. Fed R Bankr P 4001(a)(2). Counsel should also consult the local court rules and practices regarding ex parte procedures.

If the collateral is real property, it will be difficult to establish that irreparable harm will result before the usual expedited notice and hearing. See, *e.g., Delaney-Morin v Day* (*In re Delaney-Morin)* (BAP 9th Cir 2003) 304 BR 365 (tax delinquencies did not provide adequate basis for ex parte relief from stay). However, if the collateral is at immediate risk of destruction, ex parte relief may be warranted. Some courts may also be disposed to grant ex parte relief if the debtor has filed its bankruptcy case in bad faith. This is especially so if the debtor has filed successive bankruptcy cases to block foreclosure, if stay relief has been granted in earlier cases, or if the debtor is not entitled to file the new case under 11 USC §109(g). An argument can be made that denying ex parte relief solely because there is no irreparable harm under such circumstances condones abuse of the bankruptcy process. See §§11.24-11.27 for additional discussion of bad faith filings and provisions of BAPCPA (see §11.1) significantly limiting applicability of the stay in such situations.

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§11.38 f. Discovery

The Federal Rules of Bankruptcy Procedure generally adopt the discovery rules set out in the Federal Rules of Civil Procedure. See Fed R Bankr P 9014, 7026, 7028-7037. The time limits for discovery requests in the Federal Rules of Civil Procedure are, however, totally inconsistent with the expedited nature of stay relief litigation. Thus, counsel must rely either on stipulations with opposing counsel or orders shortening time for discovery. Fortunately, extensive discovery is not necessary. When needed, oral depositions of the other party or its valuation expert usually suffice. If stipulations cannot be reached, discovery issues should be addressed at the preliminary hearing.

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g. Evidence

§11.39 (1) Burden of Proof

The lender moving for stay relief has the burden of proof on the issue of the debtor's equity in the property, and the burden of proof is on the responding party for "all other issues." 11 USC §362(g). Although those are the ultimate burdens, the creditor has the initial burden of establishing a prima facie case for relief under §362(d), after which the burden of persuasion shifts to the trustee or debtor, consistent with the proof allocation in §362(g). See, *e.g., Delaney-Morin v Day (In re Delaney-Morin)* (BAP 9th Cir 2003) 304 BR 365 (reversing order granting stay relief because no competent evidence submitted). *In re Brown* (Bankr SD Ohio 1987) 78 BR 499, 502.

WARNING: The moving party must establish that it is the real party in interest. Loan servicing agents (such as MERS; see §7.15) that do not own the note but are the moving parties in stay relief motions frequently have a problem establishing who is the real party in interest for loans that have been securitized, sold on the secondary market, and assigned to other entities. See §§7.105-7.106.

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§11.40 (2) Encumbrances

The creditor has the burden of proving lack of equity if that is an issue. To establish lack of equity requires proof of the value of the property and the amount of liens against the property. See §§11.29-11.31. It is easy enough for a lender to testify about the debt secured by its own deed of trust, but it is often difficult to prove the balances secured by other liens. The easiest solution is to stipulate to the other lien amounts with opposing counsel, but debtors are not always cooperative and trustees seldom have easy access to the needed information, especially within the compressed time frame of a stay relief motion.

WARNING: The schedules of liabilities that a debtor is required to file under oath at the commencement of the bankruptcy case may contain admissions of the amounts of other liens. However, those schedules may be incomplete, inaccurate, or state "current balance unknown" rather than a dollar figure. They might also not even have been filed.

For a lender to objectively evaluate encumbrances, a trustee sale guaranty or some other form of title report by a recognized title insurance company that identifies all liens should be obtained. See §§2.34, 3.21. Such a report may be admissible in evidence under the "catch-all" exception to the hearsay rule. Fed R Evid 807. But the title report will prove only the existence and original principal amounts of other liens, not current balances. An argument can be made that the report suffices to create a presumption that the debts are as reflected in the title report, thereby shifting the burden to the debtor to prove that these claims have been reduced—but this argument may be rejected. The creditor is then placed in the unenviable position of having to accept as true the debtor's testimony about the debt. The best evidence of the other liens against the property is a declaration from each of the other creditors. If such declarations cannot be obtained, the creditor's declaration about the current amounts of senior encumbrances may qualify under an exception to the hearsay rule if the creditor has collected such information on a regular basis as part of its business records. If the creditor submits such a declaration, and even if the declaration is inadmissible, most bankruptcy judges will at least shift the burden onto the debtor to submit evidence of the extent of the debt.

PRACTICE TIP: The amount of property tax liens is generally available to the public by contacting the office of the tax collector in the county where the real property is located. This information can ordinarily be obtained by phone with just the parcel number.

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§11.41 (3) Value of Property

The creditor must prove value to show that the estate lacks equity in the real estate. 11 USC §362(g)(1). But the debtor or trustee must prove value if adequate protection is the issue. For example, a trustee would have the burden of showing property value if she or he contended that an equity cushion provides adequate protection to the lender. 11 USC §362(g)(2).

Value is usually proved by appraisal testimony, which (with the exception of low-priced to medium-priced single-family residences) is often unreliable. Substantial divergence in opinion by appraisal experts is not unusual. Differences seem primarily attributable to the volatility of both real property and financing markets and the lack of comparable sales in slow markets. Additionally, the availability and cost of financing greatly influence valuations. On appraisal standards, see §§11.91, 11.110, 11.126, 11.129.

The case involving income-producing property is no different. The standard appraisal technique is to forecast a standardized stream of income (*i.e.,* net operating income equal to gross rents less operating expenses excluding debt service) and divide it by a "capitalization rate." Even when the appraisers agree on a standardized income stream—and they frequently do not—the critical factor is the selected capitalization rate. For example, a property with a projected income stream of $200,000 per year will have a value of approximately $2,200,000 at a capitalization rate of 9 or a value of approximately $1,800,000 at a capitalization rate of 11. Selection of capitalization rates is one of the more opaque aspects of appraisal technique. Not only can experts' selected capitalization rates be widely divergent, but appraisal theory also provides several alternative methods of selecting capitalization rates (*e.g.,* the "built-up" method, the "band of investment" method, the "Ellwood" method). Because these, in turn, depend on assumptions about the availability of specified types of financing in the marketplace and the rates of return on available alternative investments, the cross-examiner is once again forced into the field of economics. This situation has led some counsel, in cases when enough is at stake to justify it, to retain expert economists as well as appraisers. But some courts have shown reluctance to permit economic-expert testimony on the theory that only an appraiser is an expert on real property value. Counsel should be prepared to qualify their expert under Fed R Evid 703.

PRACTICE TIP: An appraisal prepared specifically for a relief from stay hearing may not be admissible in some courts. The court in *In re Applin* (Bankr ED Cal 1989) 108 BR 253, 260, refused to admit a bank's appraisal, stating that "[a]ppraisals that are obtained for the purpose of litigation and upon which independent business decisions are not routinely made are generally not sufficiently trustworthy to qualify for the business records exception to the hearsay rule." A lender should arrange for the appraiser to be qualified as an expert witness and to testify in person at a final hearing on a motion for relief from stay.

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2. Agreement for Relief From Stay

§11.42 a. Overview and Approval

A lender may be able to negotiate a stipulation modifying the automatic stay with a trustee or a debtor. Typical agreements concerning real property collateral will (1) limit the duration of the stay (the "drop dead date" settlement) or (2) provide for a schedule of periodic payments, with relief automatically given upon default. These types of agreements give a trustee or debtor an opportunity to realize value from the collateral either through sale or as part of a reorganization plan.

A standard requirement in a stay relief agreement is that the trustee or debtor maintain insurance in an amount sufficient to protect the creditor's interest. The policy should name the lender as an additional insured. Often, the loan documents will provide some guidance on the appropriate level of insurance. In addition, if the lender has not already recorded a notice of default, a lender may be able to negotiate to allow itself to take that preliminary step without further delay.

Court approval of a stay relief stipulation is required. Fed R Bankr P 4001(d). Notice of the motion seeking approval is served on the same persons that are served with a stay relief motion and such other persons as the court may direct. Fed R Bankr P 4001(d)(2). Rule 4001 sets out minimum time requirements for notice, but local rules should also be consulted to confirm that they are not stricter. Fed R Bankr P 4001(d)(2)-(3). If no objection is filed, the stipulation may be approved without a hearing. Fed R Bankr P 4001(d)(3).

Sometimes, stay relief agreements are reached after the lender files a stay relief motion. Such agreements may be approved without bringing a separate motion if the court determines that the stay relief motion was sufficient to afford reasonable notice of the material provisions of the stay relief agreement. Fed R Bankr P 4001(d)(4).

PRACTICE TIP: If other secured parties have an interest in the real property, a court may require notice to such parties. Of particular concern are junior creditors that will be wiped out if stay relief authorizes a senior lienholder to foreclose. Therefore, to avoid delay, parties should consider giving notice of stay relief motions or motions seeking approval of a stay relief agreement to the other entities or persons asserting liens on the real property.

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§11.43 b. "Drop Dead" Agreement

The concept of a "drop dead date" is that the lender and debtor or bankruptcy trustee agree that if the debt is not paid in full, or reinstated by a stipulated date certain, the creditor is free to foreclose. In drafting the agreement, counsel should particularly focus on the following two issues:

(1) When is the creditor permitted to take preliminary steps toward foreclosure? If the stay remains in effect until the "drop dead date," such steps will be enjoined unless the settlement documents provide for an earlier partial modification of the stay to allow recordation of a notice of default or publication of notices of sale.

(2) Is this agreement intended to be a final settlement of all injunctive rights against foreclosure, or are there circumstances under which a further injunction may issue? If the latter, what are those circumstances? Many debtors' counsel believe that even if an absolute date is agreed on, the court retains jurisdiction under 11 USC §105(a) to issue an affirmative injunction on a proper showing. If a final settlement is intended, creditor's counsel should make that fact known to debtor's counsel and to the court, and the agreement should clearly provide that it is final.

One common variation on the simple "drop dead date" settlement is an agreement that the creditor may foreclose on a date certain unless an escrow is opened for the sale of the property. From a creditor's point of view, such agreements frequently prove illusory no matter how much care is taken in drafting, and the creditor may find it preferable to agree to a longer period of time in the first place in exchange for an absolute "drop dead date." For example, an agreement to continue the stay if a "bona fide" escrow is opened frequently results in litigation over whether a given escrow is bona fide. On the other hand, a sale by the trustee or debtor can result in a relatively simple payoff to the lender. At the very least, the following questions should be addressed:

- When must the escrow close?
- If escrow does not close by the date agreed, can the debtor get a further injunction by showing that it will close soon?
- What types of contingencies, if any, may remain open if the debtor is to be allowed further time?
- Must the sale contemplated by the escrow provide that the creditor will be paid in full upon close? If not, is this settlement a waiver of whatever due-on-sale rights the creditor may have?
- Must the proposed buyer meet with the creditor's approval? If so, what are the criteria for approval?
- Will the default in the creditor's obligation be cured by cash payment on close of escrow?
- If the note provides for a higher rate of interest after default, will the new buyer pay at the default rate or at the original contract rate?
- If the proposed sale provides for neither payment in full to the creditor nor reinstatement and assumption of the creditor's obligation, but rather for the creditor's lien to attach to the proceeds of sale in the form of a down payment and new purchase money financing, who gets what portion of the down payment, and who collects the new purchase money obligation?
- Who has the burden of going to court if a dispute arises over whether an escrow is bona fide? Who bears the burden of proof in such litigation?

PRACTICE TIP: For the sake of certainty, the preferable procedure in any "drop dead date" settlement is to provide that the automatic stay terminates immediately, with the lender agreeing to restrain its conduct on the agreed terms. Generally, a carefully drafted stipulated stay relief order will suffice as a settlement agreement.

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§11.44 c. Periodic Payment Agreement

The second common method of settling stay litigation is to agree on a schedule of periodic adequate protection payments to the lender. Again, to avoid future litigation, the usual format is a stipulated order terminating the stay, with the lender agreeing to restrain its conduct conditioned on receipt of the agreed payments.

The agreement should indicate whether acceptance of the periodic payments constitutes a waiver of earlier defaults or vitiates any prior notice of default and election to sell or notice of trustee sale. Acceptance of periodic adequate protection payments pursuant to a court order compelling such payments should not cause a waiver of prior defaults, absent reinstatement of all arrearages.

In *Harvis Trien & Beck, PC v FHLMC (In re Blackwood Assocs.)* (2d Cir 1998) 153 F3d 61, the lender agreed to a cash collateral stipulation (see, *e.g.,* §§11.67-11.68) providing for both adequate protection payments to the lender and payments of the debtor's attorney fees. Debtor's counsel later sought to have the lender disgorge adequate protection payments to pay fees of over $500,000. The request was denied because the stipulation did not give attorney fees priority over the lender's adequate protection payments. To avoid this type of dispute, counsel should clearly define the priority of authorized payments from cash collateral in the agreement.

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§11.45 d. Protection of Junior Lienholder

When a junior lienholder makes a stay relief agreement, it should include a provision that terminates the stay immediately if stay relief is granted to the holder of any senior encumbrance, in order to avoid having the senior lender foreclose first and wipe out the junior lien.

When senior encumbrances are not in default, the debtor should be willing to keep them current and pay real property taxes before penalties accrue. An impound account with the creditor is the best method of keeping these amounts current. If senior encumbrances are in default, counsel should be careful in agreeing on how they are to be handled. If possible, the debtor should be encouraged to make some proposal acceptable to the holder of such senior encumbrances to bring or keep them current.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/11 Enforcing Secured Loans Against Debtors in Bankruptcy/ E. Practical Considerations and Planning/ 1. Debtor Considerations/§11.46 a. Client Interview; Anticipating Requests for Relief From Stay

E. Practical Considerations and Planning

1. Debtor Considerations

§11.46 a. Client Interview; Anticipating Requests for Relief From Stay

When representing a debtor, counsel should interview the client before the bankruptcy case is filed to explore all facts necessary to defend or settle any anticipated stay relief motion. Preferably before the interview, counsel should obtain the following documents (see also checklist in §10.2):

- All loan documents of all secured parties, including notices of default and notices of sale;
- A recent title report, if available, on all properties owned by the client (if unavailable, it should be ordered);
- Prior appraisal reports, if any; and
- Written proof of insurance.

· Objectives of the client interview should include the following:

- Review the loan documents for any violations of lending statutes or regulations or other irregularities. See §§12.27-12.116.
- Determine the client's opinion of value and the basis for it. The client should be thoroughly "cross-examined" on value to avoid future surprises. See §11.41.
- Ascertain the current balances owed to each secured creditor, including real property taxes. See §11.40.
- Determine what the client expects to accomplish by the bankruptcy filing with respect to each property. If the filing is on the eve of foreclosure, the client should be advised that the secured party may seek relief from the stay almost immediately and that there may be a trial or other resolution of creditor's rights as soon as 30 days after the bankruptcy case is filed. In addition, if a prior case was filed, the stay may be limited or not go into effect at all under the provisions of BAPCPA (see §11.1). See §§11.6, 11.25 (successive filings, "in rem" stay relief), 11.24-11.27 (bad faith).
- Encourage the client to retain an appraiser prior to the filing of the bankruptcy case. See §11.41. Otherwise, court approval will be necessary (11 USC §327), which will delay the appraisal process. If the client will not or cannot retain an appraiser before the bankruptcy case is filed, the client should obtain and set aside enough money to do so. In any event, the appraiser should be contacted at the earliest possible date so that an appraisal may be performed and submitted in time to respond to any motion for relief from the stay.
- Inform the debtor of the costs of filing and pursuing the case to completion, including expected adversary proceedings, stay relief motions, and the possibility of unexpected proceedings initiated by a creditor. The debtor must bear not only its attorney and appraiser fees in litigation but also quite probably the lender's attorney and appraiser fees if the lender is oversecured and the loan documents support such a recovery. The filing of a bankruptcy case should usually be considered only as a last resort because of the high costs that the process entails. If possible, counsel should attempt to negotiate a settlement even before the bankruptcy case is filed or, if that is impossible, immediately after the case is filed but before a motion for relief from stay is filed. See, *e.g.,* §11.44.
- Advise the client that the delay accomplished by a bankruptcy case will not be indefinite and may be very brief. Whether a plan should be filed even before stay litigation commences should be explored. The early filing of a plan, if the plan is realistic, should add credibility to the use of the bankruptcy alternative and should remove the force of any argument by the secured party that the bankruptcy is interposed solely for an indefinite delay. The filing of a realistic plan is the best evidence that the debtor has a reasonable chance of reorganizing within a reasonable time and, therefore, that an undersecured creditor is not entitled to relief from the stay under 11 USC §362(d)(3). See §§11.20, 11.29-11.31.

- Make clear to the debtor that it is the debtor's duty to propose adequate protection and not the court's duty to fashion it. See, *e.g., In re Colrud* (Bankr D Alaska 1984) 45 BR 169, 173 n3; *Big Bear Super Market No. 3 v Princess Baking Corp. (In re Princess Baking Corp.)* (Bankr SD Cal 1980) 5 BR 587. Despite these decisions, courts frequently fashion what they deem to be adequate protection and order continuation of the automatic stay only if the debtor provides such protection. See §11.23.

When representing a trustee, most of the same considerations noted for a debtor apply but, because the trustee is appointed after the bankruptcy case is filed, time pressures may be much greater.

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§11.47 b. Checklist: Preliminary Hearing

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Although most courts schedule preliminary hearings at which no live testimony is introduced, they often make dispositive orders at the conclusion of the hearing. Therefore, debtor's counsel should fully prepare for the preliminary hearing and should not assume that the existence of a factual dispute will always result in a final hearing. The following are essential preparatory steps:

- Examine the moving party's papers to determine if the moving party has adequately proved a prima facie case for stay relief, including proof of standing. See §§7.99-7.106, 11.22-11.32.
- Be prepared to object to moving party's claimed interest in the debt if it does not produce the original note and deed of trust at the hearing. See Fed R Evid 1002. See §§7.106, 11.39-11.41.
- Prepare a declaration containing the appraiser's report and qualifications as an expert. To the extent possible, the declaration should explain the most important differences between the debtor's appraisal and the secured creditor's appraisal.
- If there is a dispute about the amount of any encumbrance, prepare or request and assemble declarations of the debtor and of any cooperative secured lender to support the debtor's position.
- Be prepared to state the debtor's adequate protection offer, if any, in responsive papers filed before the hearing or at the commencement of the hearing.
- Prepare a declaration by the debtor explaining the intended use or disposition of the property and the efforts being made to implement the debtor's business plan.
- In Chapter 11 cases, if lack of equity is an issue, assemble evidence of the necessity of the property for an effective reorganization and of the existence of a reasonable likelihood that reorganization is possible. See §§11.29-11.31.
- Prepare, and timely file and serve, a memorandum of points and authorities and any other pleadings required by the court's local rules or the judge's special orders. See §11.34.

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§11.48 c. Final Hearing

In addition to the checklist items in §§7.106 and 11.47, counsel for a debtor in possession or trustee should take the following considerations into account if there is to be a final hearing:

- All witnesses who will testify with respect to disputed facts should be available at the final hearing and should be properly prepared. If possible, minimize the need for witnesses (and their related cost and inconvenience) by stipulating to undisputed facts.
- The debtor's appraiser should review all appraisal reports submitted by the creditor. Counsel should review all discrepancies in the reports with the appraiser to properly prepare the appraiser to testify and counsel to cross-examine the creditor's appraiser.

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2. Secured Creditor's Considerations

§11.49 a. Gathering Information From Creditor

Counsel for the secured creditor should obtain the following documents (see also checklist in §10.2):

- All of the client's loan documents and, to the extent available, the documents of all other creditors secured by the same property, including all notices of default and notices of sale;
- A recent title report (if unavailable it should be ordered);
- Prior appraisal reports, if any;
- Any notices or pleadings received from the debtor; and
- Background information (including relevant pleadings and orders) regarding prior bankruptcy filings by the debtor or involving the same property.

Counsel should also ascertain the bankruptcy case number and identity and addresses of counsel for the debtor, for the bankruptcy trustee, and for the debtor in possession or trustee (for purposes of service).

A current appraisal report is necessary if there is any dispute over the value of the real property collateral. Evidence of value must be submitted with the moving papers if the creditor intends to rely on lack of adequate protection or lack of equity in the collateral. Although that evidence can consist of the value given by the debtor in the schedules or evidence of a recent sale, it will usually be necessary to submit the declaration of an expert appraiser. See §11.41. If the creditor intends to rely solely on some other "cause" for lifting the stay (*e.g.,* successive or bad faith filing by the debtor (see §§11.6, 11.11, 11.24-11.28, 11.32)), it may not be necessary to submit any evidence of value. In unusual cases, it may be possible to rely on the earlier appraisal obtained for the loan. The primary advantages of using the earlier appraisal include lower expert witness fees and a greater likelihood of having the appraisal work completed at an early date. These advantages are usually outweighed by the disadvantages: vulnerability to cross-examination if the appraisal for trial differs materially from the loan appraisal (the loan appraisal usually shows that the value of the property exceeds the secured debt, or the creditor would not have made the loan); the appearance of bias by an "in-house" appraiser; the inexperience of most institutional lenders' appraisers as expert witnesses if live testimony becomes necessary; and the lower qualifications of most "in-house" appraisers.

If the property produces income, consideration should be given to how the lien on rents is to be enforced. See §§11.56-11.59.

The client should prepare an exact breakdown of the debt—delineating principal, accrued interest, and all other charges—and be prepared to update this information as of the preliminary hearing on the motion. See §7.106. Although getting this information is seldom difficult for institutional lenders, it is often difficult for loan servicing companies handling securitized loans and private holders of purchase money obligations, who frequently give counsel merely an accounting of arrearages. To calculate equity and determine a lack of adequate protection, the creditor must account for the total encumbrances against the property. Counsel should prepare a declaration setting forth the amount of the claim and the extent of the arrearages and verifying the creditor's loan documents.

The issue of how to prove the amount of other encumbrances should be addressed immediately. See §11.40.

If there is a successive filing or bad faith issue, counsel should gather relevant information regarding, *e.g.,* prior bankruptcy filings involving the real property collateral, the date of conveyance to a new debtor and the date of the new debtor's formation. The debtor's schedules and the title report may be good sources of such information.

Clients frequently want to know how long to continue a trustee sale, if one had previously been scheduled. About 50 days following the filing of the motion is optimum because it allows time for the matter to come to the first hearing and, if the creditor prevails, an order to be prepared and lodged, objections about form to run, and the order to be entered. On postponing trustee sale, see chap 2. If there is a good prospect that the stay will only be effective for 30 days or not go into effect at all because of successive filings or stay relief in a prior case (see §§11.6, 11.11), then a shorter time period may be appropriate.

If discovery is contemplated, counsel should make immediate arrangements to obtain orders shortening time or

stipulations from opposing counsel. See §11.38.

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§11.50 b. Checklist: Preliminary Hearing

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In preparing for the preliminary hearing, counsel for the lender should see to it that the following steps are taken:

- Interview the appraiser and review the appraisal report. If appraisal reports have been exchanged, the opposing party's appraisal report should be examined by the creditor's expert so that the expert's declaration can explain the differences and why the opinion of the creditor's expert is more reliable.
- Prepare a declaration from a client representative with knowledge of the loan, stating the amount of the claim secured by the deed of trust. Assemble evidence of the amounts of other encumbrances, unless appropriate stipulations can be reached. See §§11.39-11.41.
- Obtain certified copies of other bankruptcy petitions, deeds to a new debtor, and other appropriate evidence in cases involving bad faith issues.
- If the debtor in possession or trustee has tendered or delivered adequate protection, discuss it with the client and ascertain the client's position before the hearing.
- If the debtor in possession or trustee has not opposed the motion, have a file-stamped copy of the certificate of the proof of service of the motion papers available at the hearing, in the event the judge does not yet have a copy in the court file.
- Comply with all applicable procedures, including local rules or orders of the court, because noncompliance often results in unnecessary delay.
- Coordinate any consensual extension of the time for a preliminary or final hearing not only with opposing counsel but also with the court.
- If a creditor commits some procedural error defeating its right to a hearing in 30 days, and if a limited waiver and short extension cannot be negotiated, consider dismissing the defective motion without prejudice and filing a new motion rather than accepting a long continuance.

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F. Enforcing and Challenging Stay Relief Orders and Agreements

§11.51 1. Enforcing Orders and Agreements

A stipulated order lifting the automatic stay and incorporating a settlement does not bar a later action for breach of the stipulation and settlement. Nor, absent a provision retaining jurisdiction, does the bankruptcy court have exclusive jurisdiction over such an action. *Hinduja v Arco Prods. Co.* (9th Cir 1996) 102 F3d 987.

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§11.52 2. Vacating Order on Changed Circumstances

In the right circumstances, a bankruptcy trustee or debtor may be able to have an order lifting the stay vacated. See Fed R Bankr P 9024. In one case, an order entered 10 months previously was vacated based on changed circumstances. *State Bank v Gledhill (In re Gledhill)* (10th Cir 1996) 76 F3d 1070. During the intervening period, the case had been converted from Chapter 11 to Chapter 7, the value of the property had increased greatly, and it was likely that the estate would distribute more money to creditors if the trustee sold the property on the open market.

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§11.53 3. Modifying Stay Relief Agreement in Plan

A debtor in possession may propose a reorganization plan that provides for treatment of a lender's claim under a previously negotiated stay relief agreement. If the agreement requires that any proposed plan incorporate the terms of the agreement, the plan must do so, absent a showing of special circumstances. *Meyer v Lenox (In re Lenox)* (9th Cir 1990) 902 F2d 737. If the agreement does not require incorporation, then the debtor in possession is free to propose a plan that provides for treatment of the lender that is inconsistent with the agreement but otherwise confirmable under the Bankruptcy Code. *Atalanta Corp. v Allen (In re Allen)* (9th Cir 2002) 300 F3d 1055 (stay relief agreement provided for right to foreclose; plan retained property and modified payment terms). Thus, lender's counsel should always consider the merits of including a provision blocking inconsistent treatment under a plan, even if a plan is unlikely.

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§11.54 4. Preclusive Effect of Findings in Stay Relief Litigation

The First Circuit held that the findings a court makes in a relief from stay hearing do not collaterally estop the bankruptcy trustee or a debtor from later challenging the validity or perfection of a lender's security interest. *Grella v Salem Five Cent Sav. Bank* (1st Cir 1994) 42 F3d 26.

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§11.55 5. Appeals

Unless the court orders otherwise, the effectiveness of an order granting stay relief is automatically stayed for 14 days. Fed R Bankr P 4001(a)(3). This rule is designed to give the trustee or debtor in possession an opportunity to seek a stay of the order pending appeal; failure to obtain a stay of the order permitting a sale moots the appeal. On appeals, see §§11.146-11.152.

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IV. ENFORCING LIEN ON RENTS

§11.56 A. Perfection of Lien on Rents

Generally, a party obtains a "lien" on rents by either (1) a true absolute assignment of rents or (2) an assignment for "additional security." Whether the assignment is designated "absolute" or for "additional security" affects the requirements for perfection. In the case of a true absolute assignment, there may be no need to perfect the lien because the lender's interest in the rents is unconditional. The more common approach of an assignment for additional security, however, requires perfection. Pursuant to 11 USC §544(a), a trustee would prevail against the unperfected lienholder in rents. On liens on rents generally, see chap 6 and §§7.10-7.12.

California comprehensively revised its law regarding assignments of rents effective for assignments entered into on or after January 1, 1997. Stats 1996, ch 49. The revised CC §2938(c) arguably puts the parties' rights to rents on a cash basis, measured as of the date of the enforcement of the assignment by one or more prescribed actions. See §6.31. Thus, the borrower should claim ownership of rents collected prior to enforcement (even if traceable to the mortgaged property), leaving to the lender rents, including delinquent rents, collected after enforcement of the assignment.

PRACTICE TIP: A lender that desires clearer pre-enforcement rights in, and control over, rents will take a security interest in property operating accounts (with perfection under Com C §§9310(b)(8), 9314) and will likely require a "lockbox" to maintain practical control. Com C §§9312-9313. See California Real Estate Finance Practice: Strategies and Forms §§1.98, 1.108, 4.33, 4.73, 5.9 (Cal CEB 2000).

A lockbox may take the form of a depository account into which gross rents are collected, with periodic disbursements to the borrower's property operating account only as authorized by the lender in conformity with an approved budget. Through such a tight cash management regime (more typical of a loan workout or the administration of a high-risk loan), the lender can implement an agreement that all net operating income be dedicated to debt service, property reserves, and accumulation of cash collateral. Alternative lockbox arrangements can give the borrower greater autonomy in managing property income until the lender declares a default.

WARNING: The lien of a deed of trust covers only rents and, perhaps, rental proceeds but not the proceeds or profits of a business operated on the real property. See *Financial Sec. Assur., Inc. v Days Cal. Riverside Ltd. Partnership (In re Days Cal. Riverside Ltd. Partnership)* (9th Cir 1994) 27 F3d 374 (hotel room charges are rents, but revenues from food and beverage service are not). See §§6.31, 7.124-7.125. Thus, if the cash generated by a business could be characterized as business receipts rather than rents, a secured lender should take care to perfect its interest in receipts by obtaining a security interest under the Uniform Commercial Code at the time the loan is made. See Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

Additionally, CCP §564(b)(12) provides that the court may appoint a receiver in a case brought by an assignee who has previously enforced its assignment by obtaining or demanding turnover of rents in accordance with CC §2938(g). Code of Civil Procedure §564(b)(11) provides that receiver appointment is authorized in an action by a secured lender for specific performance of an assignment of rents.

Although the systematic approach to rental assignments embodied in CC §2938 will likely influence a court's analysis of any rental assignment in dispute, the current code section expressly applies only to contracts entered into on or after January 1, 1997. Accordingly, the law governing assignments of California rents is as follows:

"Absolute" Assignments

Contract Date	*Governing Law*
Before Jan. 1, 1992	Case law
Jan. 1, 1992-Dec. 31, 1996	Former CC §2938*
Jan. 1, 1997, and later	Current CC §2938

"As Security" Assignments

Contract Date	*Governing Law*
Before Jan. 1, 1993	Case law
Jan. 1, 1993-Dec. 31, 1996	Former CC §2938.1
Jan. 1, 1997, and later	Current CC §2938**

*According to legislative comment, former CC §2938 was "declarative of existing law."

**Current CC §2938 provides that *all* assignments are for security purposes.

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§11.57 B. Impact of Bankruptcy on Perfection

If a bankruptcy case is filed before the lien on rents is perfected, the automatic stay prohibits the lender from seeking perfection through the appointment of a receiver. 11 USC §362(a). Section 546(b) of the Bankruptcy Code, however, provides an alternative means of perfection by notice, which may be given without violating the automatic stay. 11 USC §362(b)(3). Sections 546(b) and 362(b)(3) expressly permit a creditor to perfect and to maintain or continue perfection of a security interest without stay relief by giving notice under state law or, as appropriate, by giving notice in lieu of enforcement. See, *e.g., In re 201 Forest St., LLC* (Bankr Mass 2009) 404 BR 6 (lender lost right to foreclose because it failed prepetition to record extension of mortgage or acknowledgment that mortgage was not satisfied as required by state law). Giving such notice will suffice to perfect the creditor's assignment of rents, if that assignment is valid and enforceable in all respects other than perfection.

For real estate lenders who filed prepetition UCC financing statements in addition to their deeds of trust (for example, to cover accounts receivable from property income other than rents), the provisions authorizing actions to maintain a security interest permit the filing of UCC continuation statements without the need for stay relief. These provisions should have no effect, however, on creditors' rights under assignments of rents.

PRACTICE TIP: The Bankruptcy Code and Rules do not prescribe a form or procedure for giving notice under §546(b). Traditional practice has been to file some form of request for "sequestration" of rents. Such a request can be incorporated into a motion for stay relief. When the secured party is not seeking relief from the stay immediately, however, §546(b) permits the filing of a simple notice of perfection of the lien on rents with the bankruptcy court. The notice should be filed and served on the trustee or debtor in possession immediately after learning of the bankruptcy to perfect the lien on rents as early as possible. For a sample notice, see California Mechanics' Liens and Related Construction Remedies §6.78 (3d ed Cal CEB 1998).

When a prepetition deed of trust or other security agreement covers rents generated by the collateral, then those rents, including room rents, will be cash collateral in the borrower's bankruptcy case, even if generated after the petition is filed. 11 USC §552(b)(2). The cross-reference in §552(b)(2) to 11 USC §546(b) should not be read to alter creditors' rights under rental assignments governed by CC §2938, under prior absolute assignments, or under post-1992 "additional security" assignments of rents. Rather, §552(b)(2) should be read to clarify that, after recordation, the lender's interest in rents under such assignments requires no further notice under §546(b) for that interest to extend to postpetition rents. See §11.56.

For the lender holding a pre-1993 "additional security" assignment of rents that was recorded but not enforced prepetition, §552(b)(2) supports the view that notice under §546(b) should not be required to protect the lender's interest in postpetition rents; nonetheless, the interplay of §552(b)(2) with California mortgage law is not abundantly clear, and the customary §546(b) notice is easily given.

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§11.58 C. Impact of Bankruptcy on Existing Receivership

When a bankruptcy case is filed, a receiver—as a custodian of property of the bankruptcy estate—has a duty to account and to turn over the real property and the net rents in the receiver's possession. 11 USC §543(a)-(b). See 11 USC §101(11) ("custodian" includes receiver). Section 543(a) is extremely broad, but essentially it prohibits the receiver, after learning of the bankruptcy case, from distributing any of the debtor's property, or the proceeds or rents from such property, or from otherwise taking "any action in the administration of" such property, except as necessary to preserve the property. Section 543(b) requires the receiver (1) to deliver to the debtor in possession (or trustee if one has been appointed) all property of the debtor in the receiver's control on the date the receiver acquires knowledge of the bankruptcy case and (2) to file an accounting of all property of the debtor, or proceeds or rents from such property, that are in the receiver's control. Thus, the receiver must turn over not only the real property itself but also any undisbursed rents or profits that had been collected.

Under 11 USC §543(c), the bankruptcy court is required to do the following:

- "Protect" all entities to which the receiver has become obligated;
- Provide for payment of reasonable compensation and expenses to the receiver; and
- Surcharge the receiver for "any improper or excessive disbursement, other than a disbursement that has been made in accordance with applicable law or that has been approved, after notice and a hearing, by a court of competent jurisdiction before the commencement" of the bankruptcy case.

Given the limits of §543(c), it is prudent to try to include in the receiver's original appointment order provisions allowing payment of the receiver's fees and expenses, payment of taxes and senior liens, and authorization to make any out-of-the-ordinary disbursements that can be anticipated and specifically identified in the order. The receiver should pay those items as soon as possible because a subsequent bankruptcy will prohibit even previously authorized payments, except as needed for preservation of the property. Similarly, if a receiver must make an extraordinary disbursement before the bankruptcy case, it would seem prudent for that receiver to seek authorization from the appointing court in order to insulate the disbursement from later attack.

WARNING: The same considerations suggest including provisions in the appointment order directing payment of surplus rents to the secured party, but concerns over a potential one-action violation under CCP §726 often deter lenders from collecting preforeclosure payments through the receivership. See §6.41.

The bankruptcy court may excuse the receiver from compliance with §543(a), (b), or (c). The applicable statutory standard is vague: The court may excuse compliance "if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property." 11 USC §543(d). The statute does not specify who may request an excuse from compliance. Presumably, a secured lender, the receiver, or some other party in interest could do so. Such a request would usually be brought by motion. Fed R Bankr P 9013-9014. Nothing in the Bankruptcy Code excuses the receiver from the obligation to turn over assets while a motion to excuse compliance is pending. When a prompt request to excuse compliance is made, the moving party may argue that subsections (b) and (d) of §543 should be read together to allow the receiver to retain possession while the request is pending.

A receiver's turnover of real property and rents in compliance with §543 should not defeat perfection of the lender's interest in either rents collected by the receiver or future rents collected by the debtor in possession or trustee. 11 USC §552(b). Nevertheless, in that situation, a lender should consider serving and filing a notice under 11 USC §546(b) (see §11.57) to avoid any argument that its lien on future rents is not perfected.

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§11.59 D. Application of Rents

It is common for a secured lender with a lien on rents to be paid postbankruptcy rents net of operating expenses as a form of adequate protection. See §11.23 on adequate protection and §§11.67-11.69 on cash collateral use. Indeed, after enactment of BAPCPA (see §11.1), the Bankruptcy Code expressly provides that in a single asset real estate case the debtor is authorized to use rent to make monthly payments to the lender. 11 USC §362(d)(3)(B)(i). See §11.32. Rents accumulated during the case that are subject to the secured lender's lien are additional security for the lender's claim. Therefore, the total value of the secured creditor's collateral is the value of the real estate collateral plus accumulated rents. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650. Under this view, net rents paid to a lender during a bankruptcy case should, arguably, simply be applied to the portion of the lender's claim secured by rents. See *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284 (postpetition adequate protection payments were properly applied to reduce secured portion of creditors' claim when collateral did not diminish in value during case).

The lower courts, however, are divided on the issue. See *In re Union Meeting Partners* (Bankr ED Pa 1995) 178 BR 664 (discussing cases). One view is that, under 11 USC §552(b), the claim secured by accumulated rents is decreased by the amount of net rents paid to the lender, resulting in a "wash." 178 BR at 674; *In re Gramercy Twins Assocs.* (Bankr SD NY 1995) 187 BR 112. Another view is that the net rents received must be subtracted from the portion of the claim secured by the value of the real estate. *In re 354 E. 66th St. Realty Corp.* (Bankr ED NY 1995) 177 BR 776. A third view adopts a "dual valuation" approach. Use and application of rents is determined at each valuation point. The secured claim is first valued as of the petition date for adequate protection purposes. Accumulated postpetition rental proceeds increase the collateral securing the claim but do not increase the secured claim amount for adequate protection purposes. If adequate protection payments to the lender are not required because the real estate collateral is not declining in value, then, subject to court approval, the debtor may use the rents to pay administrative expenses, maintain or improve the real estate, pay real property taxes, or make payments to the lender. Later, at the time of plan confirmation, the lender's secured claim is revalued and the real estate is reappraised. The secured claim is reduced by postpetition rent payments received by the lender. Accumulated rental proceeds that are not necessary to pay expenses incurred by the trustee to preserve the real property collateral for the creditor's benefit, which can be surcharged under 11 USC §506(c), increase the amount of the secured claim. *In re Duval Manor Assocs.* (Bankr ED Pa 1996) 191 BR 622.

On risks for secured lender in accepting assigned rents during foreclosure process, see §§2.61, 6.45. On valuation and appraisal standards, see §§11.41, 11.91, 11.110, 11.126, 11.129.

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V. OBTAINING CREDIT SECURED BY ESTATE ASSETS

§11.60 A. Overview

In any commercial real estate case, the debtor in possession or trustee will need to finance the operation of the business. Funding usually consists of use of cash collateral (rents or business receipts from the project), new loans, or some combination of the two. This section reviews the debtor in possession's ability to obtain new loans. On use of cash collateral, see §§11.67-11.69. At the commencement of the case, the debtor in possession may be a party to unfunded or partially funded loan agreements. However, the debtor will not be able to draw new funds under those loans because they are unenforceable after the petition is filed. 11 USC §365(c)(2). The Bankruptcy Code counterbalances this restriction by authorizing new unsecured and secured credit to be obtained for the bankruptcy estate. See §§11.61-11.65. Existing secured lenders need to be particularly aware of attempts to obtain new secured financing because it may directly or indirectly impact their security. 11 USC §364.

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§11.61 B. Unsecured Administrative Priority Debt

A debtor in possession or trustee authorized to operate the debtor's business may obtain unsecured credit in the ordinary course of business without court approval. Such indebtedness will be accorded administrative priority under 11 USC §503(b)(1). 11 USC §364(a). The Bankruptcy Code does not define "ordinary course," but the courts will likely evaluate ordinary course based on the size of the transaction relative to the debtor's business and creditors' objective expectations about risks that such a business would usually undertake. See *Burlington N. R.R. Co. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700 (determining whether postpetition lease transactions were "ordinary course" for purposes of 11 USC §363). For example, trade credit from companies or persons providing ordinary course property maintenance services might be obtained under this provision. Unsecured credit may also be incurred outside the ordinary course of business if approved by the court "after notice and a hearing." 11 USC §364(b). Such debt is also accorded administrative expense priority under §503(b)(1).

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§11.62 C. Unsecured Superpriority Debt and Debt Secured by Unencumbered Property or Junior Liens

If unsecured debt with administrative priority cannot be obtained or is insufficient to finance the business, the Bankruptcy Code provides three alternative credit enhancements to entice a lender to extend credit. The first is to authorize unsecured credit with "superpriority" administrative status that is senior to other administrative debts under the Bankruptcy Code. 11 USC §364(c)(1). Alternatively, the trustee can obtain credit secured by a lien on unencumbered property or by a junior lien on property that is already encumbered. 11 USC §364(c)(2)-(3). These provisions will not directly impact existing holders of security interests because any lien granted under §364(c) is subordinate to existing liens.

Credit obtained under §364(c) must be approved by the bankruptcy court after "notice and a hearing," which is defined at 11 USC §102(1). This notice requirement is primarily for the protection of unsecured creditors, who may wish to oppose dilution of their ultimate share in the estate by new, senior indebtedness. The scope of such notice is governed by Fed R Bankr P 2002(a)(2) and 4001(c)(3).

WARNING: Because of misstatements or lax diligence, lenders may make a secured loan without knowing that the borrower is a debtor in bankruptcy, which can be problematic. See *Thompson v Margen (In re McConville)* (9th Cir 1997) 110 F3d 47.

In *Thompson*, the lender financed an individual's purchase of real property and obtained a deed of trust without knowing that its borrower had filed for Chapter 11 relief. The trustee, who was appointed later, sued to avoid the deed of trust as an unauthorized postpetition transfer of estate property under 11 USC §549. Withdrawing a prior decision based on §549, and ignoring that section entirely on the basis that precedent held that creation of a lien does not transfer property for purposes of §549, the Ninth Circuit panel ruled that the borrowing violated 11 USC §364(c)(2) because the bankruptcy court had not approved it. "An appropriate remedy for this disregard is cancellation by the court of the transaction.... It is within the power of that court to rescind the contract unlawfully made." 110 F3d at 50. Exercise of this corrective power, however, is subject to the "equities of the situation." The panel then concluded, apparently as a matter of law, that the lender should have a lien for the full principal amount of its loan, less the loan fee it charged, without interest. This decision, which is difficult to follow, implicitly holds that the "remedy" under §364 trumps avoidance of the lender's deed of trust under §549. Some of the confusion stems from the panel's failure to explore (or explain) why real estate bought after the bankruptcy filing by a postpetition loan to an individual debtor should be considered estate property at all. The bankruptcy estate generally consists of all the debtor's interests at commencement of the case, not property acquired postpetition. 11 USC §541(a). In Chapter 13 cases, however, property of the estate *does* include property (including earnings) acquired by the debtor after the petition and before closure, dismissal, or conversion of the case. 11 USC §1306. BAPCPA (see §11.1) adds the same rule in Chapter 11 individual debtor cases. 11 USC §1115. Nevertheless, in situations in which after-acquired property is not part of the estate, a lender may still argue that neither §364 nor §549 applies and that the loan is enforceable in full.

The *Thompson* holding that creation of a lien by the granting of a mortgage does not constitute a "transfer" subject to §549 is suspect. In any event, BAPCPA revises the definition of "transfer" so that it expressly includes "creation of a lien." 11 USC §101(54)(A). It also revises the §549(c) safe harbor to include transfer of "an interest in" real property. These changes, discussed in §11.87, appear to legislatively overrule the *Thompson* decision.

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§11.63 D. Debt Secured by Equal or Senior Liens

The court may also authorize the estate to obtain credit secured by a lien senior or equal to a preexisting lien on the property, but only if (1) the credit is unavailable on any other basis and (2) there is adequate protection of the existing lienholder's interest in such property. 11 USC §364(d). It is unlikely that a sufficient equity cushion exists to provide the existing lienholder adequate protection; otherwise, the new lender should be satisfied with a junior lien. To establish adequate protection, the debtor or trustee will usually show that the new loan funds will be used to enhance or preserve the existing lenders' collateral to an extent at least equal to the new borrowing. The burden of establishing adequate protection falls on the debtor or trustee. *In re Mosello* (Bankr SD NY 1996) 195 BR 277, 292.

Procedurally, court authorization "after notice and a hearing" is required for this type of loan. See 11 USC §102(1); Fed R Bankr P 2002(a), 4001(c). The phrase "after notice and a hearing" requires an actual hearing only if a timely request is made by a party in interest. 11 USC §102(1)(B). Thus, court approval may be obtained without a hearing unless there is an objection.

The Bankruptcy Code and Bankruptcy Rules recognize that prompt approval of a postpetition loan may be necessary to keep the business alive. See 11 USC §364; Fed R Bankr P 4001. Applications to obtain secured credit, therefore, are often heard on shortened time because of the debtor's or trustee's need to obtain credit immediately to preserve existing operations. Accordingly, counsel for secured creditors should caution their clients to contact counsel immediately if any notice seeking authority to borrow funds is received. Counsel should also consider filing a request for special notice in the case so that counsel will also receive notices. See Fed R Bankr P 2002(i). If the existing lender fails to oppose a requested financing on a timely basis, the priority of its lien or the recovery on its claim may be affected. But see *Owens-Corning Fiberglas Corp. v Center Wholesale, Inc. (In re Center Wholesale, Inc.)* (9th Cir 1985) 759 F2d 1440 (cash collateral order void on due process grounds because junior lien creditor was not given sufficient notice).

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§11.64 E. Postpetition Advances on Secured Guaranty

The Ninth Circuit has ruled that advances can be made on a secured guaranty after the guarantor files a bankruptcy petition. See *Beeler v Jewell (In re Stanton)* (9th Cir 2002) 303 F3d 939, involving a lender that made advances to a corporate borrower that were guaranteed by the shareholders of the corporation. The corporation was not in bankruptcy at the time of the advances, but the individual guarantors were. The guaranty was secured by residential real property owned by the individuals. The Ninth Circuit found that the lien against the guarantors' house was created when they gave the lender a second mortgage prior to the bankruptcy filing. The subsequent advances merely affected how much money the lien secured. Consequently, the court ruled that the advances to the corporation did not, with respect to the individual debtors' bankruptcy cases, violate the automatic stay or require court approval under 11 USC §364. As a result, the advances were validly secured by the guarantors' real property. For commentary on *Beeler,* see 25 CEB Real Prop L Rep 137 (May 2002).

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§11.65 F. Appeals From Borrowing Orders

A party that appeals from an order authorizing a borrowing or the granting of a lien must obtain a stay pending appeal, or the appeal will become moot as long as the lender extends credit in good faith. 11 USC §364(e). To ensure that §364(e) applies, counsel should request that the court make an express finding that the lender acted in good faith. See §§11.146-11.152 on appeals generally and on mootness rules regarding appeals from borrowing orders.

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VI. USE, SALE, LEASE, OR ABANDONMENT OF PROPERTY

§11.66 A. Overview of Debtor in Possession or Trustee Authority

A debtor in possession or trustee authorized to operate the debtor's business may use, sell, or lease property of the bankruptcy estate other than "cash collateral" in the ordinary course of business. 11 USC §363(c). Because of its unique characteristics, cash collateral may be used only in the more limited circumstances described in §11.67. On occasion, it is unclear whether the debtor owns the property to be sold. A dispute about ownership of property to be sold may need to be decided before the sale can be authorized. *Darby v Zimmerman (In re Popp)* (BAP 9th Cir 2005) 323 BR 260. This decision, however, rests on *Warnick v Yassian (In re Rodeo Canon Dev. Corp.)* (9th Cir 2004) 362 F3d 603, withdrawn (9th Cir 2005) 2005 US App Lexis 3802, and may no longer be persuasive. Finally, bear in mind that 11 USC §363 is not limited to real property collateral, and a good many of its provisions will apply primarily in the context of personal property.

In a commercial real estate case, continued leasing of space would usually be "ordinary course" as long as the lease terms were typical of the project. Selling parts of a real estate project might be ordinary if, for example, it was a residential real estate project and lots or homes were being sold at typical prices. A side business, such as a bar or restaurant, will usually involve use or sale of property that is considered ordinary. The Bankruptcy Code does not define "ordinary course," but the courts will evaluate ordinary course based on the size of the transaction relative to the debtor's business and creditor's objective expectations about risks that such a business would usually undertake. *Burlington N. R.R. Co. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700 (determining whether postpetition leases were "ordinary course").

A debtor or trustee may also use, sell, or lease property out of the ordinary course of business after "notice and a hearing," regardless of whether the debtor's business is authorized to be operated. 11 USC §363(b)(1). The phrase "after notice and a hearing" requires an actual hearing only if a timely request is made by a party in interest. 11 USC §102(1)(B); Fed R Bankr P 2002(a), 6004. Thus, counsel for secured creditors should caution their clients to contact counsel immediately if any notice seeking authority to use, sell, or lease property is received. Counsel should also consider filing a request for special notice in the case so that counsel will also receive notices. See Fed R Bankr P 2002(i).

The Bankruptcy Code prohibits any use, sale, or lease of collateral that would be inconsistent with any prior order granting relief from the automatic stay. 11 USC §363(d). See *240 N. Brand Partners v Colony GFP Partners, LP (In re 240 N. Brand Partners)* (BAP 9th Cir 1996) 200 BR 653 (rejecting modification of above-market lease on eve of lender's foreclosure because debtor failed to provide valid justification for transaction and because it appeared to be bad faith attempt to jeopardize lender's security).

The Bankruptcy Code allows the trustee to use, sell, or lease property despite the existence of contractual "bankruptcy" clauses (sometimes called "ipso facto" clauses) that might otherwise give a contracting party a right to forfeit, modify, or terminate the debtor's interest in the property. 11 USC §363(*l*). *DB Structured Prods., Inc. v American Home Mortgage Holdings, Inc. (In re American Home Mortgage Holdings, Inc.)* (Bankr Del 2009) 402 BR 87. Although a clause prohibiting an insolvent debtor from assigning property is not enforceable, its breach gives rise to a claim for damages but does not affect the trustee's power to sell the property under §363. 402 BR at 101.

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§11.67 B. Use of Cash Collateral

In any commercial real estate case, the debtor in possession or trustee will need to finance the operation of the business. Ordinarily, cash on hand as well as cash being generated by the property is the most readily available source of operating funds. As discussed in §11.60, new loans can also be obtained, but such financing is often entirely unavailable or not ready at the beginning of a case. As a consequence, authority to use cash generated by the project is almost always sought.

If a real estate lender has a security interest in rents and profits generated by the property, the filing of a bankruptcy petition does not cut off the lender's security interest in such rents or profits. 11 USC §552(b)(2). Thus, cash generated by real estate projects ordinarily falls within the Bankruptcy Code definition of "cash collateral," which includes "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest." 11 USC §363(a). Also included in the definition are "rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in §552(b) … whether existing before or after the commencement of a case."

Use of cash collateral is conditioned on the debtor in possession's or trustee's first obtaining either (1) the consent of the secured lender(s) with an interest in the cash or (2) a court order. 11 USC §363(c)(2). BAPCPA (see §11.1) provides express authorization in §362(d)(3) for a debtor in a single asset real estate case to use rents or other project income to make monthly payments to creditors secured by the real estate. See §11.32. In addition, unless the lender otherwise permits, debtors and trustees must segregate and account for any cash collateral in their control. 11 USC §363(c)(4). If the debtor has not acknowledged these statutory limits, it may be prudent for lender's counsel to file and serve a notice confirming that the lender has not consented to cash collateral use, objecting to any such use absent its consent or a court order, and requesting that cash collateral be segregated. If the debtor in possession uses cash collateral without authorization, the burden of tracing the cash collateral shifts to the debtor in possession (or subsequently appointed trustee). *Freightliner Market Dev. Corp. v Silver Wheel Freightlines, Inc.* (9th Cir 1987) 823 F2d 362. See *In re Qmect, Inc.* (Bankr ND Cal 2006) 2006 Bankr Lexis 1489.

Usually, discussions regarding consensual use of cash collateral occur shortly before or immediately after the bankruptcy filing. Debtors and trustees who anticipate this issue have a better chance of reaching a stipulation (see §11.68) or, if that is not possible, obtaining timely court approval of necessary cash usages (see §11.69). Lenders are usually inclined to agree to some reasonable use of cash collateral so that the property can be properly maintained, operated, and insured and so that senior liens and property taxes can be paid. On use of cash collateral for debtor's attorney fees, see *Harvis Trien & Beck, PC v FHLMC (In re Blackwood Assocs.)* (2d Cir 1998) 153 F3d 61, discussed in §11.44. On use of rents and profits, see §§11.56-11.59.

NOTE: A threshold issue might exist if a lender holds a binding and presently effective absolute assignment of rents. In that situation, the rents would not be property of the bankruptcy estate that the debtor or trustee could use. See *First Fid. Bank v Jason Realty (In re Jason Realty)* (3d Cir 1995) 59 F3d 423 (affirming relief from stay order based on finding that rents validly assigned to lender did not constitute property of estate).

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§11.68 1. Stipulated Authority

The parties are often able to negotiate a stipulation allowing use of cash collateral for a set period based on a budget detailing approved uses of cash. It generally makes sense to build some "flex" into a stipulation. This can be accomplished by providing a cushion for approved budget items or by establishing a discretionary amount that can be spent on approved budget categories. Alternatively, the stipulation might provide a procedure for the lender to approve expenditures above or not included in a budget without additional court approval required. Whatever the agreed terms are, clarity in drafting is important to avoid future disputes.

Court approval of a cash collateral stipulation is required. Fed R Bankr P 4001(d)(1). Notice of the motion seeking approval must be served together with a copy of the proposed stipulation on any creditors' committee appointed in the case and, in Chapter 11 cases that have no committee, on the 20 largest unsecured creditors. Fed R Bankr P 4001(a)(1). Rule 4001 sets out minimum time requirements for notice, but local rules should also be consulted to confirm that they are not stricter. Fed R Bankr P 4001(d)(2)-(3). If no objection is filed, the stipulation may be approved without a hearing. Fed R Bankr P 4001(d)(3). Cash collateral stipulations are often reached after a motion seeking authority to use such collateral is filed. Such stipulations may be approved without bringing a separate motion if the court determines that the motion filed was sufficient to afford reasonable notice of the material provisions of the stipulation. Fed R Bankr P 4001(d)(4).

WARNING: Bankruptcy courts are wary of cash collateral stipulations with overreaching provisions favoring a lender, especially when stipulations are presented very early in a case before unsecured creditors have had a chance to organize and when a debtor may have little leverage in a negotiation with the lender. See, *e.g.,* ND Cal Bankr Guidelines for Cash Collateral and Financing Stipulations (confirming that court will not usually approve stipulations containing, *e.g.,* cross-collateralization provisions, findings that liens are perfected, or waivers of right to surcharge secured lender's collateral).

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§11.69 2. Court Approval

A debtor or trustee should promptly bring a motion seeking authority to use cash collateral if a stipulation with the lender cannot be reached. Recognizing the critical role of cash collateral in operating a business, the Bankruptcy Code provides that a motion to use cash collateral must be scheduled "in accordance with the needs of the debtor" and that the court "shall act promptly" on the motion. 11 USC §363(c)(3). A "preliminary" and "final" hearing may be held on the motion. Fed R Bankr P 4001(b)(2). The final hearing cannot be heard on less than 15 days' notice, but the court can authorize use of cash collateral at the preliminary hearing to avoid immediate and irreparable harm to the estate pending the final hearing.

Similarly, a lender may respond to a debtor's improper, unauthorized use of cash collateral by affirmatively moving the court for an order prohibiting or conditioning use of cash collateral as necessary to adequately protect the lender's interest in the collateral. 11 USC §363(e). Such a request may be made "at any time" and the court, with or without a hearing, is required to condition or prohibit the use on such terms as will provide the lender with adequate protection.

Litigation over use of cash collateral will typically focus on adequate protection of the lender's interest under 11 USC §361. See §11.70 (on adequate protection of lender's interest in noncash collateral). See §11.23 (on adequate protection in context of stay relief proceedings). In cash collateral litigation, the trustee will have the burden of showing adequate protection, and the lender will have the burden of showing it has a valid security interest in the cash collateral. 11 USC §363(o) (now §363(p) under BAPCPA (see §11.1)). In *Security Leasing Partners, LP v ProAlert, LLC (In re ProAlert, LLC)* (BAP 9th Cir 2004) 314 BR 436, the court rejected an undersecured creditor's argument that a debtor in possession's proposed use of cash collateral to pay professionals could not be authorized unless requirements for a §506(c) surcharge were met. The court ruled that §363 controlled the question and that use of cash collateral was authorized so long as adequate protection was provided. 314 BR at 444. On surcharge of collateral, see §11.78.

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§11.70 C. Adequate Protection of Secured Lender's Interest in Noncash Collateral

At any time, a lender may request adequate protection of its interest in noncash collateral that is proposed to be used, sold, or leased. Absent an emergency, a secured lender can combine a request for adequate protection with a stay relief motion. The court must prohibit or condition such use, sale, or lease as necessary to provide adequate protection of the lender's interest. 11 USC §363(e). Adequate protection may be provided by any of the methods allowed in 11 USC §361, cited in §11.23 (adequate protection in context of stay relief).

A secured party's interest is also adequately protected when the value of the property sufficiently exceeds the amount of the secured claim to create an "equity cushion." See §11.23.

With respect to real estate secured loans, adequate protection issues may arise in a number of contexts, but perhaps the most common involves real property that is declining in value. Assuming the lender is undersecured and the real property collateral is declining while the debtor in possession or trustee continues using the property, the lender will usually be awarded cash payments as adequate protection, but replacement liens on other property may sometimes be offered.

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§11.71 D. Superpriority Claim for Insufficient Adequate Protection

Sometimes, the "adequate protection" provided to the lender turns out to be inadequate. In those situations, the lender can assert a superpriority administrative claim for the deficiency, which is senior to all other administrative claims, including the fees of counsel for the debtor or trustee. 11 USC §507(b). This scenario occurs most often when real property value declines precipitously. Nevertheless, counsel should be aware of this possibility when litigating about or stipulating to the value of the real property, the amount of the creditor's claim, or the form and amount of adequate protection payments, because such facts will be relevant to whether a §507(b) superpriority claim is allowed.

If the lender's superpriority claim arises in a Chapter 11 case that is later converted to Chapter 7, the superpriority claim is subordinated to administrative claims in the Chapter 7 case. 11 USC §348(d); *Citibank, N.A. v Transamerica Commercial Fin. Corp. (In re Sun Runner Marine, Inc.)* (BAP 9th Cir 1991) 134 BR 4. A lender with an allowed superpriority claim is not entitled to postpetition interest on its claim. *Gill v CBS Records, Inc. (In re Peaches Records & Tapes, Inc.)* (BAP 9th Cir 1989) 102 BR 193.

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E. Bankruptcy Sales of Collateral

§11.72 1. Overview; Employment of Real Estate Broker

As discussed in §11.66, assets of the bankruptcy estate may be sold in the ordinary course without court approval or out of the ordinary course pursuant to a "notice and hearing" procedure. If the debtor's business involves the sale of real property (*e.g.,* lots or homes being sold at a development), sales may be conducted in the ordinary course. However, it may not be possible to obtain title insurance without providing notice and a hearing and obtaining a court order approving the sales.

Estate assets are often sold through an auction process, but there is no requirement that a sale be made by auction. Assets can also be sold by public sale or by private sale subject to overbids. Fed R Bankr P 6004(f). The process and procedures for sales are governed by the Bankruptcy Code and Federal Rules of Bankruptcy Procedure as well as by local bankruptcy court rules, procedures, and guidelines and the circumstances of the case. One advantage of the auction process, when conducted in a fair and reasonable manner, is to avoid charges of collusion between the debtor and proposed purchaser. On collusive sales, see §11.75.

In structuring a sale of encumbered real property, a debtor or trustee may use ordinary methods for selling the collateral, by which liens are paid through escrow or the buyer takes the property subject to existing liens. Alternatively, as discussed in §11.73, the Bankruptcy Code allows the trustee or debtor in possession to sell property free and clear of liens and other interests. Because a bankruptcy sale is a voluntary sale, an oversecured lender can collect a prepayment premium (see chap 8) if the loan documents provide for one. 11 USC §506(b); *Imperial Coronado Partners v Home Fed. Sav. & Loan Ass'n (In re Imperial Coronado Partners)* (BAP 9th Cir 1989) 96 BR 997. For more on 11 USC §506(b), see §11.94.

Real estate brokers and other related representatives and consultants are treated as professionals under the Bankruptcy Code; therefore, approval of their employment and compensation must usually be sought when they are retained. 11 USC §§327-328, 330; Fed R Bankr P 2014, 2016. In certain circumstances, a broker who fails to file a timely employment application may be allowed to seek retroactive authorization. Compare *Mehdipour v Marcus & Millichap (In re Mehdipour)* (BAP 9th Cir 1996) 202 BR 474, aff'd (9th Cir 1998) 139 F3d 1303 (retroactive authorization appropriate when debtor assured broker that approval of employment would be sought but it was not) with *In re Jarvis* (1st Cir 1995) 53 F3d 416 (post facto employment not authorized because of mere oversight). If a broker provided services before the bankruptcy, the commission will be treated as a general unsecured claim rather than an administrative priority claim earned postpetition. *Marcus & Millichap, Inc. v Munple, Ltd. (In re Munple, Ltd.)* (9th Cir 1989) 868 F2d 1129.

PRACTICE TIP: To avoid conflicts of interest, counsel should always refer debtors to independent real estate or loan brokers and other professionals on marketing to buyers rather than personally handling those details in real property bankruptcy sales for the client. See *Price v Lehtinen (In re Lehtinen)* (9th Cir 2009) 564 F3d 1052.

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§11.73 2. Sales Free and Clear of Liens

The power of a debtor in possession or trustee to sell a lender's collateral free and clear of liens and other interests is particularly important to the secured real estate lender whose lien will be impacted. If a sale is to be made subject to the lender's lien or if the lender might acquire the property by credit bid (see §11.76), the lender must focus on how the proposed sale will impact other liens and interests in the property. In particular, attention should be paid to what liens will not be removed by the sale and what leases will be included in or removed from the sale. See *C.H.E.G., Inc. v Millennium Bank* (2002) 99 CA4th 505, 121 CR2d 443 (order selling property free and clear of lease terminated lease, thereby defeating broker's claim that commission due under lease could be charged to lender that acquired property by credit bid). See also *Precision Indus., Inc. v Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.)* (7th Cir 2003) 327 F3d 537 (sale terminated debtor's lease to lessee and lessee lost right to continued possession and to compensation for value of lost lease when it failed to demand "adequate protection" of its leasehold interest under 11 USC §363(e)).

When Sale Free and Clear Is Permitted. The Bankruptcy Code, in 11 USC §363(f), authorizes a free and clear sale in a Chapter 7, 11, 12, or 13 case under any of the following circumstances:

- Applicable nonbankruptcy law permits sale of the property free and clear of the lien or other interest (§363(f)(1));
- The entity with the interest in the property consents (§363(f)(2));
- The interest is a lien and the sale price of the property is greater than the aggregate value of all liens on the property (§363(f)(3));
- The interest is in bona fide dispute (§363(f)(4)); or
- The entity with the interest in the property could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of its interest (§363(f)(5)).

Sales Under §363(f)(2)-(4). Power to sell free and clear of a secured lender's deed of trust is generally obtained by consent under §363(f)(2) (*e.g.,* an undersecured lender may support a sale at a fair price even if the lender will not be paid in full) or by a showing under §363(f)(3) that the proceeds of the sale are sufficient to pay all lien claims. On occasion, the validity of the lender's lien may be sufficiently in dispute to justify sale based on the bona fide dispute provision in §363(f)(4). In *Clear Channel Outdoor, Inc. v Knupfer (In re PW, LLC)* (BAP 9th Cir 2008) 391 BR 25, 40, the Ninth Circuit Bankruptcy Appellate Panel held that §363(f)(3) does not authorize a sale free and clear of liens if the sale price is equal to or less than the total face amount—as distinct from the total allowed amount—of all claims held by the creditors holding a lien or security interest in the property to be sold. Thus, the liens of undersecured junior creditors cannot be stripped under §363(f)(3).

Sales Under §363(f)(5). In examining the mechanics of 11 USC §363(f), the Bankruptcy Appellate Panel in *Clear Channel* also concluded that nonconsensual lien stripping under §363(f)(5) is rarely, if ever, permitted. In *Clear Channel*, the bankruptcy court entered an order confirming a sale of assets free and clear of liens to a credit-bidding senior lienholder, which it found to be a good faith purchaser under 11 USC §363(m). The BAP reversed and remanded. In analyzing §363(f)(5), the BAP held (1) that the term "interest" in §363(f)(5) did include liens and (2) that, to order a sale under §363(f)(5), the bankruptcy court must make findings that (a) a legal mechanism exists by which the creditor could be compelled to accept less than the full amount of its secured claim to extinguish its lien, and the bankruptcy trustee must show how extinguishment of the lien could be compelled, and (b) there exists, or exists a possibility of, a legal or equitable proceeding in which the creditor could be forced to accept money in satisfaction of its lien.

PRACTICE TIP: A buyer who purchases assets from an estate for less than the "aggregate value of all liens" should not close before the order confirming sale becomes final.

Sales Free and Clear in Chapter 12. In Chapter 12 cases, the power to sell free and clear is broader and allows a sale of farmland or farm equipment free and clear of any lien or other interest, without satisfying any of the other conditions of §363(f), with the proceeds of such a sale automatically subject to the lien or interest that has been shed.

11 USC §1206. Subject to first refusal rights, property may also be sold free and clear of any vested or contingent right in the nature of dower or curtesy, and the interest of the estate and a co-owner may be sold when property is not easily partitioned. 11 USC §363(g)-(i).

Adequate Protection Required. A lienholder must be given adequate protection if its lien is shed in a free and clear sale. 11 USC §363(e); *Clear Channel Outdoor, Inc.,* 391 BR at 47 n24. This is ordinarily done by providing that the lien attach to the sale proceeds. See 11 USC §361, discussed in §11.23. Such proceeds will nearly always be in the form of cash, a purchase money note, or a combination of the two. As such, they will constitute cash collateral, the use of which is restricted. See §11.67. The proceeds need not be all cash, but they must be sufficient to constitute adequate protection to the transferred lien unless, of course, some other or additional form of adequate protection is provided. If a purchase money note is part of the consideration from the buyer, the creditworthiness of the buyer should be examined carefully. If lien claims are undisputed and a cash sale is involved, the trustee or debtor will often seek court authorization to pay cash proceeds to secured lenders in order of seniority as part of a strategy to pay down debt and reduce or eliminate interest accruals. If the lien claim is disputed, the common approach is to reserve proceeds sufficient to cover the full amount of the claim pending resolution of the dispute.

NOTE: A bankruptcy sale free and clear of liens under 11 USC §363(f) is not the equivalent of a judicial or nonjudicial foreclosure sale under California law. See chaps 2, 3. As a result, the fair value provisions applicable to foreclosure sales under CCP §§580a and 726 (see chap 5) do not apply. *Coppola v Superior Court* (1989) 211 CA3d 848, 259 CR 811.

Enforceability of Successor Liability Claims Against Buyer. Buyers at a bankruptcy sale typically seek to block claims against the debtor, whether secured or unsecured, from following the assets or the buyer (usually referred to as "successor liability" claims) unless the buyer agrees to expressly assume such a claim. Section 363(f) permits a sale free and clear of "interests … in property." It is generally agreed that this language covers claims secured by the property being sold, but courts are divided on whether a sale can be made free and clear of the debtor's unsecured claims. The more expansive view is that "interests in … property" covers both "in rem" interests in property and unsecured claims arising from the debtor's property and assets. See *EEOC v Knox-Schillinger (In re Trans World Airlines, Inc.)* (3d Cir 2003) 322 F3d 283 (involving employees' unsecured claims arising out of employment with debtor brought against buyer of debtor's assets). In *Trans World Airlines,* the Third Circuit ruled alternatively that barring successor liability claims was appropriate because allowing unsecured creditors to seek full recovery from a buyer under successor liability theories, while limiting lien creditors to sales proceeds and other estate assets, would be inconsistent with the Bankruptcy Code's normal priority scheme and contrary to the underlying policy that one creditor should not be preferred over others unless such preference is expressly authorized by the Code.

Other cases are contrary to *Trans World Airlines'* expansive interpretation. See, *e.g., Folger Adam Sec., Inc. v DeMatteis/MacGregor, J.V.* (3d Cir 2000) 209 F3d 252 (affirmative defense such as recoupment does not constitute "interest" under §363(f) and therefore is not extinguished by free and clear sale); *Chicago Truck Drivers, Helpers & Warehouse Workers Union (Indep.) Pension Fund v Tasemkin, Inc.* (7th Cir 1995) 59 F3d 48 (no per se rule that bankruptcy sale prevents successor liability). Similarly, the Ninth Circuit concluded that a valid successor product liability tort claim exists if the buyer and seller make a collusive agreement to use bankruptcy proceedings to shield the successor corporation from the predecessor's liabilities. *Nelson v Tiffany Indus., Inc.* (9th Cir 1985) 778 F2d 533 (interpreting California successor liability principles). However, the court also stated that this would not be the case when "there is a good faith dissolution in bankruptcy which is not intended to avoid future tort claims against the predecessor." 788 F2d at 538.

NOTE: If the Third Circuit's interpretation of §363(f) in *In re Trans World Airlines, supra,* is adopted by the Ninth Circuit or the United States Supreme Court, *Nelson*'s interpretation of California law may be superseded entirely under the Supremacy Clause.

PRACTICE TIP: When the real estate being sold is a hotel, shopping center, office building, or other operating business, a prospective buyer should carefully assess the potential for successor liability claims under state and federal law to reduce exposure to such claims. A buyer should consider taking affirmative steps, such as the following, to cut off successor liability claims:

- Including express provisions in the sale agreement confirming that the buyer is assuming either no claims or only specified claims;
- Adding express provisions in the order of the court approving the sale that the sale is made free and clear of as broad a range of claims as possible (see §11.74 on need for giving proper notice of sale to claimants to make such provision effective); and
- Making it clear in communication with vendors and other claimants that the buyer is a different entity than the debtor and that it has not assumed claims against the debtor.

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§11.74 3. Procedure Governing Sales

A motion seeking authority to sell property free and clear is a contested matter. Fed R Bankr P 6004(c), 9013-9014. The motion must be served on all parties who have liens or interests in the property being sold. Fed R Bankr P 6004(c). Although the trustee may sell free and clear of one of more liens or interests but subject to others, Rule 6004 does not distinguish between the two. Notice of the sale must also be provided to unsecured creditors for sales out of the ordinary course of business. See §11.66.

Failure to provide adequate notice to a lienholder will justify setting aside the sale order for lack of due process. *Hasso v Mozsgai (In re La Sierra Fin. Servs., Inc.)* (BAP 9th Cir 2002) 290 BR 718; *GMAC Mortgage Corp. v Salisbury (In re Loloee)* (BAP 9th Cir 1999) 241 BR 655. Consequently, it is very important that counsel for sellers and buyers conduct appropriate diligence to determine who has liens against, or other interests in, the property. A title report should disclose claimants of record, but counsel should also assess whether there might be "secret liens" (not of record). If there is personal property involved, a lien search with the secretary of state should be obtained. Buyers should also review the proposed service list for the motion in advance of it being served and obtain a file-endorsed copy. Secured lenders should also be aware that if they acquire property by credit bid at an 11 USC §363 sale, the sale alone will not wipe out junior liens as a foreclosure would. See chaps 2-5. Therefore, it is important that the sale order specify which liens and interests are being removed.

PRACTICE TIP: Check local rules, guidelines, and orders providing court-specific notice and other procedures applicable to motions to sell free and clear of liens, including an approved model form of order. See, *e.g.,* ND Cal Guidelines re Sale Orders located under "Guidelines" at http://www.canb.uscourts.gov/rules/guidelines.

It is common for buyers to ask for comprehensive language in a sale order confirming that the property being sold is free and clear of any and all liens, claims, or other interests. The motivation for this request is understandable—buyers do not want to have any claims against the debtor to follow the property. Although some courts will sign off on such sweeping language, the order should not be enforceable against lien or interest holders who do not receive notice of the motion, because of the failure to provide due process.

PRACTICE TIP: Counsel should conduct due diligence so that parties holding liens and other interests are properly identified and served with notice of the motion in the first instance (see §§2.4, 2.34, 3.21), ensuring that the sale order will include and be effective regarding all such parties. Giving notice to all (or a large number) of the creditors should help avoid notice gaps and may convince a court to include broader "free and clear" language in the sale order.

WARNING: Counsel may encounter motions to sell property free and clear that also include a request that the court set lien priorities with respect to the proceeds. Such a request raises due process issues. Ordinarily, an adversary proceeding (*i.e.,* formal litigation initiated by a complaint) is required to establish the validity, priority, or extent of a lien or other interest in property. Fed R Bankr P 7001(2). Failure to follow the proper procedure can result in the sale order, or at least the portion attempting to set priorities, being vacated. *GMAC Mortgage Corp. v Salisbury, supra*.

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§11.75 4. Collusive and Other Improper Sales

The consequences of collusive or other improper conduct at a bankruptcy sale are significant. Under 11 USC §363(n), a debtor in possession or trustee may do either of the following:

- Avoid a sale if the sale price was controlled by an agreement among potential bidders at the sale; or
- Recover from a party to such an agreement any amount by which the value of the property sold exceeds the price at which the sale was consummated.

The debtor in possession or trustee may also recover any costs, attorney fees, or expenses incurred in avoiding the sale or recovering damages. In addition, the court may award punitive damages against any party that entered into such an agreement in willful disregard of §363(n).

Although the language of §363(n) is broad, it has been interpreted narrowly. The trustee must prove the existence of a secret agreement among potential bidders with the intent to control the price; it is not enough to show an agreement that simply affected the bidding. *Lone Star Indus. v Compania Naviera Perez Companc (In re New York Trap Rock Corp.)* (2d Cir 1994) 42 F3d 747. See *Landscape Props., Inc. v Vogel* (8th Cir 1995) 46 F3d 1416 (jury verdict dismissing action upheld despite agreement by third party to pay fee to buyer and withdraw higher offer in return for assignment of buyer's rights).

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§11.76 5. Credit Bidding at Bankruptcy Sale

Unless the court orders otherwise for cause, a secured lender may credit-bid at a sale that is made out of the ordinary course of business to the extent of its allowed secured claim, whether or not the sale is free and clear of liens. 11 USC §363(k). A court will usually prevent a secured lender from credit-bidding only if there is a bona fide dispute over the lender's claim amount or the validity or extent of its lien. On credit bidding at state-regulated foreclosure sales, see chaps 2-3.

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§11.77 F. Abandonment of Collateral

Property of the bankruptcy estate that is burdensome or of inconsequential value and benefit to the estate may be abandoned after notice and a hearing. 11 USC §554. A motion to abandon property may be brought by a trustee, a debtor in possession, or a third party. It is common for a trustee to seek to abandon property that is overencumbered. Abandonment effects a divestiture of the estate's interest in the property. *In re Dewsnup* (10th Cir 1990) 908 F2d 588, 590, aff'd sub nom *Dewsnup v Timm* (1992) 502 US 410, 116 L Ed 2d 903, 112 S Ct 773. Once abandoned, title to the property reverts back to the debtor, subject to any liens against or interests in the property.

PRACTICE TIP: The automatic stay prevents a lender from enforcing a lien securing a prepetition claim against property of the debtor. 11 USC §362(a)(5). Thus, abandonment will not obviate the need for a prepetition secured lender to seek relief from the automatic stay if the stay has not already terminated. See §§11.5-11.6. However, the grounds for abandonment (*e.g.,* lack of equity) may provide the lender with "cause" to seek stay relief.

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§11.78 G. Surcharge of Secured Creditor's Collateral

A debtor in possession or trustee "may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." 11 USC §506(c). See *Poonja v Alleghany Props. (In re Los Gatos Lodge, Inc.)* (9th Cir 2002) 278 F3d 890 (denying surcharge against secured lender after lender's claim disallowed). In essence, this provision is intended to block a secured lender from receiving a "free ride" while the bankruptcy estate incurs costs taking care of the lender's collateral. BAPCPA (see §11.1) modifies §506(c) to provide that surchargeable costs include ad valorem property taxes.

Section 506(c) issues may arise in a number of circumstances, but they are usually most contentious when the value of the collateral turns out to be less than the amount of the claims secured by it. As a result, counsel sometimes attempt to negotiate §506(c) rights early in the case as part of cash collateral or other financing agreements. Lenders often seek waiver or limitations on §506(c) rights, while debtors and trustees prefer to keep these rights available. Some courts have expressed antipathy toward §506(c) waivers. See ND Cal Bankr Guidelines for Cash Collateral and Financing Stipulations (waiver usually not allowed unless effective only during period in which debtor is authorized to use financing—this avoids problem of later appointed trustee, forced to care for lender's collateral, having no recourse). See also Warning in §11.68. The terms of a §506(c) stipulation should be clear to avoid subsequent litigation. See *Daniel v AMCI, Inc. (In re Ferncrest Court Partners, Ltd.)* (6th Cir 1995) 66 F3d 778 (broker fee could be surcharged against lender because lender consented to commission even though sale later failed to close with buyer procured by broker).

Only a bankruptcy trustee or debtor in possession may pursue a §506(c) surcharge against a secured lender. *Hartford Underwriters Ins. Co. v Union Planters Bank* (2000) 530 US 1, 147 L Ed 2d 1, 120 S Ct 1942 (denying claim by insurer). In the Ninth Circuit, the trustee may seek a surcharge and pay the party providing the benefit directly. *Debbie Reynolds Hotel & Casino, Inc. v Calstar Corp. (In re Debbie Reynolds Hotel & Casino, Inc.)* (9th Cir 2001) 255 F3d 1061, 1067. Other courts hold that any surcharge recovery is payable only to the estate. *Ungaretti & Harris, LLP v Steinberg (In re Resource Technol. Corp*.) (ND Ill 2006), 356 BR 435 (prohibiting payment to trustee's counsel). In addition, a §506(c) surcharge is limited to those expenses that the secured lender would have incurred had it foreclosed and used the foreclosed property. *Compton Impressions, Ltd. v Queen City Bank (In re Compton Impressions, Ltd.)* (9th Cir 2000) 217 F3d 1256 (denying surcharge for legal fees and marketing costs above amounts agreed to by lender in cash collateral budget and that did not benefit lender); *Golden v Chicago Title Ins. Co. (In re Choo)* (BAP 9th Cir 2002) 273 BR 608 (denying surcharge because trustee failed to quantify benefit to secured creditor of avoiding costs of foreclosure sale and subsequent disposition).

There is no per se rule that an oversecured creditor may not be surcharged for expenses of preserving collateral. While facts may show that an oversecured creditor does not benefit from efforts to preserve collateral (because the creditor would be paid in any event), evidence could show that the creditor would have become undersecured if the services had not been provided. See *Debbie Reynolds Hotel & Casino, Inc. v Calstar Corp. (In re Debbie Reynolds Hotel & Casino, Inc.)* (9th Cir 2001) 255 F3d 1061. A secured creditor can stipulate to payment of a surcharge directly to debtor's counsel who provides "quantifiable" benefit in preservation of collateral. Such a payment does not have to be paid into the estate for ratable distribution among administrative claimants. 255 F3d at 1067.

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§11.79 H. Appeals

A party that appeals from an order authorizing a sale or lease of property must obtain a stay pending appeal or the appeal will become moot as long as the purchaser or lessor acted in good faith. 11 USC §363(m). *Official Comms. of Unsecured Creditors v Anderson Senior Living Prop., LLC (In re Nashville Senior Living, LLC)* (BAP 6th Cir 2009) 407 BR 222. See §11.150. To ensure that §363(m) applies, counsel should request that the court make an express finding that the purchaser or lessor acted in good faith. Unless the court orders otherwise, the effectiveness of an order authorizing the use, sale, or lease of property other than cash collateral is automatically stayed for 10 days. Fed R Bankr P 6004(h). See §§11.146-11.152 for further discussion of appeals generally and mootness rules regarding appeals from sale or lease orders.

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VII. AVOIDANCE POWERS

§11.80 A. Legal Basis; Limitations

Chapter 5 of the Bankruptcy Code creates actions allowing a trustee (or debtor in possession) to avoid certain types of transactions. In general terms, the avoiding powers can be broken into two groups:

(1) "Strong arm" powers vesting the trustee with power to avoid transfers or obligations that would be voidable by certain specified types of creditors under state law (see 11 USC §544); and

(2) Avoidance actions created by the Bankruptcy Code (see 11 USC §§522, 547-549).

Avoiding powers have been used to avoid liens or security interests granted to lenders, payments to lenders, and obligations to lenders. This chapter focuses on avoidance powers that are most likely to have an impact on secured real property financing transactions and should not be considered a comprehensive review.

All avoiding powers sections in the Bankruptcy Code state that "the trustee" may bring the avoidance action. Debtors in possession have the powers of a trustee and, therefore, can also bring avoidance actions. See §11.4. For decades, it had been widely accepted practice that a creditors' committee or individual creditor could also bring an avoidance action if the trustee or debtor in possession refused to bring the action and a good faith basis existed for the action. The Supreme Court's holding that creditors cannot bring §506(c) surcharge claims (see §11.78), because the section only grants surcharge rights to the trustee, casts doubt on that practice. See *Hartford Underwriters Ins. Co. v Union Planters Bank* (2000) 530 US 1, 147 L Ed 2d 1, 120 S Ct 1942. This issue will likely be resolved through further litigation. See, *e.g., Official Comms. of Unsecured Creditors of Cybergenics Corp. ex rel Cybergenics Corp. v Chinery* (3rd Cir 2003) 330 F3d 548 (court's equitable powers support authorization of creditors' committee's derivative action to avoid fraudulent transfer); *United Phosphorous, Ltd. v Fox (In re Fox)* (BAP 10th Cir 2004) 305 BR 912 (reaching opposite result). However, a trustee may assign the estate's avoidance powers to third parties. *Duckor Spradling & Metzger v Baum Trust (In re P.R.T.C., Inc.)* (9th Cir 1999) 177 F3d 774.

The statute of limitations for most bankruptcy avoidance actions is the earlier of (11 USC §546(a)(1))

- 2 years after the case is begun, or 1 year after appointment of the first trustee if the appointment is made during the initial 2 years of the case; or
- the date that the bankruptcy case is closed or dismissed.

The statute of limitations can be tolled by inequitable conduct. *Olsen v Zerbetz (In re Olsen)* (9th Cir 1994) 36 F3d 71.

Section 550 of the Bankruptcy Code gives the avoidance powers their teeth. It provides that the trustee can recover the property transferred or the value of such property from the initial transferee of an avoided transfer, the entity for whose benefit the transfer was made, or any "immediate or mediate" transferee of the initial transferee liable for an avoided transfer. 11 USC §550(a). The immediate or mediate transferees of the initial transferee have no liability if they took for value, in good faith, and without knowledge of the voidability of the avoided transfer. 11 USC §550(b)(1). Any transferee of an immediate or mediate transferee that takes in good faith is also shielded from liability. 11 USC §550(b)(1). The essential concepts are that property may be transferred a number of times and only persons aware of the tainted original transfer should have liability.

Transferee status has been heavily litigated because of the greater defenses accorded downstream transferees. The courts have interpreted the term "transferee," which is not defined by the Bankruptcy Code, to mean one who exercises "dominion" over the property transferred. *Danning v Miller (In re Bullion Reserve)* (9th Cir 1991) 922 F2d 544, 549. Application of this definition, however, is not always clear cut. In *General Elec. Capital Auto Lease, Inc. v Broach (In re Lucas Dallas, Inc.)* (BAP 9th Cir 1995) 185 BR 801, an insider of a corporate debtor wrote a check on the debtor's account to pay the insider's personal mortgage. The appellate court rejected the argument of the lender receiving the mortgage payment that the insider, rather than the lender, was the initial transferee. 185 BR at 809. See also *Richardson v FDIC (In re M. Blackburn Mitchell, Inc.)* (Bankr ND Cal 1994) 164 BR 117 (reaching same conclusion on insider transferee status but collecting opposing cases).

An action under §550 may not be brought after the earlier of 1 year after avoidance of the transfer or the time the case is closed or dismissed. 11 USC §550(f). Because a complaint seeking to avoid a transaction almost always asserts a separate claim under §550 for recovery of the avoided transaction, this limitation period is rarely an issue. But if the trustee brings a separate action for recovery under §550 against a subsequent transferee based on a stipulated judgment, the subsequent transferee may have a right to litigate the merits of the avoidance claim. *Dye v Sachs (In re Flashcom, Inc.)* (Bankr CD Cal 2007) 361 BR 519. Though multiple parties may have liability under §550, the trustee can only obtain a single recovery. 11 USC §550(d).

Section 550(e) may buffer the plight of a secured lender that suffers an avoidance judgment. Under §550(e)(1), a good faith transferee from whom a trustee recovers is given a lien on the property recovered to secure the lesser of (1) the cost of improvements made after the transfer less any profit realized or accrued to the transferee or (2) the increase in the value of the property from the improvements. "Improvements" are defined to include payment of any debt secured by the property that is superior to the rights of the trustee and payment of taxes on the property. 11 USC §550(e)(2). The courts are divided on whether this provision protects a secured lender who does not have possession of the property that is the subject of the avoidance action. Compare *Black & White Cattle Co. v Granada Cattle Servs., Inc. (In re Black & White Cattle Co.)* (9th Cir 1986) 783 F2d 1454, 1462 (§550(e) (formerly numbered as §550(d)) protects nondebtor transferee who did not receive possession of property even though debtor successfully avoided transfer of title) with *Suhar v Burns (In re Burns)* (6th Cir 2003) 322 F3d 421 (secured lender whose lien was avoided because of defective documentation under state law not protected by §550(e)).

When a payment to a secured lender is avoided and the lender returns the avoided payment to the bankruptcy estate pursuant to §550, the lender should have a revived prepetition claim for the amount returned. 11 USC §502(h). A proof of claim for the revived debt must be filed within 30 days of the avoidance judgment's becoming final. Fed R Bankr P 3002(c)(3) (Chapter 7, 12, or 13), 3003(c)(3) (Chapter 11). (For an example of when judgment is final, see *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1998) 223 BR 203, aff'd (9th Cir 2000) 234 F3d 1108, discussed in §§4.30, 5.39, 7.96.) Section 502(h), however, does not speak to interest on, or security for, such a claim. A debt "revival" provision in the loan documents covering payments that are disgorged pursuant to the Bankruptcy Code might be helpful in clarifying these issues. More difficult issues may arise if the lender has previously released its collateral.

PRACTICE TIP: If a settlement of an avoidance action is reached, counsel should expressly state whether the lender will have a claim as a result of the settlement and, if so, the amount and secured status of the claim.

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§11.81 B. Unrecorded Deeds of Trust: 11 USC §544

As discussed in §11.7, the automatic stay blocks a lender holding an unrecorded deed of trust from recordation after a bankruptcy case is filed. The lender in this situation should also expect the trustee to seek avoidance of the unrecorded deed of trust using the trustee's 11 USC §544 "strong arm" powers.

A trustee's "strong arm" powers under 11 USC §544(a) (see §11.80) include the power to avoid any transfer of the debtor's property that is voidable by any of the following:

- A hypothetical judicial lien creditor as of the commencement of the case;
- A hypothetical creditor with an execution against the debtor that is returned unsatisfied as of the commencement of the case; or
- A hypothetical bona fide purchaser of real property, other than fixtures, from the debtor against whom applicable state law permits such transfer to be perfected, that obtains the status of a bona fide purchaser (BFP) and has perfected such transfer at the time of the commencement of the case. This allows a trustee to avoid unrecorded deeds of trust, and the analysis requires application of state law regarding the rights of a subsequent BFP against the holder of a prior, unrecorded deed of trust.

In a "race-notice" jurisdiction such as California (see §9.44), a subsequent BFP is protected against a prior unrecorded interest if the subsequent BFP records first. CC §1214. The Bankruptcy Code, however, states only that the trustee in bankruptcy is deemed to be a BFP, not a BFP who records first or at all. The meaning of this provision, if any, requires clarification through court decision, although it appears that Congress intended to empower the trustee to defeat an unrecorded interest. In most "race-notice" and "pure notice" jurisdictions, the status of a BFP is defeated by the existence of facts giving rise to "inquiry notice." The most common example is possession consistent with record title. See *Natural Resources, Inc. v Wineberg* (9th Cir 1965) 349 F2d 685; *Fry Bros. Co. v Van Waters & Rogers (In re Fry Bros. Co.)* (Bankr SD Ohio 1985) 52 BR 169; *High Fid. Enters. v Hull* (1962) 210 CA2d 279, 26 CR 654.

In determining whether a trustee is entitled to BFP status, the trustee is charged with the knowledge of a "prudent purchaser" on the basis of information reasonably available to such a purchaser. *Robertson v Peters (In re Weisman)* (9th Cir 1993) 5 F3d 417. Pushing the limits of inquiry notice, the Ninth Circuit held that an involuntary petition that referred to an unrecorded deed of trust was sufficient to put the trustee on inquiry notice and block avoidance. *Briggs v Kent (In re Professional Inv. Props.)* (9th Cir 1992) 955 F2d 623. This decision, however, has been limited to its specific facts. Unrecorded interests listed in the schedules or statement of affairs in a voluntary case do not put the trustee on inquiry notice and are avoidable. *Taxel v Chase Manhattan Bank (In re Deuel)* (BAP 9th Cir 2006) 361 BR 509.

If a deed of trust is avoided under §544, the lender becomes an unsecured creditor and the avoided lien position is preserved for the benefit of the bankruptcy estate. 11 USC §551. Sometimes, an unrecorded deed of trust passes through a Chapter 7 bankruptcy case without being avoided. In that scenario, the discharge injunction granted to the debtor, which results in the termination of the automatic stay (11 USC §362(c)(2)(C)), does not prevent recordation of that deed of trust or foreclosure on the property, but the creditor is barred from seeking a deficiency judgment. *Cortez v American Wheel, Inc. (In re Cortez)* (BAP 9th Cir 1995) 191 BR 174.

A trustee may also use §544 to avoid a trustee's deed that is not recorded as of the bankruptcy petition date. *Walker v California Mortgage Serv. (In re Walker)* (9th Cir 1988) 861 F2d 597. California foreclosure law provides for "deemed perfection" of a trustee's deed as of 8 a.m. on the actual date of the foreclosure sale if that deed is recorded within 15 calendar days after the date of sale, or the next business day following the 15th day if the county recorder's office is closed on the 15th day. CC §2924h(c). A trustee's deed recorded after the bankruptcy filing but within this 15-day period does not violate the automatic stay (see §11.9) and is not avoidable under 11 USC §544 or §549. *Bebensee-Wong v FNMA (In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820. A trustee's deed recorded after both the bankruptcy filing and this 15-day period is avoidable under the ruling in *Walker*.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/11 Enforcing Secured Loans Against Debtors in Bankruptcy/ C. Avoidable Preferences: 11 USC §547/§11.82 1. Prima Facie Preference Action

C. Avoidable Preferences: 11 USC §547

§11.82 1. Prima Facie Preference Action

The power to avoid transfers that "prefer" one creditor over another acts as a check on abuses by debtors and creditors prior to the filing of a bankruptcy petition. The risk of having a transfer avoided (*i.e.,* set aside and recovered back into the bankruptcy estate) as a preference

- encourages creditors to maintain ordinary credit terms with distressed customers;
- facilitates the bankruptcy policy of equality of distribution among creditors; and
- discourages creditors from seeking or debtors from granting secret liens.

· The Bankruptcy Code defines an "avoidable preferential transfer" as a transfer of an interest of the debtor in property (11 USC §547(b))

- to or for the benefit of a creditor;
- for or on account of an antecedent debt owed by the debtor before such transfer was made;
- made while the debtor was insolvent;
- made either (1) on or within 90 days of the date of filing of the petition or (2) between 90 days and 1 year if the creditor was an "insider"; and
- that enables the creditor to receive more than such creditor would receive if (1) the case were a case under Chapter 7; (2) the disputed transfer had not been made; and (3) the creditor receives payment of its debt as provided by the Bankruptcy Code.

Transfers can include a cash payment, the grant of a deed of trust or other consensual lien, a conveyance of title to realty, or the creation of a judgment or other involuntary lien. See 11 USC §101(54).

Most preference claims against secured real estate lenders focus on either the lender's receipt of payment(s) or the validity of the grant of the deed of trust, both of which are transfers of an interest of the debtor in property. When the challenged transaction is a payment, an oversecured lender should be protected by the last prong of the preference test (*i.e.,* the lender would have received just as much in a Chapter 7 case even if the payment had not been made). This is because, in a Chapter 7 case, the claim of an oversecured lender would be paid from the collateral ahead of other creditors anyway. Thus, the oversecured lender who receives regular prepetition loan payments or is fully paid by a prepetition foreclosure sale does not receive a preference. The loan payments and the sale simply convert the secured lien into cash and do not improve the lender's position.

Payments received by an undersecured lender, however, are more vulnerable to attack. For example, prepetition payment in full of a lender owed $100,000 that is secured by real property worth $75,000 allows the lender to receive $25,000 more than the lender would receive in a Chapter 7 case. See 11 USC §506(a) (limiting the secured claim to the lesser of the claim or the value of the collateral). Regular loan payments would also be vulnerable to the same attack, but the lender may well have an "ordinary course of business" defense as described in §11.83.

Whether oversecured or undersecured, a lender who purchases a debtor's house by credit bidding (see §11.76) at a prepetition, regularly conducted, noncollusive, nonjudicial foreclosure sale does not receive a preference because it will not receive more than it would have in a Chapter 7 liquidation. See *Ehring v Western Community Moneycenter (In re Ehring)* (9th Cir 1990) 900 F2d 184. (On acts constituting collusion or bid-chilling, see §§2.80, 11.75.) Arguably, a judicial foreclosure sale should also be immune because the proceeds only reduce the secured portion of the lender's claim and the deficiency is retained as an unsecured claim. See §§3.4, 3.86, 3.89. Finally, proceeds received from the full or partial disposition of the collateral by the debtor arguably should be protected because the payment will reduce the secured portion of the claim (as the value of the collateral is reduced by the disposition) but not the unsecured portion of the claim.

A trustee may also attack the grant of a deed of trust as a transfer if it is made during the preference period. Section 547 contains several rules to determine when a transfer by deed of trust occurs. If the deed of trust is recorded within

30 days of its execution, the transfer is treated as being made on the date it is signed. 11 USC §547(e)(1)(A), (e)(2)(A). If the recordation occurs more than 30 days later, the transfer date is the date of recordation. 11 USC §547(e)(2)(B). If the deed of trust has not been recorded by the later of the petition date or 30 days after the deed of trust is signed, then it is deemed to be a transfer made "immediately before the date of the filing of the petition." 11 USC §547(e)(2)(C). (These 30-day periods were each 10 days before BAPCPA.) Finally, there can be no transfer until the debtor has acquired rights in the property transferred. 11 USC §547(e)(3).

If the deed of trust is recorded before the loan is advanced, arguably the grant of the deed of trust should be immune from attack because it is not made because of antecedent debt (*i.e.,* an obligation already owing), and therefore one of the prima facie elements of the preference claim is missing. See 11 USC §547(b)(2). It follows that a lender is most at risk when it delays recordation of a deed of trust until after a loan is made or receives new collateral after having previously made loans. The latter can occur in converting an unsecured loan to a secured loan or in a restructuring of a secured loan. If the delay in recordation is not too great, the lender's best argument is the defense afforded contemporaneous transfers that are, in fact, substantially contemporaneous. See §11.83. But if the delay is significant, or if the lender is converting unsecured debt to secured debt, it will be difficult to defend a preference action seeking to avoid the grant of the deed of trust. With a restructuring involving a change in collateral that does not improve the lender's collateral position, arguably the lender should not have exposure because it would have received the same value in a Chapter 7 case.

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§11.83 2. Defenses to Preference Actions

There are several statutory defenses to a preference claim. See 11 USC §547(c). Two of these defenses are relevant to a lender making a new loan secured by real property. Standard purchase money financing secured by a deed of trust should be protected as long as the deed of trust is recorded within 20 days (30 days under BAPCPA (see §11.1)) of the debtor obtaining possession of the collateral. 11 USC §547(c)(3). Non-purchase money financing may be protected by the defense provided for contemporaneous exchange transfers made for new value. 11 USC §547(c)(1). See §11.82 on the rules for determining the time of transfer. This defense is particularly relevant to deeds of trust granted in connection with a new loan. The longer a lender delays the recordation of its deed of trust, the less likely the defense will be available. *Dye v Rivera (In re Marino)* (BAP 9th Cir 1996) 193 BR 907, aff'd (9th Cir 1997) 117 F3d 1425 (unpublished opinion) (deed of trust recorded 14 days after funding of loan not preferential; trial court must inquire into facts and circumstances of particular transaction to determine whether perfection was substantially contemporaneous).

Another defense shields transfers made in payment of debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the lender. See 11 USC §547(c)(2). To assert an ordinary course defense, a lender must establish one of the following:

- The payment was *made in the ordinary course* of business or financial affairs of the debtor and lender, or
- The payment was made *according to* ordinary business terms.

The ordinary course defense applies to regularly scheduled payments on long-term debts. *Union Bank v Wolas* (1991) 502 US 151, 116 L Ed 2d 514, 112 S Ct 527. The following types of payments have been considered to be in the ordinary course of business:

- A secured loan payoff consistent with the broad range of industry practices. *Ganis Credit Corp. v Anderson (In re Jan Weilert RV, Inc.)* (9th Cir 2003) 315 F3d 1192, amended 326 F3d 1028.
- Late payments if payments were regularly late and late payments were commonly accepted in the industry. See *Sulmeyer v Pacific Suzuki (In re Grand Chevrolet, Inc.)* (9th Cir 1994) 25 F3d 728.
- Payments pursuant to a restructuring agreement if such agreements are regularly made in the industry. See *Arrow Electronics, Inc. v Justus (In re Kaypro)* (BAP 9th Cir 1999) 230 BR 400, aff'd (9th Cir 2000) 218 F3d 1070; see also *In re Tolona Pizza Prods. Corp.* (7th Cir 1993) 3 F3d 1029.
- Payment that is the first transaction between the debtor and the transferee. See *Wood v Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.)* (9th Cir 2007) 482 F3d 1118.
- Payment of rents from a mortgaged property into a lockbox or escrow controlled by the lender (see §11.56). Compare *Galloway v First Ala. Bank (In re Wesley Indus., Inc.)* (11th Cir 1994) 30 F3d 1438 (ordinary course) with *Clark v Balcor Real Estate Fin*. (*In re Meridith Hoffman Partners)* (10th Cir 1993) 12 F3d 1549 (not ordinary course).

When the payment agreement between the debtor and the creditor has been revised or restructured, the court may consider both the revised agreement and the original transaction in applying §547(c)(2). *Wood v Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.)* (9th Cir 2007) 482 F3d 1118, 1127.

BAPCPA is intended to reduce nuisance suits. In cases that do not involve primarily consumer debt, the minimum preferential transfer (in the aggregate) that can be avoided is $5475. 11 USC §547(c)(9). Moreover, venue of an action to recover nonconsumer debt of less than $10,950 can only be brought in the district in which the defendant resides. 28 USC §1409(b).

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§11.84 3. Insider Preferences

If transfers are made to an insider, the avoidance period is extended from 90 days to 1 year. 11 USC §547(b)(4). Insiders are generally relatives or partners of individual debtors and directors, officers, general partners, or other persons in control of a corporate or partnership debtor. 11 USC §101(31). On first impression, most secured real estate lenders would not appear to be insiders. However, in 1989 the extended insider preference period was held to be applicable to lenders holding a personal guaranty from an insider of the debtor. See *Levit v Ingersoll Rand Fin. Corp. (In re V.N. Deprizio Constr. Co.)* (7th Cir 1989) 874 F2d 1186. See also *Official Unsecured Creditors Comm. of Suffola, Inc. v U.S. Nat'l Bank (In re Suffola, Inc.)* (9th Cir 1993) 2 F3d 977 (adopting *Deprizio*). These rulings caused significant distress in the lending community.

In 1994, Congress attempted to overrule *Deprizio* by enacting 11 USC §550(c), which provides that if the transfer is made between 90 days and 1 year before the petition date for the benefit of an insider, the trustee cannot recover the property or the value of the property transferred from a transferee that is not an insider. However, the amendment did not appear to shelter security interests (which would include deeds of trust), because avoidance of a security interest does not involve recovery of property held by the debtor or the value of such property. The BAPCPA amendments to the Bankruptcy Code (see §11.1) intend to lay the issue to rest. Under 11 USC §547(i), avoidance of a transfer to a noninsider that was made for the benefit of an insider is effective only against the insider. Unlike most of BAPCPA, this change is effective for existing and future cases. Pub L 109-8, §1213(b), 119 Stat 23. This change should alleviate lenders' concerns about taking insider guarantees.

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§11.85 4. Effect of Avoided Preferential Transfer

Once a preferential transfer is avoided, by court order or settlement, the underlying debt on which the preferential payment was made, along with any guaranty of the debt, is revived as a matter of law, absent a contractual provision to the contrary. *Centre Ins. Co. v SNTL Corp. (In re SNTL Corp.)* (9th Cir BAP 2007) 380 BR 204. The revived claim against the debtor's estate will be subordinated or barred, however, unless the creditor files a proof of claim on it within 30 days of entry of the judgment against the creditor. Fed R Bankr P 3002(c)(3).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/11 Enforcing Secured Loans Against Debtors in Bankruptcy/§11.86 D. Fraudulent Transfers: 11 USC §§544, 548

§11.86 D. Fraudulent Transfers: 11 USC §§544, 548

A trustee may also avoid transfers of the debtor or obligations incurred by the debtor that are fraudulent. Under the Bankruptcy Code, either of the following transfers may be avoided:

- *Actually fraudulent*. The debtor "made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity" to which the debtor was or became indebted "on or after the date that such transfer was made or such obligation was incurred" (11 USC §548(a)(1)(A)); or
- *Constructively fraudulent*. The debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation" and there is evidence the debtor was financially unsound (11 USC §548(a)(1)(B)).

Alternatively, the trustee may pursue a fraudulent transfer action under California's version of the Uniform Fraudulent Transfer Act (UFTA) (see CC §§3439-3439.12), which is incorporated into the trustee's avoidance powers under 11 USC §544. See Debt Collection Practice in California §§8.7, 8.31, 8.33, 12.66 (2d ed Cal CEB 1999).

The tests for determining a fraudulent transfer under §548 are virtually identical to the tests under California's version of UFTA. The primary difference is that §548 only reaches transfers made within 1 year of the bankruptcy. 11 USC §548(a)(1). Under BAPCPA (see §11.1), this reach-back period has been extended to 2 years but applies only to cases filed 1 year after the BAPCPA enactment date, *i.e.,* cases filed after April 20, 2006. Pub L 109-8, §1406(b)(2), 119 Stat 23.

With some exceptions (see, *e.g.,* CC §3439.08(a)), California law allows transfers to be avoided within 4 years after they are made and up to 7 years if they are not immediately recognized and the later-discovery rule applies to extend the statute of limitations. CC §3439.09; CCP §338. See *Macedo v Bosio* (2001) 86 CA4th 1044, 104 CR2d 1. Additionally, depending on the particular provision of the UFTA on which the trustee relies, there may be a need to prove the existence of a pretransfer creditor. Section 548 does not contain a similar requirement.

Extensive fraudulent transfer litigation has occurred in connection with foreclosure sales. The standard for determining when a prebankruptcy foreclosure sale can be set aside as a fraudulent transfer was established in *BFP v Resolution Trust Corp.* (1994) 511 US 531, 128 L Ed 2d 556, 114 S Ct 1757. In *BFP*, the Supreme Court held that the price received at a noncollusive real estate mortgage foreclosure sale constitutes reasonably equivalent value for the purposes of 11 USC §548(a)(2), provided that the foreclosure was conducted in full compliance with all requirements of applicable state law. The Court rejected a fair market value test and was not persuaded that the 1984 Bankruptcy Code amendments, which expanded the definition of "transfers" under 11 USC §101(54) to include foreclosure of the debtor's equity of redemption, were intended to codify a different rule.

Adhering to the Supreme Court's *BFP* decision, the Ninth Circuit rejected the argument that gross inadequacy of price or commercial reasonableness could be grounds for setting aside a foreclosure sale unless state law so provides. See *Lindsay v Beneficial Reins. Co.* (*In re Lindsay)* (9th Cir 1995) 59 F3d 942, 948. See also *C.F. Brookside, Ltd. v Skyview Mem. Lawn Cemetery (In re Affordable Hous. Dev. Corp.)* (BAP 9th Cir 1994) 175 BR 324 (no separate federal standard of commercial reasonableness applicable to foreclosure sale after plan confirmation). *Lindsay* also held that the applicable state law should be determined by federal (rather than forum state) choice of law rules. Texas law controlled in *Lindsay* because the real property at issue was located there.

A lender who receives a deed in lieu of foreclosure may have greater exposure to fraudulent transfer claims because there is no foreclosure sale to establish the value of the property. See *Main v Brim (In re Main)* (Bankr D Ariz 1987) 75 BR 322 (deed in lieu may be fraudulent transfer even if it is assumed that noncollusive foreclosure sale cannot be fraudulent transfer).

The grant of a deed of trust may be attacked as a fraudulent transfer if the debtor granting the trust deed receives no consideration. This problem might arise in a loan transaction if an affiliate of the debtor receives the loan funds. *Wood v Delury, Pomares & Co. (In re Fair Oaks, Ltd.)* (BAP 9th Cir 1994) 168 BR 397 (avoiding deed of trust to partnership real property in California given as security for preexisting debts of partnership's principal and its affiliates). See also *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1994)

174 BR 557 (debtor's obligation on $1 million note avoided as fraudulent obligation because loan funded to debtor's parent corporation).

Securitized lending and other underwriting practices among lending entities may give rise to fraudulent transfer litigation when one of the lenders files for bankruptcy relief. See, *e.g., Henry v Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)* (9th Cir 2006) 471 F3d 977 (trustee did not succeed in avoiding prepetition payments to creditor-lender by debtor-lender under their revolving credit and securitization agreements).

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§11.87 E. Unauthorized Postpetition Transfers: 11 USC §549

A trustee may avoid postpetition transfers by the debtor of property of the bankruptcy estate that are not authorized by the Bankruptcy Code or the bankruptcy court. 11 USC §549. Absent the required authorization, postpetition loan payments made with estate funds can be avoided under §549. *Mora v Vasquez (In re Mora)* (9th Cir 1999) 199 F3d 1024. In commercial real estate cases, postpetition payments to lenders usually consist of adequate protection payments that are authorized by the Bankruptcy Code (see §11.23), approved by the court (see §§11.44, 11.46, 11.70, 11.73, 11.94), or made pursuant to a reorganization plan approved by the court (see §11.96). Such payments should not be at risk. In Chapter 13 cases, a debtor is required to start funding payments under the proposed plan within 30 days of filing the plan. 11 USC §1326. See §11.119. These payments should not be at risk either.

Section 549 cannot be used to avoid a deed of trust recorded prepetition that secures a debtor's guaranty of future advances to a corporate borrower under a factoring agreement (including postpetition advances) because the priority of the deed of trust dates from its recordation. *Beeler v Jewell (In re Stanton)* (9th Cir 2002) 303 F3d 939. Section 549 also cannot be used to avoid a deed of trust recorded before the bankruptcy merely because the lender assigns the deed of trust to another lender postpetition. *Kapila v Atlantic Mortgage & Inv. Corp. (In re Halabi)* (11th Cir 1999) 184 F3d 1335.

The trustee may also try to use §549 to avoid a trustee's deed for a prepetition foreclosure sale that is not recorded as of the bankruptcy petition date. However, a trustee's deed recorded within 15 days of the sale is deemed perfected as of the sale date. CC §2924h(c). If the trustee's deed is recorded within the 15-day period, it is not a postpetition transfer avoidable under §549. *Bebensee-Wong v FNMA (In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820.

Moreover, unless the bankruptcy petition or a notice of the petition was recorded, §549 cannot be used to avoid a transfer of real property sold at foreclosure to a good faith purchaser without knowledge of the commencement of the bankruptcy case and for a present fair equivalent value. 11 USC §549(c). If the foreclosure purchaser pays less than fair equivalent value, the transfer may be avoided but the purchaser will have a lien for the value given. See also *40235 Washington St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, discussed in §11.18 (§549(c) does not create safe harbor for bona fide purchaser at foreclosure sale held in violation of automatic stay).

However, BAPCPA (see §11.1) creates an exception to the stay for a bona fide purchaser by revising the definition of "transfer" to include the "creation of a lien." 11 USC §101(54). It also revises 11 USC §549(c) to cover the transfer of "an interest" in real property. As a result, a lender who receives a deed of trust postpetition in good faith, for value, and without knowledge of the bankruptcy case should be protected by the §549(c) safe harbor. These changes appear to overrule the contrary view taken in *Thompson v Margen (In re McConville)* (9th Cir 1997) 110 F3d 47 (discussed in §11.62). A transferee with knowledge of the bankruptcy case, however, will have no defense or offset to avoidance under 11 USC §549(a) or to recovery by the trustee under 11 USC §550(a). *Aalfs v Wirum (In re Straightline Invs.)* (9th Cir 2008) 525 F3d 870.

PRACTICE TIP: To avoid application of §549(c), on the petition date or as soon thereafter as possible, counsel for trustees and debtors in possession should record notice of the bankruptcy filing in counties where the debtor's real estate is located and, if possible, have a process server attend the foreclosure sale and announce the bankruptcy filing, especially if the notice recordation date is close to or on the sale date.

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§11.88 F. Judicial Liens Impairing Homestead Exemption: 11 USC §522

A debtor may avoid a judicial lien impairing the debtor's interest in a homestead exemption. 11 USC §522(b). This provision does not affect a lienholder secured by a deed of trust because the deed of trust is not a judicial lien. See 11 USC §101(36) ("judicial lien" means lien obtained by legal process). However, a judgment lien securing a judgment obtained in an action directly on the note by a sold-out junior trust deed holder may be avoided if it impairs a debtor's homestead exemption. See *California Cent. Trust Bankcorp v Been (In re Been)* (9th Cir 1998) 153 F3d 1034 (exception in 11 USC §522(f)(2)(C) to avoidance of transfer for mortgage foreclosure judgment does not apply to sold-out junior). BAPCPA (see §11.1) caps the amount of the homestead exemption at $136,875 if the debtor elects state law exemptions. See 11 USC §522(p). See also §§2.108-2.109 on effect of homestead exemptions.

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VIII. TREATMENT OF SECURED CLAIMS IN BANKRUPTCY

§11.89 A. Overview of Claims Process

The word "claim" is defined expansively by the Bankruptcy Code to include any right to payment, whether liquidated or unliquidated, fixed or contingent, matured or unmatured, disputed or undisputed, legal or equitable, secured or unsecured, and any right to an equitable remedy for breach of performance if such breach gives rise to a right to payment. 11 USC §101(5).

Proof of claim generally required. In Chapter 7, 12, and 13 cases, a creditor must file a proof of claim within 90 days after the first date set for the meeting of creditors unless, in a Chapter 7 case, a notice of insufficient assets to pay a dividend is given. Fed R Bankr P 3002(c). Under Rule 3002(c)(6), a court may extend the claim deadline to a creditor served at a foreign address by 60 days if the court finds that notice was not sufficient under the circumstances to give the creditor a reasonable time to file a proof of claim.

In Chapter 11 cases, a creditor whose claim is not scheduled or that is scheduled as disputed, contingent, or unliquidated must file a proof of claim within the time fixed by the court. 11 USC §1111(a); Fed R Bankr P 3003(c)(3). As the amount stated for a creditor's claim in the schedule of liabilities filed by the debtor is not often readily available (or is inaccurate), most creditors will file a proof of claim in a Chapter 11 case. Counsel should be aware of local rules automatically fixing the bar date in Chapter 11 cases. See, *e.g.,* ND Cal Local Bankr R 3003-1 (claim must be filed within 90 days after first date set for meeting of creditors unless court orders otherwise). Notice of the date for the meeting of creditors required by 11 USC §341(a) is given to all creditors shortly after the bankruptcy case is filed.

Preparation and filing of proof of claim. A proof of claim should be prepared on or substantially conform to Official Form 10 (Proof of Claim), available for downloading at http://www.uscourts.gov/rules/BK_Forms_1207/B_010_1207f.pdf. See Fed R Bankr P 3001(a). The proof of claim should be executed by the creditor. Fed R Bankr P 3001(b). For institutional creditors, the claim should be signed by an authorized officer. A secured creditor must attach the writing supporting its secured claim and proof that the security interest has been perfected. Fed R Bankr P 3001(c)-(d). It is important for creditors to check the local rules of the bankruptcy court in which the case is pending for additional requirements.

A creditor who receives adequate notice of the claims bar date and fail to timely file a proof of claim

- will not have an allowed claim in a case under Chapter 12 or 13, which means the creditor will not be eligible for any distributions from the bankruptcy case (Fed R Bankr P 3002(a));
- will not be treated as a creditor for purposes of voting or receiving distributions in a Chapter 11 case (Fed R Bankr P 3003(c)(2)); and
- will have, at best, a subordinated claim in a Chapter 7 case that is payable only after all other creditors are paid in full (11 USC §726(a)(3)).

Claims allowance, objections. A properly filed proof of claim is deemed allowed unless a party in interest objects. 11 USC §502(a). See Fed R Bankr P 3001(f) (properly filed claim is prima facie evidence of validity and amount of claim). The Ninth Circuit treats a deemed allowed claim as a final judgment having res judicata effect. *Siegel v FHLMC* (9th Cir 1998) 143 F3d 525, 529. There are several bases for objecting to a claim, but the most comprehensive ground is for claims that are "unenforceable against the debtor and property of the debtor, under any agreement or applicable law…." 11 USC §502(b). A claim may also be disallowed if the creditor is liable for an avoided transfer unless the liability has been satisfied. 11 USC §502(d) (disallowance proper even if underlying avoidance action is time barred); *El Paso v America W. Airlines, Inc. (In re America W. Airlines, Inc.)* (9th Cir 2000) 217 F3d 1161.

If the trustee or debtor in possession disputes the claim, the trustee or debtor may file an objection to it, and the court will hold an evidentiary hearing on the objection. 11 USC §§704(a)(5), 1107; Fed R Bankr P 3007(a). An objection to a claim is a contested matter in the main bankruptcy case. Fed R Bankr P 3007, 9014. However, a demand for relief that requires an adversary proceeding, such as a challenge to the validity, priority, or extent of a lien (see, *e.g.,*

Calabria v CIT Consumer Grp. (In re Calabria) (Bankr WD Pa 2009) 407 BR 671), may not be included in an objection, but a related objection may be included in the adversary proceeding. Fed R Bankr P 3007(b), 7001(2). Objections to more than one claim may be joined in an omnibus objection if specified conditions are met. Fed R Bankr P 3007(d)-(e).

NOTE: Some courts have local rules regarding claim objections. See, *e.g.,* ND Cal Local Bankr R 3007-1(b) (initial hearing on claim objection treated as status conference if factual disputes involved, but objection may be argued if it only involves question of law).

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B. Secured and Unsecured Claims

1. Allowance of Secured Claims: 11 USC §506

§11.90 a. Oversecured and Undersecured Lien Claims

A claim is treated as being secured, assuming it is validly perfected, only to the extent of the value of the creditor's interest in the collateral. 11 USC §506(a). Depending on the value of the collateral and the presence or absence of other lien claims against the collateral, a lender may be oversecured, undersecured, or unsecured. If the collateral value net of any senior lien claims is greater than the lender's claim, the lender is oversecured. If the collateral value net of senior liens is equal to only a portion of the lender's claim, the lender is undersecured or, stated another way, partly secured. If the collateral value does not exceed senior liens (or has no value if there are no senior liens), the lender is unsecured. The distinction among oversecured, undersecured, and unsecured claims is important. The oversecured creditor can recover postpetition interest and reasonable attorney fees and other loan charges, while the undersecured and unsecured creditor cannot. See §§11.94-11.95. Moreover, with some exceptions, undersecured lien claims can be stripped down to their collateral value in Chapter 11, 12, and 13 plans. See §§11.101 (Chapter 11), 11.121 (Chapter 13), 11.137 (Chapter 12).

NOTE: If the underlying claim is disallowed, the lien is deemed void unless the disallowance is solely the result of the lender's failure to file a proof of claim or other limited reasons. 11 USC §506(d); *Hamlett v Amsouth Bank (In re Hamlett)* (4th Cir 2003) 322 F3d 342, 349 (failure to file timely claim, like failure to file claim, does not constitute sufficient grounds for extinguishing valid lien).

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§11.91 b. Valuation of Lien Claims

The valuation of collateral needed to establish a creditor's secured status "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 USC §506(a). This provision enables the parties and the court to make appropriate adjustments in determining a secured creditor's claim if the collateral value changes over time, as may happen in protracted cases. On valuation standards, see §§11.41, 11.110, 11.126, 11.129.

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§11.92 c. Undersecured Claims; Lien-Stripping

Under 11 USC §506(a), in certain cases, the amount of a secured claim may be reduced or "stripped down" to the fair market value of the collateral as of the petition date. See also 11 USC §506(d). Section 506(a)(1) provides that

> an allowed claim of a creditor secured by a lien on property in which the estate has an interest … is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, … and is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim.

If the debtor is permitted to strip a secured creditor's claim down to the value of the collateral, the claim will be bifurcated into secured and unsecured portions. The creditor is treated as a secured creditor to the extent of the value of the collateral and as an unsecured creditor to the extent of the remainder of the amount owed.

Despite the language of §506(a)(1), lien-stripping has been significantly restricted as a strategy for bankruptcy debtors. Lien-stripping is prohibited in both Chapter 11 and Chapter 13 cases for liens on a debtor's principal residence. 11 USC §§1123(b)(5), 1322(b)(2). See §§11.102, 11.123. But see Note on pending legislation in §11.1. Under 11 USC §506(a)(2), added by BAPCPA, lien-stripping has been limited for personal property collateral in individual Chapter 7 and 13 cases. Section 506(a)(2) requires the value of personal property securing an allowed claim to be determined based on the replacement value of the property as of the petition date without deduction for costs of sale or marketing. If the property was acquired for personal, family, or household purposes, the replacement value is its retail replacement value, taking into account its age and condition. Further, 11 USC §1325(a) was amended by BAPCPA to prohibit lien-stripping altogether in Chapter 13 cases with regard to purchase money security interests in (1) motor vehicles acquired for the debtor's personal use within 2½ years before the petition date and (2) any other type of property acquired within 1 year before the petition date. See §11.121.

Even before BAPCPA, in *Dewsnup v Timm* (1992) 502 US 410, 116 L Ed 2d 903, 112 S Ct 773, the Supreme Court held that 11 USC §506 was ambiguous and that a debtor in Chapter 7 could not strip a creditor's real estate lien down to the value of the real property collateral when the creditor's claim had already been allowed as a secured claim. *Dewsnup* is generally understood to prohibit lien-stripping in Chapter 7 cases only. See *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165; *In re Castro* (Bankr D Ariz 2002) 285 BR 703, 705. The prohibition against lien-stripping in Chapter 7 cases applies to nonconsensual as well as consensual liens. *Concannon v Imperial Capital Bank (In re Concannon)* (BAP 9th Cir 2006) 338 BR 90 (judgment lien).

For further discussion of undersecured claims in Chapter 11, see §11.93; for further discussion of undersecured claims and scope of permissible lien-stripping in Chapter 13 cases, see §§11.121-11.126, 11.132.

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§11.93 2. Undersecured Claims in Chapter 11 Cases

Chapter 11 contains two special provisions in 11 USC §1111(b) dealing with allowance of undersecured creditor claims under a proposed plan of reorganization:

- The first allows the creditor an unsecured deficiency claim under §1111(b)(1)(A); and
- The second allows the creditor to elect to be treated as fully secured under §1111(b)(2).

In the first provision, the lender holding an undersecured, nonrecourse claim is deemed to have recourse, *i.e.,* to have an allowed unsecured deficiency claim. 11 USC §1111(b)(1)(A). It does not matter whether the nonrecourse aspect of the loan arose under the original contract or by operation of law. There are two exceptions to this rule. The first applies if the lender (or the class in which the lender is a member) elects, in conjunction with a proposed plan, to have its claim treated as fully secured under §1111(b)(2). See 11 USC §1111(b)(1)(A)(i). The second exception applies if the collateral is sold under 11 USC §363 or under the plan. 11 USC §1111(b)(1)(A)(ii).

The second provision, §1111(b)(2), permits an undersecured lender (or the class in which the lender is a member), whether the debt is recourse or not, to elect to have its "allowed secured claim" equal the full amount of its allowed claim notwithstanding 11 USC §506(a) and the fact that its claim is greater than the value of the collateral. Note that plans usually place each secured claim in a separate class. The election is not available if the lender has a recourse claim and the collateral is sold under §363 or is to be sold under the plan or if the collateral is "of inconsequential value." See §1111(b)(1)(B).

Section 1111(b) can be a powerful tool for the undersecured lender and requires the lender to evaluate a proposed plan carefully. If the lender does not elect to be treated as fully secured under §1111(b)(2), it may receive some distributions on account of its deficiency claim. *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284. In addition, a lender may have substantial negotiating "leverage" in plan formulation if the deficiency claim is sufficiently large to determine whether the class of unsecured creditors will accept or reject the proposed plan. On the other hand, a lender may believe that the debtor is undervaluing the collateral either in the near term or long term. In such a situation, depending on the proposed treatment of unsecured creditors under the plan, a lender may believe that its best recovery will be to elect to have its claim treated as being fully secured. If the election is made and the collateral appreciates in value, the lender benefits from that increase up to the full amount of its claim. 227 BR at 295 n12.

Undersecured lenders are not accorded special treatment under §1111(b) in the context of a sale of the collateral because the lender will have the opportunity to "credit-bid" at a sale (see §11.76), pursuant to 11 USC §363(k). However, if a lender is denied the right to credit-bid, the lender may assert a deficiency claim under §1111(b). *In re California Hancock, Inc.* (BAP 9th Cir 1988) 88 BR 226.

Lenders must elect to be treated under §1111(b)(2) prior to the conclusion of the hearing on the disclosure statement regarding the plan or within such later time as the court may fix. Fed R Bankr P 3014. The election must be made in writing and signed unless made at the hearing on the disclosure statement.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/11 Enforcing Secured Loans Against Debtors in Bankruptcy/ 3. Recovery of Interest and Reasonable Attorney Fees and Costs/§11.94 a. By Oversecured Creditor

3. Recovery of Interest and Reasonable Attorney Fees and Costs

§11.94 a. By Oversecured Creditor

An oversecured lender is entitled to postbankruptcy interest and "reasonable fees, costs, or charges provided for under the agreement under which [the] claim arose." 11 USC §506(b). Although §506(b) seems straightforward, the courts have been required to fill in a number of gray areas.

Predefault interest. A preliminary issue is the allowable interest rate. For consensual lienholders, the proper rate of interest is the contract rate. *P.S. Taggares Co. v Glenn (In re Glenn)* (9th Cir 1986) 796 F2d 1144. See *U.S. v Ron Pair Enters., Inc.* (1989) 489 US 235, 103 L Ed 2d 290, 109 S Ct 1026 (oversecured, nonconsensual lienholder also entitled to interest).

Default interest. A more contentious issue involves allowance of default interest provided by the loan documents. See §§7.123, 8.1, 8.5, 8.34-8.35. Generally, postpetition interest is not paid until the court determines that the creditor is oversecured, which may not occur until a sale of collateral, confirmation of a plan, or other conclusion of the case, although a creditor may receive interim adequate protection payments to protect against decline in the value of its collateral. *Orix Credit Alliance, Inc. v Delta Resources, Inc. (In re Delta Resources, Inc.)* (11th Cir 1995) 54 F3d 722. A reorganization plan may provide for the cure of defaults and thereby nullify the consequences of default, including default penalties such as higher interest. In the Ninth Circuit, an oversecured creditor is not entitled to interest at the default rate if its claim is paid in full in accordance with the terms of a Chapter 11 plan. *Great W. Bank & Trust v Entz-White Lumber & Supply, Inc*. (*In re Entz-White Lumber & Supply, Inc.)* (9th Cir 1988) 850 F2d 1338, 1342. See §§11.127 (Chapter 13), 11.138 (Chapter 12). Alternatively, the debtor may impair the creditor's claim and propose a market rate of interest in a "cram-down" plan. See §§11.110 (Chapter 11), 11.129 (Chapter 13), 11.140 (Chapter 12).

A default interest rate will apply, however, when the collateral is sold under 11 USC §363, outside the context of a Chapter 11 plan. *General Elec. Capital Corp. v Future Media Prods., Inc*. (9th Cir 2008) 536 F3d 969. In *General Elec. Capital Corp.,* the Ninth Circuit held that *Great W. Bank & Trust v Entz-White Lumber & Supply, Inc*. *supra,* did not establish a per se rule against default interest and that there is a presumption that the default rate should be enforced, subject only to any contrary provision of the Bankruptcy Code and to applicable nonbankruptcy law. 536 F3d at 973-974. See *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199, 1204.

Even if default interest is allowed, the lender's failure to provide notice of acceleration may result in denial of that interest for the period before actual notice. See *Beal Bank v Crystal Props., Ltd. (In re Crystal Props., Ltd.)* (9th Cir 2001) 268 F3d 743. Moreover, an unreasonably high default interest rate may be challenged as a penalty under applicable nonbankruptcy law. See CC §3275; *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378.

Reasonable attorney fees, costs, charges. Section 506(b) also permits a secured lender to recover reasonable fees, costs, or charges if the parties' agreement or applicable state law provides for such recovery. Recoverable costs may include attorney fees, even when the fees were incurred in connection with litigation of issues peculiar to bankruptcy law, provided that the fees and costs were reasonable and provided for in the lender's loan documents. *Kord Enters. II v California Commerce Bank (In re Kord Enters. II)* (9th Cir 1998) 139 F3d 684. Lenders often include provision for recovery of fees of in-house counsel in their loan documentation. Recovery of such fees appears supportable under §506(c) and, to the extent applicable, under California law. *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198 (company using salaried in-house counsel may recover fees at prevailing, private hourly rates multiplied by hours expended). See also *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199; *Qmect, Inc., v Burlingame Capital Partners II, LP (In re Qmect, Inc.)* (Bankr ND Cal 2007) 368 BR 882.

Often an agreement or state law permits only the prevailing party to recover its attorney fees, and the definition of "prevailing" may be too narrow to allow an award of attorney fees to the oversecured creditor, even if the creditor is paid in full on its claim. See, *e.g*., *Hoopai v Countrywide Home Loans, Inc. (In re Hoopai)* (9th Cir 2009) 581 F3d 1090

(allowed award of attorney fees incurred by creditor before plan confirmation but denied postconfirmation attorney fees to creditor because court concluded debtor was prevailing party under Hawaii law on disputed main issue; neither validity of lien nor prospect for full payment were ever disputed because of substantial equity cushion, and lender was losing party on contested proceedings that it initiated to prevent sale free and clear of lien).

Unreasonable fees and costs may be reduced or may not be allowed as part of the lender's secured claim. *Hoopai v Countrywide Home Loans, Inc., supra; First Bank v Brunswick Apartments (In re Brunswick Apartments)* (6th Cir 1999) 169 F3d 333 (consultant fees denied because consultant was bank insider with no bankruptcy experience and kept inadequate records; attorney fees reduced by $61,500 (84 percent) because bank pursued unreasonable demands in litigation); *CityBank v Udhus (In re Udhus)* (BAP 9th Cir 1998) 218 BR 513 (loan loss reserves and employee costs disallowed); *In re Irick* (Bankr ED Cal 1997) 216 BR 433 ($72,521 fee request reduced to $28,651 when lender engaged three law firms regarding $1.2 million secured debt). But a lender may be able to assert an unsecured claim for unreasonable fees and costs. *Welzel v Advocate Realty Invs., LLC (In re Welzel)* (11th Cir 2001) 275 F3d 1308.

Section 506(b) governs an oversecured creditor's entitlement to attorney fees incurred before plan confirmation and preempts state law. *Hoopai v Countrywide Home Loans, Inc., supra*. Section 506(b) is not applicable to fees incurred by a lender after plan confirmation unless the plan specifically provides otherwise. Instead, the recovery of such fees should be governed by the mortgage terms and applicable state law. *Telfair v First Union Mortgage Corp.* (11th Cir 2000) 216 F3d 1333.

CAUTION: Some courts have held that until the court reviews an application and issues an order modifying the payment allocation scheme under a Chapter 13 plan, a mortgage lender may not collect reimbursable expenses (such as attorney fees and costs) without violating the order confirming the debtor's plan. *Wilborn v Wells Fargo Bank, NS (In re Wilborn)* (Bankr SD Tex 2009) 401 BR 872 (certifying class action on behalf of all Chapter 13 debtors in the Southern District of Texas who were charged by Wells Fargo Bank for attorney fees and costs that were not disclosed under Fed R Bankr P 2016(a) or approved by court).

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§11.95 b. By Unsecured Creditor

Although an unsecured creditor may not recover interest unless there are sufficient funds in the bankruptcy estate to pay all claims in full, it may recover postbankruptcy attorney fees as part of its unsecured claim to the extent allowed under its prepetition contract. *Centre Ins. Co. v SNTL Corp. (In re SNTL Corp.)* (9th Cir BAP 2007) 380 BR 204.

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IX. REORGANIZATION PLANS: CHAPTERS 11, 12, AND 13

§11.96 A. Overview of Plans

The reorganization plan is the key feature differentiating bankruptcy cases under Chapters 11, 12, and 13 from a straight liquidation under Chapter 7. The title of Chapter 11, "Reorganization," explicitly refers to the financial reorganization objective of a Chapter 11 case. The title of Chapter 13, "Adjustment of Debts of an Individual With Regular Income," implies the personal rehabilitation focus of a Chapter 13 case, but many Chapter 13 plan concepts are similar to Chapter 11. Chapter 12, titled "Adjustment of Debts of a Family Farmer or Fisherman With Regular Annual Income," is modeled after Chapter 13 and shares most of the same features.

In a Chapter 7 case, a trustee liquidates assets of the bankruptcy estate and distributes the proceeds of encumbered assets to repay secured creditors to the extent of their "allowed secured claims" and the proceeds of unencumbered assets to unsecured creditors in accordance with the priority scheme of 11 USC §507. 11 USC §§704(a)(1), 725-726. In most Chapter 7 cases, issues involving secured claims are resolved well before the case is completed.

In cases commenced under Chapters 11, 12, and 13, as in Chapter 7 cases, property of the debtor becomes property of the estate at the commencement of the case. Under Chapters 11, 12, and 13, unlike Chapter 7, property of the estate is revested in the debtor when a plan is confirmed unless the plan provides otherwise. 11 USC §§1141(b), 1227(b), 1327(b). Plans confirmed under Chapters 11, 12, and 13 allow a debtor to restructure its finances by modifying the rights of creditors and equity holders subject to the requirements of the Bankruptcy Code. Chapter 12 and 13 plans typically have a simplified structure providing for payments over a period of 3 to 5 years. Upon completion of the plan payment schedule, the debtor receives a discharge of debts (other than certain nondischargeable debts) that were treated by the plan. 11 USC §§1228(a), 1328(a). Chapter 11 plans may be in the form of a true reorganization under which the debtor emerges as a reorganized going concern. In that event, a discharge of debts treated under the plan is granted upon confirmation of the plan. 11 USC §1141(d). Under BAPCPA (see §11.1), no discharge is granted in a Chapter 11 case filed by an individual debtor until all plan payments are made. 11 USC §1141(d)(5). Chapter 11 plans may also provide for liquidation of substantially all property of the estate, with no ongoing business after consummation of the plan. In that scenario, a discharge is not granted. 11 USC §1141(d)(3).

If a plan is confirmed and the debtor is unable to substantially consummate the plan or materially defaults under the plan, a creditor may request that the case be dismissed or converted to Chapter 7. 11 USC §1112(b) (Chapter 11), §1208(c) (Chapter 12—dismissal only remedy for plan default), §1307(c) (Chapter 13). Note that stay relief granted because of defaults under a confirmed plan does not void the plan. In *Carvalho v Federal Nat'l Mortgage Ass'n (In re Carvalho)* (1st Cir 2003) 335 F3d 45, the court confirmed a debtor's plan that bifurcated a nonresidential mortgage into secured and unsecured portions. The secured lender obtained stay relief after the debtor defaulted on plan payments. Before the lender foreclosed, the debtor made all plan payments, but the lender refused payments tendered to it. The court rejected the lender's argument that stay relief nullified the plan's bifurcation of its claim, concluding that the lender had other remedies such as specific performance and expectation damages to put it in the same position as the plan provided.

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B. Chapter 11 Plans

1. Parties and Claims

§11.97 a. Who May Propose Plan

For the first 120 days after the date of the order for Chapter 11 relief, *i.e.,* after the commencement of the case, only the debtor may file a plan. See 11 USC §1121(b). If the debtor files a plan in that time, the "exclusivity period" continues for another 60 days to allow the debtor the opportunity to confirm its proposed plan. 11 USC §1121(c). The court may enlarge or reduce any of the above time periods for cause shown. 11 USC §1121(d). However, the appointment of a Chapter 11 trustee automatically terminates the exclusivity period. 11 USC §1121(c)(1). Under BAPCPA (see §11.1), the 120-day and 180-day periods can be extended, respectively, no later than 18 and 20 months after the petition date. In a similar vein, 11 USC §105(d)(1) has been changed to require (as opposed to allow) the court, on request of a party in interest or its own motion, to conduct "such status conferences as are necessary to further the expeditious and economical resolution of the case."

After the exclusivity period expires, any party in interest, including a creditor, may file a plan. In commercial real estate cases, a secured lender sometimes proposes its own plan, after the exclusivity period ends, if its claims are predominant, if there is an extended delay by the debtor in proposing a plan, or if the debtor proposes an unrealistic plan.

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§11.98 b. Contents of Chapter 11 Plan

Section 1123(a)-(b) of the Bankruptcy Code set forth, respectively, the mandatory and permissive requirements for a Chapter 11 plan. All Chapter 11 plans must (11 USC §1123(a)) do the following:

- Designate classes of claims;
- Designate which classes are impaired;
- Specify the treatment of such classes of claims;
- Provide for the same treatment for each claim in a class of claims;
- Provide adequate means for the plan's implementation;
- Provide that the charter of the debtor, if the debtor is a corporation, will be amended to prohibit the issuance of nonvoting stock; and
- Contain provisions consistent with the interest of creditors and equity security holders and with public policy with respect to the selection of management of the reorganized debtor.

BAPCPA (see §11.1) also requires that the plan of an individual debtor provide for payment to creditors of income received after the commencement of the case, to the extent needed to execute the plan. Section 1123(b) also lists several permissive provisions, but there are no other restrictions on the contents of a plan, leaving a plan proponent with significant flexibility.

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§11.99 c. Classification of Claims

Creditor claims and the interests of equity holders are placed into classes with other substantially similar claims or interests. 11 USC §1122. The debate over whether a mortgagee's deficiency claim can be classified separately from other general unsecured claims continues. If the deficiency claim is large and it is classified with general unsecured claims, the lender may be able to control voting in that class and whether the plan can be confirmed. As a result, debtors often attempt to classify the deficiency claim separately. In grappling with the classification issue, the courts reject gerrymandering classes of creditors under a plan to increase the likelihood of confirmation. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, 656.

In the Ninth Circuit, determining whether claims are similar enough to preclude separate classification is a question of fact, reviewable under the clearly erroneous standard. *Steelcase, Inc. v Johnston (In re Johnston)* (9th Cir 1994) 21 F3d 323. Absent "legitimate business or economic justification," a debtor may not separately classify a lender's deficiency claim from those of general unsecured creditors. *Barakat v Life Ins. Co. (In re Barakat)* (9th Cir 1996) 99 F3d 1520, 1526. The mere fact that a lender has the right to make an 11 USC §1111(b) election (see §11.93) does not amount to such justification. 99 F3d at 1526. Nor is it appropriate to separately classify unsecured trade creditors with whom the debtor continues to do business. 99 F3d at 1528. See *Oxford Life Ins. Co. v Tucson Self-Storage, Inc. (In re Tucson Self-Storage, Inc.)* (BAP 9th Cir 1994) 166 BR 892 (separate classification based solely on undersecured mortgagee's right to make §1111(b) election is impermissible); *Montclair Retail Ctr., LP v Bank of the W. (In re Montclair Retail Ctr., LP)* (BAP 9th Cir 1995) 177 BR 663 (plan classifying deficiency claim and trade debt separately but treating each the same is not confirmable, because equal treatment negates business or economic justification for separate classes). In addition to the substantial similarity requirement of §1122, claims classification may also implicate the "fair and equitable" requirement of 11 USC §1129(b). Without reference to its earlier decisions in *Johnston* and *Barakat*, the Ninth Circuit has stated, in what may be dicta, that discrimination between classes must satisfy four criteria to be considered fair under 11 USC §1129(b): "(1) the discrimination must be supported by a reasonable basis; (2) the debtor could not confirm or consummate the Plan without the discrimination; (3) the discrimination is proposed in good faith; and (4) the degree of the discrimination is directly related to the basis or rationale for the discrimination." *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, 656.

Outside the Ninth Circuit, the appellate courts have disagreed widely about the proper standard for classification. The First Circuit had held that, as a matter of law, claims of equal priority must be placed in the same class. *Granada Wines, Inc. v New England Teamsters & Trucking Indus. Pension Fund* (1st Cir 1984) 748 F2d 42. At the other extreme, the Seventh Circuit has held that 11 USC §1111(b) requires that a deficiency claim be classified separately from general unsecured claims. *In re Woodbrook Assocs.* (7th Cir 1994) 19 F3d 312. Without reference to its *Woodbrook* decision, the Seventh Circuit approved a partnership debtor's plan that separately classified a lender's nonrecourse deficiency claim and general trade creditors. It provided for a 16-percent payout on the deficiency claim and a 100-percent payout to the trade creditors. *In re 203 N. LaSalle St. Partnership* (7th Cir 1997) 126 F3d 955, rev'd on other grounds sub nom *Bank of America Nat'l Trust & Sav. Ass'n v 203 N. LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411. This discrimination, which recognized that the trade would be paid in full in a Chapter 7 case (presumably by recourse against the general partner) and that the lender's deficiency claim would receive nothing, was found to be legitimately and narrowly tailored to satisfy the "best interests" test of 11 USC §1129(a)(7).

The Second, Third, Fourth, Fifth, and Eighth Circuits have each adopted more flexible, intermediate approaches. *Boston Post Rd. Ltd. Partnership v FDIC (In re Boston Post Rd. Ltd. Partnership)* (2d Cir 1994) 21 F3d 477 (different origins of unsecured deficiency claims and general unsecured claims do not alone justify separate classification; debtor must produce evidence of legitimate reason for segregating claims); *John Hancock Mut. Life Ins. Co. v Route 37 Bus. Park Assocs.* (3d Cir 1993) 987 F2d 154 (separate classification allowable only when reasonable); *Travelers Ins. Co. v Bryson Prop., XVIII (In re Bryson Prop., XVIII)* (4th Cir 1992) 961 F2d 496 (separate classification not per se prohibited,

but plan could not separately classify claims for purpose of manipulating voting); *Phoenix Mut. Life Ins. Co. v Greystone III Joint Venture (In re Greystone III Joint Venture)* (5th Cir 1991) 995 F2d 1274, 1279 (separate classification is presumptively impermissible but can be allowed for reasons independent of debtor's motivation to secure vote of impaired, assenting class of claims); *Lumber Exchange Bldg. Ltd. Partnership v Mutual Life Ins. Co. (In re Lumber Exchange Bldg. Ltd. Partnership)* (8th Cir 1992) 968 F2d 647 (same).

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§11.100 d. Impaired Classes

A Chapter 11 plan may, and often does, modify the rights of at least some classes of claims or equity interests in order to effect the proposed reorganization. Those classes of creditors and equity holders whose rights are modified are generally considered "impaired" by the plan. This distinction is critical because, to confirm the plan, all impaired classes must vote for the plan or the plan must be "fair and equitable" for an impaired class that votes against the plan. 11 USC §1129(a)(8), (b). Preliminary identification of impaired classes is facilitated by the requirement that a plan specify whether a class of claims or interests is impaired or unimpaired. See 11 USC §1123(a)(2)-(3). Impairment status is determined under 11 USC §1124, which provides that a class of claims or equity interest is impaired unless the plan does one of two things:

(1) The plan "leaves unaltered the legal, equitable, and contractual rights" of each claim in the class (*e.g.,* the lender would be free to foreclose a defaulted real property loan). 11 USC §1124(1). See *L&J Anaheim Assocs. v Kawasaki Leasing Int'l, Inc. (In re L&J Anaheim Assocs.)* (9th Cir 1993) 995 F2d 940 (secured creditor proposed plan that favorably modified its own remedies, thereby making itself impaired class). But see *Barakat v Life Ins. Co. (In re Barakat)* (9th Cir 1996) 99 F3d 1520 (security deposit claims not impaired when treated in accordance with state law).

(2) The plan merely de-accelerates an accelerated obligation and does not otherwise modify it. 11 USC §1124(2).

The following conditions are also necessary in order for a claim to be deemed not impaired:

- The default must be cured in full in cash (if the plan proposes to cure the default over a period of time, the class is impaired);
- The original maturity of the obligation must be reinstated;
- The creditor must be compensated for damages incurred by reasonable reliance on the right to accelerate; and
- The plan may not otherwise alter the obligation.

A cure of defaults under a plan will generally nullify all consequences of default, including default penalties such as higher interest (see §11.94), and will render lenders unimpaired. *Florida Partners Corp. v Southeast Co. (In re Southeast Co.)* (9th Cir 1989) 868 F2d 335; *Great W. Bank & Trust v Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)* (9th Cir 1988) 850 F2d 1338; *CityBank v Udhus (In re Udhus)* (BAP 9th Cir 1998) 218 BR 513. The *Entz-White* decision was not overruled by the 1994 addition of 11 USC §1123(d). *In re Phoenix Bus. Park Ltd. Partnership* (Bankr D Ariz 2001) 257 BR 517 (cure under §1123 need not include default interest but only contract rate of interest due absent default). A cure of defaults outside the context of a plan, however (*e.g.,* in connection with a sale of assets under 11 USC §363), will not nullify the secured parties' right to recover default-rate interest. *General Elec. Capital Corp. v Future Media Prods., Inc.* (9th Cir 2008) 536 F3d 969.

The Bankruptcy Reform Act of 1994 deleted former 11 USC §1124(3), which had provided that a claim is unimpaired if it is paid in full as of the effective date of the plan. Prior to the amendment, the cases were divided on whether the plan proponent could "artificially" impair the class merely by delaying payment for a short period after confirmation. Compare *Connecticut Gen. Life Ins. Co. v Hotel Assocs. (In re Hotel Assocs.)* (BAP 9th Cir 1994) 165 BR 470 (30-day delay impaired class; however, delay could be considered in deciding if plan was proposed in good faith) with *Windsor on the River Assocs., Ltd. v Balcor Real Estate Fin., Inc. (In re Windsor on the River Assocs., Ltd.)* (8th Cir 1993) 7 F3d 127, 132 (class not paid for 60 days not impaired because "the alteration of rights in question arises solely from the debtor's exercise of discretion"). Given the change in the Bankruptcy Code, it appears that a class will be impaired even if paid in full on the plan's effective date unless such payment is consistent with the legal, equitable, and contractual rights of the creditors in the class.

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§11.101 e. Modification of Secured Claims

A Chapter 11 plan may modify the terms for payment of a secured claim other than a claim secured only by the debtor's primary residence. 11 USC §1123(b)(5). (The home mortgage exception is discussed in §11.102.) If the plan proposes to modify a secured lender's claim, the lender's claim will be impaired. See §11.100. A debtor seeking to modify a lender's claim generally focuses on one or more of the following aspects of the secured claim: (1) showing that the lender is undersecured in order to reduce the lender's secured claim down to the value of the collateral (also known as "lien-stripping"); (2) lowering the interest rate payable to the lender; or (3) stretching the maturity of payments due to the lender. On whether proposed modification is permissible over lender's objection, see §11.109.

Note, however, that the debtor may not use a Chapter 11 plan to unilaterally reduce a creditor's allowed secured claim without the consent of the creditor or compliance with the claim objection procedures under Fed R Bankr P 3007. See *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)* (BAP 9th Cir 2003) 293 BR 489, in which the secured creditor's claim had been scheduled by the debtor as undisputed and was deemed allowed under 11 USC §1111(a) and Fed R Bankr P 3003(b)(1). The bankruptcy appellate panel concluded that the debtor's attempt to unilaterally reduce the claim in its plan was not a modification of the claim. The issue highlights the tension between the preclusive effect of plan confirmation (see §11.116) and the due process rights afforded creditors under the Bankruptcy Code's claim allowance provisions.

Similarly, in the Chapter 13 context, the Ninth Circuit bankruptcy appellate panel held that "a plan can effectively determine value and/or avoid a lien only if the creditor receives clear notice that the plan will do so. A plan that is silent about the fate of a secured claim provides no notice of what will happen to the secured claim and therefore cannot effectively avoid a lien or determine its value." *Shook v CBIC (In re Shook)* (BAP 9th Cir 2002) 278 BR 815, 824. See *County of Ventura Tax Collector v Brawders (In re Brawders)* (BAP 9th Cir 2005) 325 BR 405, aff'd (9th Cir 2007) 503 F3d 856 (plan did not provide adequate notice of debtors' intent to strip down tax lien). See also *Espinosa v United Student Aid Funds, Inc.* (9th Cir 2008) 545 F3d 1113, cert granted (2009) 174 L Ed 2d 289, 129 S Ct 2791 (court of appeals allowed discharge of student loan without finding of undue hardship in adversary proceeding because lender did not object after receiving adequate notice of Chapter 13 plan required by Bankr R 7004); *In re Rascon* (ND Cal 2005) 321 BR 48 (plan that unambiguously provided for modification of secured lender's claim did not violate due process). See §11.122. The concurring opinion in *Varela v Dynamic Brokers, Inc., supra,* also underscores the problems that may be created by a plan that fails to note a lien reduction or explain it so that the creditor understands that its claim is challenged and will be reduced unless the creditor takes action. 293 BR at 500.

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§11.102 f. Modification of Claims Secured Only by Principal Residence

A Chapter 11 plan cannot modify the terms of a claim secured only by a security interest in real property that is the debtor's principal residence. 11 USC §1123(b)(5). This provision, which was enacted as part of the Bankruptcy Reform Act of 1984, parallels the treatment of home mortgages in a Chapter 13 case and blocks "lien-stripping" of an undersecured home mortgage. See 11 USC §1322(b)(2), discussed in §§11.121-11.127. However, in enacting 11 USC §1123(b)(5), Congress did not enact a provision in Chapter 11 that is analogous to 11 USC §1322(b)(5), which allows the debtor to cure any arrearages on his or her home mortgage under a Chapter 13 plan within a reasonable period. Read literally, this difference could require an individual debtor in a Chapter 11 case to cure any defaults on the home mortgage in full on the effective date of the plan.

Holding collateral incidental to the debtor's principal residence should not defeat application of §1123(b)(5). *Lee v Home Savs. (In re Lee)* (BAP 9th Cir 1997) 215 BR 22 (principal residence exception applies to mortgage that includes lien on personal property, such as washer, that is made component of real property by agreement and that has little or no independent value); *Lievsay v Western Fin. Sav. Bank (In re Lievsay)* (BAP 9th Cir 1996) 199 BR 705 (same result even if debtor maintains home office). However, in the Chapter 13 context, some courts have found certain types of relatively minor, supplemental collateral sufficient to disqualify the antimodification under §1322(b)(5). See §11.123. Courts have also held that §1322(b)(5) does not apply if the lender is completely unsecured. See §11.126. The logic of these cases should also apply in the Chapter 11 context.

NOTE: See Note in §11.1 regarding pending legislation to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence.

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§11.103 2. Voting on Plan; Disclosure Statement

Not all classes of creditors or equity interest holders vote for or against a plan. Unimpaired classes are deemed to accept the plan. 11 USC §1126(f). Similarly, classes that receive nothing under the plan are deemed to reject the plan. 11 USC §1126(g). Hence, only those classes impaired by the plan (see §11.100) and receiving consideration under the plan are entitled to vote (see §11.107). For a class of creditors (secured or unsecured) to accept a plan, two-thirds in amount and a simple majority in number of the allowed claims held by creditors in the class must vote for the plan. 11 USC §1126(c).

To reach the voting stage, the plan proponent must first obtain court approval of a disclosure statement, which is akin to a prospectus, that describes the plan and background information sufficiently to allow a hypothetical reasonable creditor or equity holder to make an informed judgment about the plan. See 11 USC §1125; *Computer Task Group, Inc. v Brotby (In re Brotby)* (BAP 9th Cir 2003) 303 BR 177 (determination of adequate information is subjective and made on case-by-case basis according to court's discretion). BAPCPA (see §11.1) requires the disclosure statement to include a discussion of material federal tax consequences. BAPCPA also directs the court to consider the complexity of the case, the benefit of additional information to creditors, and the cost of providing additional information in determining the sufficiency of the disclosure statement. 11 USC §1125(a)(1). In a small business case, the court may conditionally find that a disclosure statement is not required if a plan contains adequate information. Fed R Bankr P 3017.1(a). For information required in plan, see Fed R Bankr P 3016 and 11 USC §1125(f)(1).

The plan proponent must give at least 25 days' notice to parties of the time fixed for filing objections to the disclosure statement and for the hearing to consider the statement's approval or, under §1125(f), to make a final determination of whether the plan provides adequate information so that a separate disclosure statement is not necessary. Fed R Bankr P 2002(b).

PRACTICE TIP: Counsel should check for local rules establishing court-specific procedures for approval of a disclosure statement. See, *e.g.,* ND Cal Local Bankr R 3017-1.

If the plan is unconfirmable on its face, a creditor might consider objecting to the disclosure statement on that ground. Once approved, the disclosure statement is delivered along with a copy of the plan and a ballot to creditors and equity holders entitled to vote. 11 USC §1125; Fed R Bankr P 3017(d). See *Computer Task Group, Inc. v Brotby, supra* (immaterial misleading statement in disclosure statement will not block confirmation nor will providing corrected financial projections at confirmation hearing, but reballoting may be appropriate if voting process is tainted by misinformation). Parties are not allowed to solicit votes for or against a plan until the disclosure statement is approved. 11 USC §1125(b). Parties who do not follow the procedures for plan solicitation may be subject to sanctions. *Duff v U.S. Trustee (In re California Fid., Inc.)* (BAP 9th Cir 1996) 198 BR 567 (debtor's president sanctioned for improperly soliciting votes against confirmation of trustee's plan before approval of disclosure statement by sending letter to 300 unsecured creditors).

At the conclusion of the voting period, returned ballots are tabulated and a report of the voting is given to the court. A hearing is then set for confirmation of the plan, at which the plan proponent must show that all confirmation requirements have been satisfied and creditors or equity holders may object to confirmation.

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§11.104 3. Confirmation of Chapter 11 Plan

A plan may be confirmed if it satisfies the requirements set forth in 11 USC §1129. The bankruptcy court has "an affirmative duty" to ensure that a plan satisfies all §1129 requirements. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, 653. See *Computer Task Group, Inc. v Brotby (In re Brotby)* (BAP 9th Cir 2003) 303 BR 177, 197 (cursory finding that requirements for confirmation have been satisfied under §1129 is insufficient if specific objection has been raised to confirmation).

The plan proponent must give at least 25 days' notice of the time fixed for filing objections to the plan and for the hearing to consider the plan's confirmation. Fed R Bankr P 2002(b).

In 2000, a bankruptcy appellate panel held that if the debtor prevails on an objection to confirmation, the debtor is not entitled to an award of prevailing party attorney fees under CC §1717. See *Hassen Imports Partnership v KWP Fin. VI (In re Hassen Imports Partnership)* (BAP 9th Cir 2000) 256 BR 916, 922. However, the effect of this holding is doubtful under a supreme court case that overruled *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149, overruled on other grounds in *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199, and related Ninth Circuit precedents that prohibited recovery of contract-based attorney fees incurred in litigating matters peculiar to bankruptcy law. Under *Travelers*, a claim for reasonable attorney fees incurred by a creditor prevailing in litigation involving issues peculiar to bankruptcy law must be allowed as part of a creditor's claim if the right to recover attorney fees is enforceable under state law, unless "other principles of bankruptcy law" provide "an independent basis for disallowing" the attorney fee award. 549 US at ___, 167 L Ed 2d at 189. Unresolved is the issue of whether an award in favor of the trustee or debtor may be offset by the losing creditor's prepetition claim. If not, creditors may be far more reluctant to seek relief or challenge debtor or trustee actions in a case.

PRACTICE TIP: Counsel involved in a confirmation proceeding should be familiar with applicable federal and local rules of procedure. See, *e.g.,* Fed R Bankr P 2002, 3015-3020; ND Cal Local Bankr R 3018-1. At the confirmation hearing, the plan proponent should be prepared to present evidence that shows that all 11 USC §1129 requirements are satisfied. The proponent will often submit a declaration in advance of the confirmation hearing for this purpose. If the plan is uncontested, it may be sufficient to make an offer of proof that each requirement has been satisfied, with a witness available to provide testimony if necessary.

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§11.105 a. Other Bankruptcy Code Requirements

The first two requirements of 11 USC §1129 are that the plan and the plan proponent comply with the applicable provisions of the Bankruptcy Code. 11 USC §1129(a)(1)-(2). Thus, a plan must include the mandatory provisions set forth in 11 USC §1123(a) (see §11.98). Moreover, the plan proponent must be qualified to submit a plan and must abide by the Bankruptcy Code's limits on plan solicitation and use of an approved disclosure statement. See §11.103.

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§11.106 b. Plan Proposed in Good Faith

The plan must be proposed in good faith and not by any means forbidden by law. 11 USC §1129(a)(3). A plan has been proposed in good faith when it is intended to achieve a result consistent with the objectives of the Bankruptcy Code. *In re Corey* (9th Cir 1989) 892 F2d 829, 835, cert denied (1990) 498 US 815, 112 L Ed 2d 31, 111 S Ct 56. Whether the plan meets the "good faith" requirement is a question of fact that is reviewed on appeal under the "clearly erroneous" standard. *Pacific First Bank v Boulders on the River, Inc. (In re Boulders on the River, Inc.)* (BAP 9th Cir 1994) 164 BR 99. See *Platinum Capital, Inc. v Sylmar Plaza, LP (In re Sylmar Plaza, LP)* (9th Cir 2002) 314 F3d 1070 (plan filed to reinstate loan's lower, nondefault interest rate through cure of default not proposed in bad faith); *In re 203 N. LaSalle St. Partnership* (7th Cir 1997) 126 F3d 955, rev'd on other grounds sub nom *Bank of America Nat'l Trust & Sav. Ass'n v 203 N. LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411 (plan motivated in significant part by desire to defer $20 million tax liability that would arise from foreclosure not proposed in bad faith).

The second prong of §1129(a)(3)—that the plan has not been proposed by means forbidden by law—may be satisfied when it is established that the plan complies with the Bankruptcy Code and state law, to the extent state law is applicable and has not been superseded by the Bankruptcy Code. *Acequia, Inc. v Clinton (In re Acequia, Inc.)* (9th Cir 1986) 787 F2d 1352, 1360, aff'd in part, rev'd in part, remanded (9th Cir 1994) 34 F3d 800.

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§11.107 c. Plan Acceptance by Impaired Classes

When a plan impairs classes of claims or interests, the general rule is that all impaired classes are required to accept the plan. 11 USC §1129(a)(8). On impairment, see §11.100. However, the plan may still be confirmed even if less than all impaired classes vote for the plan when (1) at least one impaired class of claims accepts the plan, excluding the votes of insiders (11 USC §1129(a)(10)), and (2) the plan satisfies the requirements for confirmation of a "cram-down plan" (11 USC §1129(b)). On cram down, see §§11.109-11.112. If none of the members of an impaired class vote on the plan, the class is treated as not having voted for the plan. *Bell Road Inv. Co. v M. Long Arabians (In re M. Long Arabians)* (BAP 9th Cir 1989) 103 BR 211.

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§11.108 d. "Best Interests" of Impaired Creditors

Unless every member of an impaired class votes for the plan, holders of impaired claims or equity interests must receive or retain under the plan, on account of such claim or interest, property of a value as of the effective date of the plan that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7 as of the effective date of the plan. 11 USC §1129(a)(7)(A). This treatment has been dubbed the "best interests" test because it requires that impaired creditors and shareholders do at least as well under the plan as they would in a hypothetical straight liquidation under Chapter 7. If impaired creditors and shareholders would do worse under the plan, the plan would not be in their best interests. Generally, secured lenders will receive as much under a Chapter 11 plan as they would in a Chapter 7 case because of the restriction on modification of the rights of secured creditors. On cram down, see §§11.109-11.112. See also *In re Patrician St. Joseph Partners, LP* (D Ariz 1994) 169 BR 669, 680 (oversecured creditor lacked standing to object on "best interest" grounds because it was adequately protected).

Section 1129(a)(7) requires the plan proponent to show both the present value of the property projected to be received by the impaired class under the plan, as of the plan effective date, and the expected value of such property if liquidated in a Chapter 7 case. See *M&I Thunderbird Bank v Birmingham (In re Consolidated Water Utils., Inc.)* (BAP 9th Cir 1998) 217 BR 588, 591 (best interests test satisfied when creditor received more than it would have in Chapter 7, according to liquidation analysis as of effective date of plan). In determining liquidation value, a plan proponent should consider the potential impact of Chapter 7 provisions concerning the following:

- Claims subordination;
- Allowance of tardily filed claims;
- Allowance of claims for fines, penalties, or punitive damages not in compensation for actual pecuniary loss;
- Treatment of certain liens;
- The rights of a partnership trustee against general partners; and
- Distributions of community property.

See HR Rep No. 95-595, 95th Cong, 1st Sess 412 (1977); *Bell Road Inv. Co. v M. Long Arabians (In re M. Long Arabians)* (BAP 9th Cir 1989) 103 BR 211, 216 (reversing confirmation order and remanding for consideration of net worth of debtor's general partner because Chapter 7 trustee would have cause of action against partner to recover any obligations to creditors unpaid after liquidation of debtor's asset); *In re Sierra-Cal* (Bankr ED Cal 1997) 210 BR 168 (denying confirmation, in part, because insider creditor would be subject to preference avoidance action, and such insider's claim would be subject to disallowance under 11 USC §502(d) in Chapter 7 case).

The best interests test is modified for impaired, secured creditors who elect to treat their claim as fully secured under 11 USC §1111(b)(2) (see §11.93). For such creditors, the best interests test is satisfied if the creditors will receive or retain property having a present value at least equal to the value of the collateral as of the effective date of the plan. 11 USC §1129(a)(7)(B).

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§11.109 e. "Cram Down" of Impaired, Dissenting Classes; Absolute Priority Rule

If at least one class of impaired claims votes for a plan, 11 USC §1129(b) permits the cram down of the plan on other impaired classes of claims or equity interests. 11 USC §1129(a)(8), (a)(10), (b)(1). A cram down, however, is allowed only "if the plan does not discriminate unfairly, and is fair and equitable" for each impaired class that has not accepted the plan. 11 USC §1129(b)(1). The "fair and equitable" standard derives from the former Bankruptcy Act and is a term of art. Whether a plan is "fair and equitable" depends on whether the class is a class of (1) secured creditors, (2) unsecured creditors, or (3) equity interests. See 11 USC §1129(b)(2).

Section 1129(b)(2) establishes the "absolute priority rule," which in essence requires that a cram-down plan provide for the following:

- Full payment of any dissenting secured creditors' claims ahead of those of unsecured creditors; and
- Full payment of any dissenting unsecured creditors' claims ahead of those of the debtor's equity holders.

See *Norwest Bank Worthington v Ahlers* (1988) 485 US 197, 99 L Ed 2d 169, 108 S Ct 963. Implementation of the rule, however, does not require that a class of creditors actually be paid in full before any distributions can be made to junior classes; rather, it requires only that the senior class of creditors be provided full present payment, or its equivalent, under the plan. The debtor must demonstrate at the time of confirmation, however, that the senior class of creditors will actually receive the payments promised under the plan. *Steelcase, Inc. v Johnston (In re Johnston)* (9th Cir 1994) 21 F3d 323. There are three alternatives for "fair and equitable" treatment of a class of dissenting secured creditors. See §§11.110-11.112.

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§11.110 (1) Make Deferred Cash Payments

The first alternative is for the plan to provide that the secured creditor (1) retains its lien to the extent of the allowed amount of its claim and (2) receives deferred cash payments totaling at least the allowed amount of the claim and of a value, as of the effective date of the plan, of at least the value of the creditor's secured interest in the collateral. 11 USC §1129(b)(2)(A)(i). These provisions, read in conjunction with 11 USC §§506(a) and 1111(b), permit a plan proponent to propose reducing the lender's claim to the value of its collateral (also known as "lien stripping") as long as the required payments are to be made to the secured creditor under the plan. *Wade v Bradford* (10th Cir 1994) 39 F3d 1126; *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284, 292. Recall, however, that a plan may not modify the rights of a lender secured only by the debtor's principal residence. See §11.102. But see Note on pending legislation in §11.1.

At first glance, determining the required amount of deferred payments to the secured creditor may seem confusing. More directly stated, the payments to the secured creditor must total at least the amount of the allowed secured claim. In addition, the total payments to be made must have a value, on the effective date of the plan, equal to the secured claim. This requires a present value calculation using an appropriate interest rate. The correct application of these parameters requires determining whether a creditor is oversecured or undersecured and, if the creditor is undersecured, knowing whether the lender has elected to be treated as fully secured under §1111(b)(2).

For an oversecured lender, the total deferred cash payments must have a present value equal to the full amount of the lender's allowed claim. This requires the plan to correctly value the collateral and to use a proper interest rate. With respect to an undersecured lender, the analysis depends on whether the lender elects under §1111(b)(2) to have its claim treated as fully secured (see §11.93). Assume a $5,000,000 debt secured by property worth $3,000,000. If the §1111(b)(2) election is not made, the allowed secured claim is $3,000,000, and the present value of the total deferred payments must equal $3,000,000. Treatment of the allowed unsecured claim of $2,000,000 is a different subject. It is possible that the class in which the unsecured claim is placed will accept the plan; if not, an entirely different definition of "fair and equitable" will govern cram down for that unsecured class. On the other hand, if the lender makes the §1111(b)(2) election, the allowed secured claim is $5,000,000, and there is no unsecured deficiency claim. The deferred cash payments to the lender must total at least $5,000,000. But because the value of the collateral is $3,000,000, the present value of the deferred cash payments need only equal $3,000,000. Unless the proper interest rate is very high or the difference between the claim amount and the collateral value is small, in most cases when the lender makes the §1111(b)(2) election, the deferred payments on account of the allowed secured claim ($5,000,000 in the example) will exceed the amount of payments needed to provide the lender with a present value equal to the collateral value ($3,000,000 in the example). In sum, to calculate the necessary payments under 11 USC §1129(b)(2)(A)(i), the plan must correctly value the secured lender's collateral and select the proper interest rate.

The two recurring disputes in a cram-down fight are determination of the value of the lender's collateral and determination of the interest rate to be used to calculate present value. The starting point for collateral valuation is 11 USC §506(a), which provides that "value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." If the debtor proposes to retain the collateral, the court must use the property's fair market value (rather than its forced-sale liquidation value) without deduction of hypothetical sale costs. *Taffi v U.S. (In re Taffi)* (9th Cir 1996) 96 F3d 1190 (en banc). See *Associates Commercial Corp. v Rash* (1997) 520 US 953, 959 n2, 138 L Ed 2d 148, 156 n2, 117 S Ct 1879 (citing *Taffi* in ruling that proper valuation standard in Chapter 13 case for collateral being retained by debtor under cram-down plan is "replacement value" of that collateral rather than liquidation value secured creditor would realize after foreclosure sale); *In re Young* (Bankr ND Cal 2007) 367 BR 183 (in retaining mobile home, debtor must pay secured creditor its replacement value, excluding value of its location); *Ardmor Vending Co. v Kim (In re Kim)* (9th Cir 1997) 130 F3d 863 (when debtor's plan proposed retaining real estate lease and equipment used for dry cleaning business, those assets must be valued together as turnkey operation).

In *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997)

115 F3d 650, the plan proposed to fix the lender's secured claim as the value of the collateral (an apartment complex) less accumulated net rents already paid to the lender and in which the lender had a security interest. Cram down was rejected because the plan, though providing for postconfirmation interest, undervalued the lender's claim by improperly deducting the rents paid to the lender.

For further discussion of valuation and appraisal standards, see §§11.41, 11.91, 11.126, 11.129.

NOTE: The value established at a failed plan confirmation hearing is not binding on the lender in subsequent litigation. *Gold Coast Asset Acquisition, LP v 1441 Veteran St. Co.* (*In re 1441 Veteran St. Co.)* (9th Cir 1998) 144 F3d 1288, modified and rehearing denied (9th Cir 1998) 154 F3d 1103.

The Supreme Court, in a plurality decision, held that the cram-down interest rate in a Chapter 13 case should be determined by use of the "prime-plus" approach (also known as the "formula rate"). *Till v SCS Credit Corp. (In re Till)* (2004) 541 US 465, 158 L Ed 2d 787, 124 S Ct 1951. This calculation starts with the national prime rate charged to creditworthy borrowers. That rate is then adjusted to reflect the greater risk of nonpayment by the debtor, which depends on factors such as "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." 541 US at 479, 158 L Ed 2d at 800. *Till* will likely be treated as determinative in the Chapter 11 context because the Chapter 11 cram-down requirements parallel those of Chapter 13.

Earlier precedent in the Ninth Circuit and other circuits that adopted the formula-rate approach should continue to be persuasive. See, *e.g., Farm Credit Bank v Fowler (In re Fowler)* (9th Cir 1990) 903 F2d 694 (determining interest rate by looking to prevailing market rate for loans having similar terms, collateral, and risk of default); *Pacific First Bank v Boulders on the River, Inc. (In re Boulders on the River, Inc.)* (BAP 9th Cir 1994) 164 BR 99 (blended-rate analysis; oversecured lender entitled to one rate for funds up to 70-percent loan-to-value ratio and higher rate for funds that would take loan above 70-percent loan-to-value ratio); *In re Duval Manor Assocs.* (Bankr ED Pa 1996) 191 BR 622 (proper interest rate determined on case-by-case basis, taking into account risks associated with debtor, collateral, and plan); *In re Gramercy Twins Assocs.* (Bankr SD NY 1995) 187 BR 112 (rejecting proposed market-rate standard based on "workout loans"); *In re HRC Joint Venture* (Bankr SD Ohio 1995) 187 BR 202 (good discussion of proper discount rate for 100-percent loan-to-value ratio case; plan confirmed); *In re Villa Diablo Assocs.* (Bankr ND Cal 1993) 156 BR 650 (applying formula to specify interest required for Chapter 11 plan note by adjusting typical market rate in light of loan-to-value ratio, quality of security, debt coverage ratio and cash reserves, and risk reduction inherent in confirmation process).

Most cram-down plans propose payment of a secured claim with a regular amortization schedule or with interest only and a balloon payment at maturity. However, it is also possible to propose a negative amortization plan. *Great W. Bank v Sierra Woods Group* (9th Cir 1992) 953 F2d 1174. There is no fixed limit on the length of the repayment term in a Chapter 11 case. See *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)* (BAP 9th Cir 2003) 293 BR 489 (20-year term approved). In any event, however, the plan must be feasible. See §11.114.

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§11.111 (2) Sell Collateral Free and Clear of Lien

A cram-down plan is fair and equitable to a dissenting secured creditor (see §11.109) if it provides for a sale of the collateral free and clear of the lender's security interest, with an opportunity for the lender to credit-bid at the sale (see §11.76) and with the security interest transferred to the proceeds of sale and treated under either of the other two alternatives (see §§11.110, 11.112). 11 USC §1129(b)(2)(A)(ii).

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§11.112 (3) Provide Indubitable Equivalent

The fair and equitable standard (see §11.109) will be satisfied if the dissenting secured creditor class receives "the indubitable equivalent" of its claims. 11 USC §1129(b)(2)(A)(iii). The legislative history of this section indicates the language is intended to follow the strict approach taken by Judge Learned Hand in *In re Murel Holding Corp.* (2d Cir 1935) 75 F2d 941 and gives two examples: abandonment of the collateral to the secured creditors and replacement liens on similar collateral. If the plan started out with the second alternative described in §11.111 (sale of collateral free and clear), application of this third alternative to the sale proceeds would presumably mean that the secured creditor would be paid or given a lien on the cash proceeds.

Consistent with the legislative history, a secured creditor that receives its real estate collateral back under a plan has received the indubitable equivalent of its secured claim. *Arnold & Baker Farms v U.S. (In re Arnold & Baker Farms)* (BAP 9th Cir 1994) 177 BR 648, aff'd (9th Cir 1996) 85 F3d 1415, 1423; *Sandy Ridge Dev. Corp. v Louisiana Nat'l Bank (In re Sandy Ridge Dev. Corp.)* (5th Cir 1989) 881 F2d 1346. Attempted variations of the straightforward "dirt for debt" plan have not fared well. Partial "dirt for debt" plans involve the transfer of only a portion of the secured creditor's collateral in proposed full satisfaction of the lender's claim. This treatment is not the "indubitable equivalent" of the lender's secured clam unless the plan also ensures the safety of, or prevents possible jeopardy to, the principal amount of the claim, though the determination of property value alone is not necessarily determinative of "indubitable equivalence." See *Arnold & Baker Farms v U.S, supra* (adopting panel's decision). See also *In re Sparks* (Bankr ND Ill 1994) 171 BR 860 (rejecting plan that proposed conversion of apartment complex to condominiums and required partial releases of lender's lien as units were sold; converted condominium project was not "indubitable equivalent" of lender's original collateral). Moreover, a plan proposing to surrender real estate collateral in full satisfaction of both a lender's secured and unsecured claims should not be confirmable over the lender's objection. See *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149, overruled on other grounds in *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199 (Chapter 12 plan).

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§11.113 f. "New Value" Exception to Absolute Priority Rule

Under the former Bankruptcy Act, courts had recognized a "new value" exception or corollary to the absolute priority rule permitting equity holders of a debtor to retain their ownership interest, even though creditors would not be paid in full, if they contributed new money under a reorganization plan. *Case v Los Angeles Lumber Prods. Co.* (1939) 308 US 106, 84 L Ed 110, 60 S Ct 1; *Stegall v Federal Land Bank of St. Louis (In re Stegall)* (7th Cir 1989) 865 F2d 140. After the decision in *Norwest Bank Worthington v Ahlers* (1988) 485 US 197, 99 L Ed 2d 169, 108 S Ct 963 (holding that under plan no junior class can be paid unless all dissenting senior classes are paid in full; see §11.109), courts are divided on the question of whether the new value exception continues to exist under the Bankruptcy Code and, if it does, what standards govern the exception.

The Supreme Court's decision in *Bank of America Nat'l Trust & Sav. Ass'n v 203 N. LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411, did little to relieve the confusion. The Supreme Court acknowledged that the statutory language could support the new value exception but declined to decide whether the exception actually exists. Instead, the Court held that a new value plan cannot be confirmed in any event during the debtor's exclusive period to propose a reorganization plan under 11 USC §1121. It also concluded that, if the existing owners have an exclusive opportunity to acquire the equity in the reorganized debtor (*i.e.,* to put up new value), those owners are receiving value "on account of" their old interests in violation of the absolute priority rule. To test the proposed new value, the property must be exposed to the market. This holding appears to overrule the Ninth Circuit's decision in *Bonner Mall Partnership v U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)* (9th Cir 1993) 2 F3d 899, motion to vacate denied, appeal dismissed (1994) 513 US 18, 130 L Ed 2d 233, 115 S Ct 386.

NOTE: The Court in *203 N. LaSalle* declined to indicate whether the market testing would be satisfied by allowing other parties to (1) propose competing plans or (2) bid against the new value offered by the existing owners under the debtor's plan. Thus, case law regarding the new value exception that is not inconsistent with the narrow holding in *203 N. LaSalle* should continue to have precedential value.

In the Ninth Circuit, subject to the additional requirement of market testing under the *203 N. LaSalle* decision, satisfaction of the new value exception requires the debtor's equity holders to offer value under the proposed plan that is

(1) new;
(2) substantial;
(3) in money or money's worth;
(4) necessary for successful reorganization; and
(5) reasonably equivalent to the value or interest received.

Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership) (9th Cir 1997) 115 F3d 650, 654. What constitutes adequate new value depends on the circumstances of each case, but *Ambanc* provides some guidance. In that case, a partnership debtor owned an apartment complex. The plan proposed that existing equity contribute cash of $32,000 and make nine annual contributions of $32,000. The lender's secured claim was $4.4 million, its separately classified deficiency claim was $4,044,920, and other unsecured creditors held claims of about $950,000. The Ninth Circuit determined that the proposed new value contribution was insufficient. Only the initial up-front contribution of $32,000 could be considered "money or money's worth." This sum, being less than 0.5 percent of the total unsecured debt and even less of the debt being discharged under the plan, was de minimis and failed the "substantiality" requirement as a matter of law (though the court expressly noted that it was not defining a bright-line rule). The court also commented that if a new value plan is proposed, the bankruptcy court must take care that its analysis of "equivalence" (the fifth component of new value) "only compares what the partners put in to what they get." 115 F3d at 656. See *Computer Task Group, Inc. v Brotby (In re Brotby)* (BAP 9th Cir 2003) 303 BR 177 (trial court must make factual findings to support conclusion that plan provides new value).

In contrast to *Ambanc*, the court in *In re 203 N. LaSalle St. Partnership* (7th Cir 1997) 126 F3d 955, rev'd on other

grounds sub nom *Bank of America Nat'l Trust & Sav. Ass'n v 203 N. LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411, held that the proposed new value contribution was adequate. In that case, a partnership debtor owned part of a Chicago office building. The lender's secured claim was $56 million, and its unsecured claim was $37 million; property taxes of $2.3 million were outstanding; a general partner had a secured claim; and the partnership owed some $90,000 of trade debt. The plan proposed that existing equity holders contribute cash of $3 million and make five annual contributions of $625,000. Not balking at the fact that some of the contribution was coming in the future, the Seventh Circuit accepted the finding that the new capital had a "present value" of $4.1 million and affirmed the bankruptcy court's finding that this amount satisfied the substantiality requirement both in absolute terms and in relation to the lender's unsecured claim. Whether the Seventh Circuit would accept a contribution consisting solely of future contributions remains an open issue.

A number of lower court decisions also provide insights on what contribution suffices as new value. See *In re Duval Manor Assocs.* (Bankr ED Pa 1996) 191 BR 622 ($100,000 contribution was acceptable new value in case with secured debt of $3.45 million and unsecured debt of $2 million); *In re HRC Joint Venture* (Bankr SD Ohio 1995) 187 BR 202 ($1.3 million contribution constitutes acceptable new value in case with $23.4 million of secured debt and $25 million of unsecured debt, given "riskiness" of investment); *In re Gramercy Twins Assocs.* (Bankr SD NY 1995) 187 BR 112 ($250,000 contribution by old partners to retain 70 percent of equity was insufficient to be new value in case with secured debt of $7.6 million and over $13 million of unsecured debt; $1 million contribution by new participant for 30 percent of equity not counted toward old equity's contribution); *In re Dollar Assocs.* (Bankr ND Cal 1994) 172 BR 945 (plan technically complying with new value requirements but involving overencumbered single asset real estate not confirmable because plan was not fair and equitable to secured creditor); *In re Rocha* (Bankr MD Fla 1995) 179 BR 305 (income from debtor's existing rental property is not new value from outside source); *In re Short* (Bankr ED Okla 1994) 173 BR 946 (same); *In re Cipparone* (Bankr ED Mich 1994) 175 BR 643 (individual debtor's future wages and income tax refunds are not new value from outside source); *In re Davis* (Bankr D Ariz 2001) 262 BR 791 (new value plan did not satisfy *203 N. LaSalle* requirements because it did not disclose source of new value or provide market testing approach to new value).

NOTE: The absolute priority rule (see §11.109) requires only that the senior class of creditors be provided full present payment, or its equivalent, under the plan. *Steelcase, Inc. v Johnston (In re Johnston)* (9th Cir 1994) 21 F3d 323 (confirmed plan provided that dissenting unsecured creditors would be paid in full, with interest, on deferred basis, but permitted debtor to retain all of his rights to estate's property and to use estate funds to pay living expenses before he made any payments to objecting class). To satisfy the absolute priority rule, a new value plan proposing to pay creditors over time must also provide for postconfirmation interest to those creditors to compensate them for the time value of their money. *Everett v Perez (In re Perez)* (9th Cir 1994) 30 F3d 1209, 1214.

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§11.114 g. Feasibility Requirement

Before a bankruptcy reorganization plan can be confirmed, the Bankruptcy Code requires the debtor to show that plan confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." 11 USC §1129(a)(11). Commonly referred to as the "feasibility requirement," this requires, in essence, that the proposed plan be realistic. To demonstrate that a plan is feasible, the debtor need show only a reasonable probability of success. *Computer Task Group, Inc. v Brotby (In re Brotby)* (BAP 9th Cir 2003) 303 BR 177. Some plans involving deferred payments to a secured lender propose that, in the event of default in making the plan payments, the secured lender be allowed to foreclose. The Eighth Circuit has held that such a foreclosure provision does not satisfy the feasibility requirement. *Danny Thomas Props. II LP v Beal Bank SSB (In re Danny Thomas Props. II LP)* (8th Cir 2001) 241 F3d 959.

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§11.115 h. Other Plan Confirmation Requirements

A plan must provide for cash payment to holders of administrative and priority claims unless the claimant agrees to other treatment, with the exception of priority tax claims, which may be paid over a period not exceeding 6 years. 11 USC §1129(a)(9). In addition, all fees due to the United States Trustee must be paid by the effective date of the plan. 11 USC §1129(a)(12).

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§11.116 4. Preclusive Effect of Plan Confirmation

Confirmation of a Chapter 11 plan can result in the preclusion of claims by or against the debtor as well as issue preclusion. Older reported cases discuss these principles in terms of a bar, estoppel, or waiver of claims stemming from plan confirmation. An excellent overview is provided in *Alary Corp. v Sims (In re Assoc. Vintage Group)* (BAP 9th Cir 2002) 283 BR 549. In essence, two primary types of preclusion questions arise from the cases:

- When should the debtor (or its successor) be prohibited from bringing claims against lenders or others?
- When should creditors be prohibited from asserting claims against the debtor or its successor?

With respect to the debtor's claims against others, the difficulty facing the debtor (especially larger businesses) is how to preserve potential claims that have been identified but not yet initiated or that have yet to be identified. This problem is especially acute if a plan is proposed early in the case.

PRACTICE TIP: To avoid an unintentional waiver of claims, a plan and disclosure statement should describe and reserve known claims; include a broad general reservation of unknown, potential claims and defenses; and reserve jurisdiction of the bankruptcy court to decide such claims if that is desired.

More recent decisions validate blanket reservation of potential claims. See *Alary Corp. v Sims (In re Assoc. Vintage Group)* (BAP 9th Cir 2002) 283 BR 549; *National Envt'l Waste Corp. v Stephens, Berg & Lasaster (In re Nat'l Envt'l Waste Corp.)* (9th Cir 2000) 200 F3d 1266. See also *Peltz v Worldnet Corp.* (*In re USN Communications, Inc.*) (Bankr D Del 2002) 280 BR 573; *Cohen v TIC Fin. Sys. (In re Ampace Corp)* (Bankr D Del 2002) 279 BR 145. The reservation language should be as clear and as broad as possible. See *D&K Props. Crystal Lake v Mutual Life Ins. Co.* (7th Cir 1997) 112 F3d 257 (ambiguous statement did not suffice to reserve claims regarding interest-rate dispute with lender). A blanket reservation of claims has been held to include the right to seek subordination under 11 USC §510(b); however, the right to subordinate a claim under 11 USC §510(c) may require a detailed summary of the claim being reserved. *In re Worldwide Direct, Inc.* (Bankr D Del 2002) 280 BR 819, 823.

Absent a broad claim reservation, the debtor may be precluded from raising claims that existed as of the plan confirmation date. *Kelley v South Bay Bank (In re Kelley)* (BAP 9th Cir 1996) 199 BR 698 (failure to specifically identify and reserve known claims against lender barred claims); *In re County of Orange* (Bankr CD Cal 1997) 219 BR 543 (Chapter 9 plan confirmation barred equitable subordination action because plan and disclosure statement retained only defenses, counterclaims, and rights to setoff or recoupment regarding subject creditor). Several courts have dismissed postconfirmation lender-liability actions because the plan and disclosure statement failed to reference the claims. *Hay v First Interstate Bank* (9th Cir 1992) 978 F2d 555 (equitable estoppel based on failure to mention claims in debtor's schedules, disclosure statement, or plan); *Eubanks v FDIC* (5th Cir 1992) 977 F2d 166 (res judicata); *Heritage Hotel Ltd. Partnership I v Valley Bank (In re Heritage Hotel Ltd. Partnership I)* (BAP 9th Cir 1993) 160 BR 374, aff'd (9th Cir 1995) 59 F3d 175 (unpublished opinion) (equitable estoppel and res judicata). Courts have dismissed other claims, including claims by persons affiliated with the debtor, on the same basis. *Harstad v First Am. Bank* (8th Cir 1994) 39 F3d 898 (preference claims barred); *Payless Wholesale Distribs., Inc. v Alberto Culver (P.R.), Inc.* (1st Cir 1993) 989 F2d 570 (antitrust claims judicially estopped); *Sanders Confectionary Prods., Inc. v Heller Fin., Inc.* (6th Cir 1992) 973 F2d 474 (res judicata barred claims by debtor's corporate parent and officer against debtor's lender and Chapter 7 trustee). But res judicata will not bar claims against parties who are not creditors of the estate because the essential element of privity is missing. *CLC Creditors' Grantor Trust v Sonnenschein Nath & Rosenthal LLP (In re Commercial Loan Corp.)* (Bankr ND Ill 2007) 363 BR 559, 569, rev'd in part on other grounds (Bankr ND Ill 2008) 396 BR 730.

Plan confirmation has also been held to bar a debtor's efforts to amend its schedules to add a homestead exemption. *Knupfer v Wolfberg (In re Wolfberg)* (BAP 9th Cir 2000) 255 BR 879. Courts may not apply preclusion theories as stringently in a Chapter 7 case. Compare *Haley v Dow Lewis Motors, Inc.* (1999) 72 CA4th 497, 85 CR2d 352 (judicial estoppel rarely appropriate in Chapter 7 cases against debtors who fail to schedule claim unless intentional self-contradiction is used to obtain unfair advantage), with *Browning Mfg. v Mims (In re Coastal Plains, Inc.)* (5th Cir 1999)

179 F3d 197 (inadvertent nondisclosure of claims in debtor's schedule of assets precludes judicial estoppel only when debtor lacks knowledge of undisclosed claim or has no motive for its concealment).

Claims by lenders and other creditors inconsistent with their treatment under a confirmed plan can also be barred. *Trulis v Barton* (9th Cir 1995) 107 F3d 685 (plan provided that creditors who elected to become members of reorganized country club were deemed to have released managers and confirmation of plan was res judicata; prepetition Racketeer Influenced and Corrupt Organizations Act (RICO) lawsuit by various creditors who voted for plan was dismissed); *M&I Thunderbird Bank v Birmingham (In re Consolidated Water Utils., Inc.)* (BAP 9th Cir 1998) 217 BR 588 (plan that did not provide for interest was binding on creditors, notwithstanding fact that estate funds were available to pay interest). But see *Carolco Television, Inc. v National Broad. Co. (In re De Laurentiis Entertainment Group)* (9th Cir 1992) 963 F2d 1269 (confirmation did not bar creditor's right to setoff).

A creditor's unsuccessful objection to plan confirmation may also have preclusive impact. *CoreStates Bank, N.A. v Huls Am., Inc.* (3d Cir 1999) 176 F3d 187 (bank's claim in subordination action against another secured creditor barred by claim preclusion because bank's prior objection to plan confirmation was held to be same claim). Similarly, a party may not collaterally attack plan provisions that were not objected to at the time the plan was confirmed. *Stratosphere Litig. LLC v Grand Casinos, Inc.* (9th Cir 2002) 298 F3d 1137 (confirmed plan that discharged claims asserted in litigation was res judicata even if discharge was illegal third party release that could not have been approved over objection).

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§11.117 5. Interpretation and Modification of Plan

The proponent of a Chapter 11 plan may be allowed to modify the plan at any time before confirmation, but not if the modification causes the plan to fail to meet the 11 USC §§1122-1123 requirements (see §§11.98-11.102). See 11 USC §1127. See also *National Loan Investors, LP v Brewster (In re Brewster)* (BAP 9th Cir 1999) 243 BR 51 (abuse of discretion to not allow creditor continuance to obtain evidence to rebut proposed plan modification received 6 days before hearing). However, after a plan is substantially consummated, it cannot be modified. See 11 USC §§1101(2), 1127(b); *Antiquities, Inc. v Bala Cynwyd Corp. (In re Antiquities, Inc.)* (BAP 9th Cir 1994) 173 BR 926 (following cases that segregate cash from other property to determine substantial consummation). But see *Beal Bank v Jack's Marine, Inc.* (ED Pa 1996) 201 BR 376 (bankruptcy court properly enforced consent agreement regarding plan payment to secured lender; court may clarify or interpret confirmed plan under 11 USC §§105 and 1142 without modifying plan).

BAPCPA (see §11.1) modifies this rule in cases filed by individuals. At any time after confirmation and before completion of plan payments, an individual Chapter 11 debtor's plan can be modified to increase or decrease payments of claims in a particular class; extend or reduce the time for payments; or alter the amount of a distribution to a creditor to take account of any nonplan payments to that creditor. 11 USC §1127(e). A motion to make a modification may be made by the debtor, a trustee, the United States Trustee, or the holder of an allowed unsecured claim. These BAPCPA rules for Chapter 11 cases are similar to existing modification provisions in 11 USC §1329 governing modification of Chapter 13 plans, and thus case law interpreting §1329 may be influential. See §11.132. In any event, changes in the individual debtor's postconfirmation financial circumstances may lead to considerable plan modification disputes.

A confirmed plan is treated as a contract that is binding on the debtor and its creditors and, unless the plan provides otherwise, should be interpreted consistently with state law. *Hillis Motors, Inc. v Hawaii Auto. Dealers' Ass'n* (9th Cir 1993) 997 F2d 581.

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§11.118 6. Appeals From Confirmation Orders

An order confirming a plan is automatically stayed for 10 days unless the court orders otherwise. Fed R Bankr P 3020(e). Absent a stay during the pendency of the appeal, the appeal may be mooted by consummation of the plan. See §§11.146-11.152 on appeals generally and on mootness rules regarding appeals from confirmation orders.

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C. Chapter 13 Plans

§11.119 1. Individual Debt Adjustment; Qualifying Debtors

Chapter 13 is designed to provide financially troubled consumers with an alternative to a straight liquidation of assets under Chapter 7. Under a Chapter 13 plan, debtors retain most if not all of their assets and pledge future wages to what is essentially a court-supervised debt consolidation and deferred payment scheme. See 11 USC §1322(a). Unless the plan or confirmation order provides otherwise, a standing trustee makes distributions to creditors, and the debtor makes plan payments to the trustee. 11 USC §1326. It is not unusual for a plan to provide that the debtor will make mortgage payments directly to a lender.

Chapter 13 is available to individuals, or to individuals and their spouses, with regular sources of income and limited indebtedness. 11 USC §109(e). One feature distinguishing Chapter 13 from Chapter 7 is the discharge. A debtor who files a Chapter 7 case may still find that a number of debts are not dischargeable. See 11 USC §523(a). Under BAPCPA, exceptions to discharge under 11 USC §523(a) were expanded. In addition, a discharge is available under Chapter 7 only once every 6 years (8 years under BAPCPA (see §11.1)). 11 USC §727(a).

Prior to BAPCPA, individuals were encouraged to file under Chapter 13 because nondischargeable debts were primarily limited to the tax, fraud, and other exceptions under the pre-BAPCPA 11 USC §523(a), child and spousal support, student loans, restitution or fines resulting from criminal convictions, and drunk driving wrongful death claims. 11 USC §1328(a). BAPCPA (see §11.1) adds a number of additional limits to Chapter 13 discharge, the most significant of which are the following:

- No discharge of debts arising from claims of wrongful death or injury caused by the debtor's drunk driving (also not dischargeable under Chapter 7, 11, or 12) (see 11 USC §§523(a)(9), 1328(a));
- No discharge of debts owed to pension, profit-sharing, stock bonus, or similar plans (also not dischargeable under Chapter 7, 11, or 12) (see 11 USC §§523(a)(18), 1328(a));
- No discharge of debts in the form of restitution or damages resulting from civil actions against the debtor for willful or malicious acts causing personal injury or death (see 11 USC §1328(a)(4));
- No discharge of debts if the debtor received a discharge in a prior Chapter 7, 11, or 12 case during the 4 years preceding the filing of the Chapter 13 case (see 11 USC §1328(f)(1)); and
- No discharge of debts if the debtor received a discharge in a prior Chapter 13 case during the 2 preceding years (see 11 USC §1328(f)(2)).

In a Chapter 13 case, the debtor generally does not receive a discharge until all payments provided for in the plan are made and, under BAPCPA, until the debtor completes an instructional course on personal financial management. 11 USC §1328(a), (g).

Several features of Chapter 11 plans do not apply to Chapter 13 cases. Chapter 13 has no concept of impaired classes, no voting on plans (other than by secured creditors), no period of exclusivity for filing plans (only the debtor may ever file a plan (11 USC §1321)), no option for nonrecourse lenders to have recourse, and nothing resembling the 11 USC §1111(b)(2) election. Cram down is available, but without the "fair and equitable" standard. 11 USC §1325. See §§11.93, 11.98-11.101, 11.109-11.112.

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§11.120 2. Contents of Chapter 13 Plan

Section 1322 of the Bankruptcy Code governs the contents, both mandatory and optional, of a Chapter 13 plan. The payout period under a Chapter 13 plan is usually 3 years but may be extended by the court for cause to a maximum of 5 years. 11 USC §1322(d). BAPCPA (see §11.1) allows debtors with higher income (based on a median income standard) to propose plans up to 5 years in length and debtors with lower income to propose plans up to 3 years.

A Chapter 13 plan may modify unsecured debt. 11 USC §§1322(b)(2). A Chapter 13 plan may also modify secured debt other than loans secured only by the debtor's primary residence and cure defaults on secured debt. See §§11.121-11.127.

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§11.121 a. Modification of Secured Debt

Modifications of secured debt in Chapter 13 plans are governed by 11 USC §§1322 and 1325 and are similar in many respects to modifications permitted in Chapter 11 plans. They consist of lien-stripping (either completely or down to the value of the collateral, to the limited extent still allowed after BAPCPA) (see §§11.92, 11.101, 11.122-11.126); curing defaults (see §11.127); or altering loan terms (such as lowering the interest rate or extending the repayment period, with or without a corresponding reduction in the monthly payment) (see, *e.g.,* §11.101), subject to the limitations on plan periods under 11 USC §1322(d) (see §11.120).

In general, in Chapter 13, after BAPCPA, any property acquired with purchase money financing within 12 months before a bankruptcy case cannot be the subject of a strip-down motion. See clause following 11 USC §1325(a)(9). Further, when lien-stripping is allowed, the lien will not be released until all plan payments have been made and the debtor receives a discharge. 11 USC §1325(a)(5)(B)(i). If the case is converted to Chapter 7, the creditor retains the full amount of its original lien. 11 USC §348(f)(1)(C).

NOTE: Title 11 USC §506(a)(2), as amended by BAPCPA, specifically requires that property acquired for "personal, family or household purposes" be valued at its "replacement value," being the price a retail merchant would charge for that property considering its age and condition at the time of valuation. This protects creditors who finance consumer merchandise by requiring significantly higher valuations of their collateral when lien-stripping is allowed. Furthermore, costs of sale and marketing may *not* be deducted when calculating value for lien-stripping purposes. On valuation and appraisal standards, see §§11.41, 11.91, 11.110, 11.126, 11.129.

As in Chapter 11, a Chapter 13 plan may not modify the rights of a secured creditor whose claim is secured only by the debtor's principal residence. See 11 USC §1322(b)(2). See also §11.123. But see Note on pending legislation in §11.1.

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§11.122 (1) Due Process Issues

The circumstances under which a Chapter 13 plan may modify a secured creditor's claim without initiation of a claim objection have been the subject of considerable dispute. The issue highlights the tension between the preclusive effect of plan confirmation (see §11.131) and the due process rights afforded creditors under the Bankruptcy Code's claim allowance provisions. The Ninth Circuit bankruptcy appellate panel held that "a plan can effectively determine value and/or avoid a lien only if the creditor receives clear notice that the plan will do so." *Shook v CBIC (In re Shook)* (BAP 9th Cir 2002) 278 BR 815, 824. A plan that is silent or ambiguous about a secured claim provides no notice of what will happen to the secured claim and therefore cannot effectively avoid the lien or determine its value. *County of Ventura Tax Collector v Brawders (In re Brawders)* (BAP 9th Cir 2005) 325 BR 405, aff'd (9th Cir 2007) 503 F3d 856. Compare *Shook* and *Brawders* with *Universal Am. Mortgage Co. v Bateman (In re Bateman)* (11th Cir 2003) 331 F3d 821 (confirmed plan that unilaterally cut secured lender's arrearage claim by half did not preclude lender from recovering full arrears under mortgage to extent not paid in full by plan payments). See §11.101 on modification of secured claims in context of Chapter 11.

The plan in *Brawders* was found to be ambiguous and therefore provided insufficient notice to effectively strip the tax agency's lien. In an analogous case involving student loans (which require an adversary proceeding to discharge), the Ninth Circuit found that a creditor need only receive ordinary notice of a Chapter 13 plan to be bound by its terms. *Espinosa v United Student Aid Funds, Inc.* (9th Cir 2008) 545 F3d 1113, cert granted (2009) 174 L Ed 2d 289, 129 S Ct 2791. Thus, if the plan unambiguously proposes to affect a secured residential mortgage lien, it may effectively strip the lien despite the prohibition under 11 USC §1322(b)(2). See §11.126.

PRACTICE TIP: Although an adversary proceeding is not required to strip off an unsecured lien, due process requires that a plan include a clear statement of intention and be served on the affected creditor in accordance with Fed R Bankr P 7004(b)(3), not merely by mailing under Fed R Bankr P 2002 (*i.e.,* it must be addressed to an officer or agent of the creditor). *In re Pereira* (Bankr SD Cal 2008) 394 BR 501.

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§11.123 (2) Home Mortgages

In Chapter 13 cases, the debtor's encumbered property typically consists of a car and a home, although a debtor may sometimes own income-producing real property. As in Chapter 11 plans (see §11.102), the Bankruptcy Code draws a distinct line between the treatment of home mortgages and other secured debt by providing that a Chapter 13 plan may modify the rights of secured creditors, but not if the creditor's claim is secured only by the debtor's principal residence. See 11 USC §1322(b)(2). Consequently, the incidence of secured debt modification in Chapter 13 cases is low. If modifiable debt exists, a debtor may modify such debt (*e.g.,* by lien-stripping) only under a plan that provides for full payment of the secured portion of the claim over the life of the plan. *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165 (nonresidential mortgage).

NOTE: See Note in §11.1 regarding pending legislation to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence.

There are only two statutory exceptions to the prohibition on modifying a home mortgage. The first exception allows a plan to provide for the cure of home mortgage defaults. See 11 USC §1322(b)(5), (c)(1), discussed in §11.127. The second exception permits a debtor to stretch out the repayment period for a home loan that would otherwise mature prior to the completion of the debtor's 3- to 5-year payment plan. See 11 USC §1322(c)(2), (d). See also *In re Hussain* (Bankr D NJ 2000) 250 BR 502; *In re Lobue* (Bankr SD Fla 1995) 189 BR 216. The courts are divided on whether the second exception allows only an extension of the loan (subject to the requirements for cram down under 11 USC §1325(a)(5), discussed in §11.129) or authorizes additional modifications such as lien-stripping of an undersecured loan. Compare *Witt v United Cos. Lending Corp. (In re Witt)* (4th Cir 1997) 113 F3d 508 (lien-stripping *not* allowed) with *First Union Mortgage Corp. v Eubanks (In re Eubanks)* (BAP 6th Cir 1998) 219 BR 468 (lien-stripping and payment modification permitted) and *Magnolia Mortgage v Arnett (In re Arnett)* (SD Ala 2002) 278 BR 239 (lien-strip permitted if plan provides for full payment of secured portion of loan with balloon payment at end of plan).

Most deeds of trust grant the beneficiary a security interest in the impound escrow accounts used for payment of taxes or insurance, and these accounts may be used to offset a payment default. Bankruptcy courts outside California are split on whether the grant of such "incidental security interests" strips creditors of the protection provided to a claim secured solely by the debtor's principal residence under 11 USC §1322(b)(2). Such claims may not be modified by the debtor's bankruptcy plan, while a claim that is secured by the principal residence and something more may be modified. See, *e.g., Brown v Master Fin., Inc. (In re Brown)* (Bankr MD Fla 2004) 311 BR 282 (mortgagee with security interest in tax and insurance escrow account forfeits protection from modification in §1322(b)(2)); *Reed v Norwest Mortgage, Inc. (In re Reed)* (Bankr ED Penn 2000) 247 BR 618 (creditor's security interest in impound accounts allows debtor to bifurcate claim into secured and unsecured portions under plan). See also *Rodriguez v Mellon Bank, N.A. (In re Rodriguez)* (Bankr ED Penn 1998) 218 BR 764 (escrow accounts are "typical feature" in every mortgage; to hold that they remove mortgage from antimodification clause emasculates §1322(b)(2)). To date, the California bankruptcy courts do not appear to have weighed in on this issue.

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§11.124 (3) Multiunit Properties

Not surprisingly, there has been substantial litigation about whether certain mortgages held by secured lenders can be modified. If the home mortgage prohibition applies, the lender's secured claim cannot be stripped down to the value of its collateral or otherwise varied. *Nobelman v American Sav. Bank* (1993) 508 US 324, 124 L Ed 2d 228, 113 S Ct 2106 (no strip down); *Smith v Reeves (In re Reeves)* (BAP 9th Cir 1994) 164 BR 766 (short-term, non-purchase money loan could not be modified); *In re Martin* (Bankr D Conn 1995) 176 BR 675 (due-on-sale clause could not be modified).

The majority view is that the prohibition does not apply if the debtor occupies one unit of a multiunit property. Compare *Scarborough v Chase Manhattan Mortgage Corp. (In re Scarborough)* (3rd Cir 2006) 461 F3d 406 (prohibition inapplicable to income-producing units; bifurcation of secured claim allowed), *Lomas Mortgage, Inc. v Louis* (1st Cir 1996) 82 F3d 1 (same), *In re Kimbell* (Bankr WD NY 2000) 247 BR 35 (same), and *In re Del Valle* (Bankr D Conn 1995) 186 BR 347 (debtor's home with income unit is not "only" debtor's personal residence) with *In re Macaluso* (WD NY 2000) 254 BR 799 (prohibition applicable even though property contained both duplex and barber shop) and *Litton Loan Servicing, LP v Beamon* (ND NY 2003) 298 BR 508 (prohibition applicable if facts and circumstances show that parties intended to enter into consumer-residential rather than commercial transaction).

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§11.125 (4) Personal Property

Considerably more litigation has arisen because many home mortgages contain boilerplate language adding miscellaneous personal property to a lender's collateral. These cases mostly involve attempts by the debtor to confirm a plan that modifies a mortgage by stripping the lien of an undersecured lender down to the lower value of the debtor's residence. The courts have split in their analysis of the problem.

Some courts have allowed lien-stripping when additional personal property collateral such as appliances, machinery, furniture, equipment, or escrow accounts exists. See, *e.g., Hammond v Commonwealth Mortgage Corp. (In re Hammond)* (3d Cir 1994) 27 F3d 52, 56 (lien on personal property including common areas of condominium complex, escrow funds, proceeds of hazard insurance, and rents); *Johns v Rousseau Mortgage Corp. (In re Johns)* (3d Cir 1994) 37 F3d 1021; *In re Lara* (Bankr SD Tex, Apr. 8, 2008, No. 07-60188) 2008 Bankr Lexis 1158 (lien on mobilehome residence was lien on personal property under Texas law and therefore could be stripped down); *In re Libby* (Bankr D NJ 1996) 200 BR 562 (unpledged tax escrow account not additional collateral, but pledge of deposit accounts, though none existed, was); *Mellon Bank v Crystian (In re Crystian)* (Bankr WD Pa 1996) 197 BR 803 (security interest in checking account and pledged escrow account); *In re Escue* (Bankr MD Tenn 1995) 184 BR 287 (collecting earlier cases).

Other courts have rejected the argument that items typically listed in boilerplate mortgage forms—such as rents, royalties, profits, and fixtures—constitute additional collateral, because those items are inextricably bound to the real property. See, *e.g., Allied Credit Corp. v Davis (In re Davis)* (6th Cir 1993) 989 F2d 208; *RTC v Washington (In re Washington)* (5th Cir 1992) 967 F2d 173 (credit life and disability insurance not additional collateral); *In re Rosen* (D NJ 1997) 208 BR 345 ("rents and profits" and "taxes and hazard insurance" escrows not additional collateral). See also *Lievsay v Western Fin. Sav. Bank (In re Lievsay)* (BAP 9th Cir 1996) 199 BR 705 (analyzing 11 USC §1123(b)(5), Chapter 11 counterpart of 11 USC §1322(b)(2); also rejecting argument that home office use justified modification).

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§11.126 (5) Junior Liens; Creditor Strategies

One of the most important issues in Chapter 13 cases arises when debtors attempt to strip junior liens from their home. Bankruptcy Code §1322(b)(2) states that Chapter 13 plans can modify the rights of holders of secured claims "other than a claim secured only by a security interest in real property that is the debtor's residence." 11 USC §1322(b)(2). Despite §1322(b)(2), the bankruptcy appellate panel of the Ninth Circuit ruled in *Lam v Investors Thrift (In re Lam)* (BAP 9th Cir 1997) 211 BR 36 that the liens of junior deed of trust holders can be stripped by Chapter 13 debtors if the value of the debtor's home is less than the amount owed to senior deed of trust holders. In other words, if there is no equity in the debtor's home to support any part of the junior lienholder's position, the entire junior's claim can be converted to unsecured debt. See §11.27. The *Lam* holding was confirmed by the Ninth Circuit in *Zimmer v PSB Lending Corp. (In re Zimmer)* (9th Cir 2002) 313 F3d 1220, and the rule has been followed in many other circuit courts addressing the issue. See, *e.g., Griffey v U.S. Bank (In re Griffey)* (BAP 10th Cir 2005) 335 BR 166; *Obeid v SunTrust Bank (In re Obeid)* (Bankr D Md, Dec. 12, 2008, No. 08-19917) 2008 Bankr Lexis 3395.

Lam and *Zimmer* have profound implications for lenders in the state of California. It is now routine for Chapter 13 debtors to strip junior deeds of trust, depending on their home values and the dollar amounts of senior claims, and it may be difficult for creditors' counsel to be able to avoid application of these cases. In a Chapter 13 proceeding to strip a junior deed of trust, counsel for the junior trust deed holder should consider the following possible strategies:

- **Valuation:** If creditor's counsel can prove that there is sufficient value in the property to support any portion of the client's secured claim, the entire claim survives. See *Zimmer*, 313 F3d at 1226. Retaining an appraiser as an expert witness is therefore crucial. See §11.41. The proper standard for valuing property the debtor intends to keep as a residence is fair market value, not replacement value or foreclosure value, because the property is not being replaced or foreclosed under the plan. "Fair market value" means the price that "a willing seller under no compulsion to sell and a willing buyer under no compulsion to buy would agree upon after the property has been exposed to the market for a reasonable time." *Taffi v U.S. (In re Taffi)* (9th Cir 1996) 96 F3d 1190, 1192. Appraisals based on comparable properties sold by banks can be unreliable indicators of fair market value because, absent evidence to the contrary, banks selling distressed property are not willing sellers under no compulsion to sell. *In re Serda* (Bankr ED Cal 2008) 395 BR 450. For further discussion of valuation, see §§11.91, 11.110, 11.129.
- **Bad faith:** Look for evidence of bad faith. Perhaps the debtor intentionally failed to pay property taxes and mortgage payments prepetition in order to reduce the equity in the property available for the junior lienholder's claim. Evidence of this type of conduct will exist if payments to mortgage holders ceased after the debtor first consulted a bankruptcy attorney. Other evidence of bad faith exists if sufficient funds were on hand on or shortly before the petition date to make mortgage and property tax payments, the implication being that the debtor intentionally stopped making the payments in order to further a lien-stripping action.
- **Procedural objection:** Some debtors attempt to strip a junior lien by filing a motion. Under Fed R Bankr P 7001, proceedings to determine the validity, priority, or extent of a lien must be brought by an adversary proceeding. The junior lienholder should insist that the debtor comply with the more time-consuming and costly requirements for an adversary proceeding.
- **Debtor eligibility:** Look for problems in the debtor's Chapter 13 case that are unrelated to the lien-stripping proceeding. This is another way of saying that the best defense is a good offense. Perhaps the debtor is ineligible for Chapter 13, or perhaps insufficient income is being dedicated to repay unsecured creditors. Lien-stripping (based on the *Lam* case) is clearly not available in the Ninth Circuit in Chapter 7 cases. *Dewsnup v Timm* (1992) 502 US 410, 116 L Ed 2d 903, 112 S Ct 773; *Laskin v First Nat'l Bank (In re Laskin)* (BAP 9th Cir 1998) 222 BR 872. If a debtor's entire Chapter 13 case can be attacked successfully, the lien-stripping issue will become moot. To the extent that the debtor is successful in stripping a creditor's junior deed of trust, the creditor will hold an unsecured claim. If that will push the debtor over the eligibility limitation stated in 11 USC §109(e) on unsecured claims (currently $336,900), the entire Chapter 13 case must be dismissed. See, *e.g., Scovis v*

Henrichsen (In re Scovis) (9th Cir 2001) 249 F3d 975 (because undersecured debt must be considered wholly unsecured for Chapter 13 eligibility, entire amount of state court judgment, which was only partially secured by junior lien, was added to other unsecured debt; this increase effectively disqualified debtors for relief under Chapter 13).

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§11.127 b. Cure of Defaults and De-Acceleration

A Chapter 13 plan may provide for the cure of defaults, including a defaulted loan secured by the debtor's principal residence, within a "reasonable period of time" and maintenance of payments to the lender while the case is pending. 11 USC §1322(b)(3), (5). A Chapter 13 plan cannot cure defaults on a loan secured by the debtor's principal residence after the residence is actually sold at a foreclosure sale that complies with applicable nonbankruptcy law. 11 USC §1322(c)(1). See *Litton v Wachovia Bank (In re Litton)* (4th Cir 2003) 330 F3d 636 (cure includes defaults under settlement agreement with secured lender agreed to in prior bankruptcy case); *Oregon v Hurt (In re Hurt)* (BAP 9th Cir 1993) 158 BR 154 (cure permissible after entry of judgment of foreclosure if no foreclosure sale had been conducted); *Oregon v Braker (In re Braker)* (BAP 9th Cir 1991) 125 BR 798.

A cure of defaults effectively "de-accelerates" an obligation, even if the acceleration occurred prior to the filing of the Chapter 13 case. See *In re Nelson* (BAP 9th Cir 1985) 59 BR 417; *DiPierro v Taddeo (In re Taddeo)* (2d Cir 1982) 685 F2d 24. Chapter 13 does not have a provision parallel to 11 USC §1124(2), which specifically authorizes de-acceleration. Most courts, however, have held that de-acceleration of a fully accelerated obligation under 11 USC §1322(b)(3) and (5) does not trigger the home mortgage antimodification provisions of §1322(b)(2). See *In re Nelson* (BAP 9th Cir 1985) 59 BR 417; *Mid-State Homes, Inc. v Cheeks (In re Cheeks)* (Bankr MD Ala 1982) 24 BR 477 (collecting cases reaching both similar and contrary results). The Chapter 13 cure provisions are in marked contrast with those in Chapter 11, which require a cure to be made in cash at plan confirmation for de-acceleration to occur without impairment of the claim. 11 USC §1124(2).

The amount necessary to cure a default is calculated according to the underlying loan agreement and applicable state law. 11 USC §1322(e). These may require interest to be paid on arrearages. *In re Mendez* (Bankr D NJ 2000) 255 BR 143 (interest on entire arrears allowable whether claim is oversecured or not). But see *In re Arvelo* (Bankr D NJ 1995) 176 BR 349 (undersecured lender not entitled to postpetition interest before plan confirmation and entitled to postconfirmation interest on arrearages only to extent arrearages are secured). For cases involving loan agreements made before October 24, 1994, the effective date of §1322(e), confirmation of a plan curing a defaulted mortgage may require interest on arrears whether the loan is undersecured or oversecured. *In re Rita Hardware* (Bankr ED NY 1995) 189 BR 273.

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3. Confirmation and Cram Down in Chapter 13

§11.128 a. Plan Confirmation Requirements

The confirmation standards for Chapter 13 plans share many features with those for confirmation of plans in Chapter 11 cases. A Chapter 13 plan must include the provisions required by 11 USC §1322 and be proposed in good faith. 11 USC §1325(a)(1), (3). See §11.106. BAPCPA (see §11.1) also requires that the Chapter 13 petition be filed in good faith. 11 USC §1325(a)(7). On what constitutes bad faith and statutory and case law responses to bad faith, see §§11.5, 11.24-11.27.

The plan must also be feasible. 11 USC §1325(a)(6). See §11.114. See also *First Nat'l Bank of Boston v Fantasia (In re Fantasia)* (BAP 1st Cir 1997) 211 BR 420 (plan proposing payment on 15-year amortization schedule with interest and balloon payment after 60 months permissible but not shown to be feasible); *In re Harris* (Bankr D NH 1996) 199 BR 434 (plan proposing mortgage modification with substantial balloon payment at end of 5 years rejected because debtor's ability to make balloon payment too speculative).

One notable distinction from Chapter 11 is the limitation on acceptance of the plan to secured creditors. See 11 USC §1325(a)(5)(A). See also §§11.103, 11.107. As discussed in §11.129, a Chapter 13 plan may still be crammed down on a dissenting secured creditor. Solicitation of acceptance or rejection of a Chapter 13 plan from unsecured creditors is not required, but the plan's treatment of unsecured creditors must satisfy the "best interests" test. See §11.108. In other words, unsecured creditors must receive payments under the plan that are not less than the distribution they would receive in a Chapter 7 case. 11 USC §1325(a)(4).

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§11.129 b. Cram Down of Secured Creditors

If a secured creditor does not accept the proposed plan, it may still be crammed down on the creditor. Cram down is only available to modify a loan secured by the debtor's primary residence if an exception to the modification prohibition of 11 USC §1322(b)(2) exists. See §§11.102, 11.121-11.127. Chapter 13 trustees have standing to object to a plan that fails to treat secured creditors properly despite the lack of any objection by secured creditors. *Andrews v Loheit (In re Andrews)* (9th Cir 1995) 49 F3d 1404.

Assuming §1322(b)(2) does not apply, the debtor has two cram-down alternatives. One option is to surrender the collateral to the secured creditor. 11 USC §1325(a)(5)(C). If the property is overencumbered, the surrender option will only satisfy the secured portion of the creditor's claim.

PRACTICE TIP: If the debtor intends to surrender real property collateral to the secured creditor, the debtor should do so early in the case (or even before the case), when a deed in lieu of foreclosure, an agreement to foreclose by power of sale, or an outright release, any of which would bar liability for a deficiency claim, can usually be negotiated with no difficulty.

The second option requires the secured creditor to retain its lien on the collateral and to receive property (*i.e.,* payments) having a present value, as of the effective date of the plan, of at least the amount of the allowed secured claim. 11 USC §1325(a)(5)(B). Such payments must be made over the life of the plan. See *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165. See §11.121. BAPCPA (see §11.1) requires that periodic payments be "in equal monthly amounts" and provides that the lender retain its lien until the earlier of (1) payment of the underlying debt determined under nonbankruptcy law or (2) the debtor's discharge under the plan. 11 USC §1325(a)(5)(B).

This second option requires determination of the value of the collateral and an appropriate interest rate to determine present value. As in a Chapter 11 case, the allowed amount of a secured claim is governed by 11 USC §506(a). Chapter 13, however, does not contain an analog to 11 USC §1111(b)(2) allowing an undersecured creditor to elect to be treated as fully secured. See §11.93. Thus, the undersecured creditor's allowed secured claim will equal the value of its collateral, and the creditor will have an allowed unsecured claim for the deficiency, assuming the debt is a recourse obligation. In a Chapter 13 case, the proper valuation standard for collateral being retained by a debtor under a cram-down plan is the "replacement value" of that collateral (as defined in *Associates Commercial Corp. v Rash* (1997) 520 US 953, 959 n2, 138 L Ed 2d 148, 156 n2, 117 S Ct 1879) rather than the liquidation value the secured creditor would realize at a foreclosure sale. The Supreme Court, in a plurality decision, held that the cram-down interest rate should be determined by use of the "prime-plus" approach (also known as the "formula rate"). This approach is in contrast to others, variously called the "similar-loan" and "presumptive-contract-rate" approaches. *Till v SCS Credit Corp. (In re Till)* (2004) 541 US 465, 158 L Ed 2d 787, 124 S Ct 1951. The formula-rate calculation starts with the national prime rate charged to creditworthy borrowers. That rate is then adjusted to reflect the greater risk of nonpayment by the debtor, which depends on factors such as "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." 541 US at 465, 158 L Ed 2d at 800. See *In re Pluma (Tax Collector for the County of San Diego v Pluma)* (BAP 9th Cir 2003) 303 BR 444, aff'd, (9th Cir 2005) 427 F3d 1163 (formula approach incorrectly applied if trial court fails to consider risk of default). On valuation and interest rates in cram down under Chapter 11, see §11.110.

NOTE: A confirmed plan purporting to avoid all liens unless a proof of claim is filed did not terminate the lien held by a secured creditor that failed to file a claim. *Cen-Pen Corp. v Hanson* (4th Cir 1995) 58 F3d 89 (rejecting such avoidance without due process safeguards of adversary proceeding).

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§11.130 c. Cram Down of Unsecured Creditors

The unfortunate secured lender may find itself with an unsecured deficiency claim either because the lender is undersecured or completely unsecured due to low collateral value or senior liens or both. Although unsecured creditors do not vote to accept or reject a Chapter 13 plan, an unsecured creditor may voice its dissent by objecting to confirmation. In that case, the debtor must satisfy the requirements for cram down of the unsecured creditor's claim. 11 USC §1325(b)(1). Cram down is allowed if the plan provides for total payment to the creditor not less than the amount of the creditor's claim. §1325(b)(1)(A). Alternatively, all of the debtor's projected disposable income for the 3 years following confirmation must be applied to making payments under the plan. §1325(b)(1)(B). BAPCPA (see §11.1) significantly revises the definition of "disposable income" primarily by incorporating the means test standards under 11 USC §707(b)(2)(A)-(B) for determining what amount will be deemed "reasonably necessary" for certain expenses. See 11 USC §1325(b)(2)-(3).

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§11.131 4. Preclusive Effect of Plan Confirmation

A confirmed Chapter 13 plan is binding on the debtor and each creditor, whether or not the claim of a creditor is provided for by the plan and regardless of whether a creditor objected to, accepted, or rejected the plan. 11 USC §1327(a). Except as otherwise provided in the plan or confirmation order, confirmation of a plan also vests all property of the bankruptcy estate in the debtor free and clear of any claim or interest of any creditor provided for by the plan. 11 USC §1327(b)-(c). It follows that confirmation of a Chapter 13 plan, as with a Chapter 11 plan, has a claim-preclusive and issue-preclusive effect for all justiciable issues that were or could have been decided at the confirmation hearing. On Chapter 11 preclusion, see §11.116. However, plan confirmation does not preclude a challenge to treatment of secured debt under a plan if that treatment was subject to a pending adversary proceeding. *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165.

Preclusion may compromise a creditor's rights that are inconsistent with the plan. *Great Lakes Higher Educ. Corp. v Pardee (In re Pardee)* (9th Cir 1999) 193 F3d 1083 (plan confirmation is res judicata even if provision at issue might otherwise have violated Bankruptcy Code); *Espinosa v United Student Aid Funds, Inc.* (9th Cir 2008) 545 F3d 1113, cert granted (2009) 174 L Ed 2d 289, 129 S Ct 2791 (court of appeals allowed student loan to be discharged by inclusion in plan because creditor failed to object after notice of proposed plan); *Multnomah County v Ivory (In re Ivory)* (9th Cir 1995) 70 F3d 73 (rejecting county's claim that tax foreclosure and expiration of redemption period preconfirmation deprived bankruptcy court of jurisdiction); *In re Chappell* (7th Cir 1993) 984 F2d 775 (court denied lender's request for additional interest after payments under confirmed Chapter 13 plan were completed consistent with lender's proof of claim—waiver and res judicata); *In re Rascon* (ND Cal 2005) 321 BR 48 (plan modification of secured claim allowed). However, the debtor has the burden of proving that claim preclusion applies and, in particular, of showing that the plan clearly stated the intended effect on the issue in dispute. *County of Ventura Tax Collector v Brawders (In re Brawders)* (BAP 9th Cir 2005) 325 BR 405, aff'd (9th Cir 2007) 503 F3d 856 (model plan treatment of tax lien not sufficiently clear to modify lien rights or claim amount).

Preclusion may also block claims by a debtor. *Sure-Snap Corp. v State St. Bank & Trust Co.* (2d Cir 1991) 948 F2d 869 (lender liability claims barred). But res judicata will not bar preconfirmation claims held by the debtor against parties who are not creditors in the case, even if the claims are omitted from the debtor's plan. *Air Cargo, Inc., Litig. Trust v i2 Technol., Inc. (In re Air Cargo, Inc.)* (Bankr D Md 2008) 401 BR 178. See also *Donato v Metropolitan Life Ins. Co.* (Bankr ND Cal 1999) 230 BR 418 (debtor's failure to include wrongful termination claim in schedules was not grounds for judicial estoppel, because debtor's plan provided for 100-percent payout to creditors; former employer was not creditor and thus had no right to vote on plan; and there was no prejudice to creditors).

An action to revoke an order confirming a plan on the basis of fraud must be filed within 180 days after entry of the order. 11 USC §1330(a). This time limit is generally not subject to exception and reinforces the intertwined policies of finality and claim preclusion. See *In re Valenti* (9th Cir BAP 2004) 310 BR 138.

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§11.132 5. Modification of Chapter 13 Plan

Before confirmation, a Chapter 13 plan may be modified at any time as long as the modified plan satisfies the requirements of 11 USC §1322. 11 USC §1323(a). A secured creditor is deemed to continue its acceptance or rejection of the modified plan unless the modification changes the rights of the secured creditor and the creditor then changes its prior acceptance or rejection. 11 USC §1323(c).

After confirmation and at any time before payments under the plan are completed, a plan may be modified at the request of the debtor, the Chapter 13 standing trustee, or an unsecured creditor to (1) increase or reduce payments to a particular class, (2) extend or reduce the time for payments, or (3) alter the distribution amount to a creditor as needed to take account of any payment on the claim outside of the plan. 11 USC §1329(a). The modified plan must still comply with the requirements for a Chapter 13 plan. 11 USC §1329(b)-(c). In the Ninth Circuit, if the trustee seeks modification but the debtor or a creditor objects, the trustee must show that there has been a substantial change in the debtor's ability to pay since the confirmation hearing and that the change had not been anticipated at the time of confirmation. *Anderson v Satterlee (In re Anderson)* (9th Cir 1994) 21 F3d 355. In certain circumstances, BAPCPA (see §11.1) also allows modification to reduce plan payments by the amount the debtor pays for health insurance. 11 USC §1329(a)(4).

The Sixth Circuit held that §1329(a) does not allow a debtor to "alter, reduce, or reclassify" a previously allowed secured claim, except to alter the amount or timing of specific payments. See *Chrysler Fin. Corp. v Nolan (In re Nolan)* (6th Cir 2000) 232 F3d 528, 533. See also *In re Cruz & Santiago* (Bankr D NJ 2000) 253 BR 638 (Chapter 13 debtors could not modify payments being made to mortgagee to zero). For cases reaching a contrary conclusion, see *In re Zeider* (Bankr D Ariz 2001) 263 BR 114 (creditor's liquidation of motor vehicle securing its claim constituted cause for allowing modification of plan, reducing schedule payments on creditor's secured claim to zero); *In re Mason* (Bankr ND Cal 2004) 315 BR 759 (rejecting reasoning of *In re Nolan* in favor of *In re Zeider*). See summary of more recent cases in *In re Davis* (Bankr SD Tex 2009) 404 BR 183.

If a debtor realizes a windfall from collateral appreciation after confirmation, it may be possible to amend the plan to increase payments to creditors, although the debtor is entitled to object to the motion to amend. See *Fridley v Forsythe (In re Fridley)* (9th Cir BAP 2007) 380 BR 538, 543. In *Barbosa v Soloman* (1st Cir 2000) 235 F3d 31, the debtor later sold for $137,500 property securing a creditor's claim that had been "stripped down" in value from $114,000 to $64,000 under the plan. The Chapter 13 trustee was allowed to amend the plan. 235 F3d at 41. It may also be possible to modify a plan to provide for payment over less than 3 years and without payment of allowed claims in full. *Sunahara v Burchard (In re Sunahara)* (BAP 9th Cir 2005) 326 BR 768 (debtor allowed to modify confirmed model plan by later refinancing to fund 50-percent payments to unsecured creditors as plan provided, but paying them off in single lump sum to receive early discharge). But see *In re Keller* (Bankr ED Cal 2005) 329 BR 697. If the plan is not formally modified by the court, however, the plan will not be deemed to have been completed early enough to qualify the debtor for an early discharge. *Fridley v Forsythe (In re Fridley)* (9th Cir BAP 2007) 380 BR 538.

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D. Chapter 12 Plans

§11.133 1. Overview of Chapter 12

Prior to the enactment of Chapter 12 in 1986, most individual farmers filed cases under Chapter 11 because they carried debts that exceeded the limits for a Chapter 13 case. The enabling legislation establishing Chapter 12 was subject to a sunset provision. However, BAPCPA (see §11.1) permanently enacts Chapter 12. Pub L 109-8, §1001, 119 Stat 23. Under BAPCPA, a "family fisherman" may also file for relief under Chapter 12. 11 USC §§101(19A), 109(f).

Chapter 12 is patterned extensively after Chapter 13. However, in addition to individuals, corporate or partnership entities in which more than 50 percent of the outstanding equity is controlled by one family are also eligible for Chapter 12. See 11 USC §§101(18), 109(f). The majority of the requirements of a Chapter 12 plan are based on Chapter 13. Some provisions of Chapter 12, which deviate significantly from Chapter 13, relate directly to the claims of creditors secured by real property. Those differences are discussed in §§11.134-11.143.

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§11.134 2. Special Definition of "Adequate Protection"

Section 1205(b) of the Bankruptcy Code contains a special definition of "adequate protection" for purposes of Chapter 12. That definition parallels the definition of "adequate protection" in 11 USC §361, which applies in Chapter 7, 11, and 13 cases, with one additional method of providing adequate protection beyond the three stated in §361. See §§11.23, 11.70. Section 1205(b)(1)-(2) states that adequate protection can be provided by making periodic cash payments or providing an additional or replacement lien to the extent of the decrease in the value of the secured creditor's interest in property. Similarly, §1205(b)(4) authorizes the debtor to provide adequate protection by providing the secured creditor with such other protection "as will adequately protect the value of property securing a claim"—a provision similar to §361(3), which states that adequate protection includes any other relief providing the creditor with "the indubitable equivalent of such entity's interest in such property."

The additional method of providing adequate protection is in §1205(b)(3), which provides that adequate protection may be supplied by "paying to such entity for the use of farmland the reasonable rent customary in the community where the property is located, based upon the rental value, net income, and earning capacity of the property." This provision was intended to circumvent a line of court decisions that required a debtor to pay interest to an undersecured creditor, but because the Supreme Court subsequently held that nothing in the Bankruptcy Code entitles an undersecured creditor to postpetition interest (see *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626), the special method of providing adequate protection in §1205(b)(3) is meaningless.

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§11.135 3. Power to Sell Property Free and Clear

Chapter 12 grants a trustee (or debtor in possession) the unique authority to sell farmland, farm equipment, or property used in a commercial fishing operation free and clear of any interest (such as a secured claim) in the property, with the proceeds automatically subject to the interest. 11 USC §1206. This allows a debtor farmer to sell such property without the consent of the lender even if the total proceeds are less than the secured claim. This power supplements the general power to sell free and clear of liens in 11 USC §363(f), which authorizes a sale free and clear when the proceeds are greater than the liens against the property or when the secured lender consents to the sale. See §11.73.

In jurisdictions where lenders may seek massive deficiency judgments, §1206 is designed to enable farmers to maximize the value of the collateral and thereby minimize their liability for any deficiency. While this consideration may be relevant with respect to personal property in California, the state's antideficiency statutes will limit the applicability of §1206. There is little likelihood that a farmer will suffer a deficiency judgment in favor of a lender whose collateral is real property, because a lender would be required to conduct a judicial foreclosure sale to obtain such a judgment. See CCP §580d. See also chap 3.

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§11.136 4. Contents of Chapter 12 Plan

Section 1222 of the Bankruptcy Code governs the contents, both mandatory and optional, of a Chapter 12 plan. The payout period under a Chapter 12 plan, like a Chapter 13 plan, is usually 3 years but may be extended by the court for cause to a maximum of 5 years. 11 USC §1222(c). A Chapter 12 plan may modify both secured and unsecured debt. 11 USC §1222(b)(2).

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§11.137 a. Modification of Secured Debt

Unlike Chapter 13, there is no limit on the right of a Chapter 12 debtor to modify the rights of secured creditors under a Chapter 12 plan, as long as the plan complies with the pertinent provisions of 11 USC §§1222 and 1225. 11 USC §1222(b)(2). In particular, there is no corollary to the 11 USC §1322(b)(2) prohibition on modification of a claim secured only by a debtor's principal residence. See §11.123. Although payments under a Chapter 12 plan are usually limited to a period of 3 to 5 years (11 USC §1222(c)), payments to secured creditors may be made over a longer period consistent with a permissible cram down of a secured creditor. See 11 USC §1222(c). See also §§1222(b)(9), 1225(a)(5).

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§11.138 b. Cure of Defaults and De-Acceleration

A Chapter 12 plan may provide for the cure of defaults within a "reasonable period of time" and for the maintenance of payments to the lender while the case is pending. 11 USC §1222(b)(5). Based on precedent interpreting a parallel provision in Chapter 13 cases, a cure of defaults under §1222(b)(5) arguably should "de-accelerate" an obligation, even if the acceleration occurred before the filing of the Chapter 12 case. See *DiPierro v Taddeo (In re Taddeo)* (2d Cir 1982) 685 F2d 24; *In re Nelson* (BAP 9th Cir 1985) 59 BR 417, cited in §11.127. The amount necessary to cure a default is calculated according to the underlying loan agreement and applicable state law. 11 USC §1222(d). These may require interest to be paid on arrearages. See §11.127 for cases interpreting the parallel provision in Chapter 13.

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5. Confirmation and Cram Down in Chapter 12

§11.139 a. Plan Confirmation Requirements

The confirmation standards for plans under Chapter 12 share many of the same features as those for Chapter 11 and 13 plans. A Chapter 12 plan must be proposed in good faith and satisfy the provisions of 11 USC §1222 and other applicable provisions. 11 USC §1225(a)(1), (3). See §§11.105-11.106, 11.128. The plan must also be feasible. 11 USC §1225(a)(6). See §11.114. See also *In re Gough* (Bankr MD Fla 1995) 190 BR 455 (plan not feasible because debtor's crop yield projections underlying proposed plan payments were overly optimistic). Like Chapter 13, only secured creditors must accept the plan. 11 USC §1225(a)(5)(A). A Chapter 12 plan may still be crammed down on a dissenting secured creditor. See §11.140. Solicitation of acceptance or rejection of a Chapter 12 plan from unsecured creditors is not required, but the plan's treatment of unsecured creditors must satisfy the "best interests" test. In other words, unsecured creditors must receive payments under the plan that are not less than the distribution they would receive in a Chapter 7 case. 11 USC §1225(a)(4). See §11.108.

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§11.140 b. Cram Down of Secured Creditors

If a secured creditor does not accept the proposed plan, the plan may still be crammed down on the creditor. The debtor's two cram-down alternatives are as follows:

- Surrender the collateral to the secured creditor (11 USC §1225(a)(5)(C)); or
- Make payments having a present value in the amount of the secured claim to the creditor (11 USC §1225(a)(5)(B)).

A plan calling for the debtor to surrender real property collateral to the lienholder in full satisfaction of both the secured and the unsecured claim of the lender does not comply with 11 USC §1225(a)(5)(C) and cannot be confirmed over the objection of the lienholder. *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149, overruled on other grounds in *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199. If the property is overencumbered, the surrender option will only satisfy the secured portion of the creditor's claim.

PRACTICE TIP: As in Chapter 13, if the debtor intends to surrender real property collateral to the secured creditor, the debtor should act promptly. See Practice Tip in §11.129.

The second option requires the secured creditor to retain its lien on the collateral and to receive property (*i.e.,* payments) having a present value, as of the effective date of the plan, of at least the amount of the allowed secured claim. 11 USC §1225(a)(5)(B). The debtor can propose a plan that pays a secured claim over a period of longer than 3 years, up to 5 years, as long as the present value of all payments is equal to the allowed amount of the secured claim. 11 USC §1222(b)(9). This option requires determination of the value of the collateral and an appropriate interest rate to determine present value. See §11.110. See also *Wells Fargo Bank Northwest, N.A. v Yett (In re Yett)* (BAP 9th Cir 2004) 306 BR 287 (no error in confirming plan that used contract rate if sole evidence of proper interest rate was contract that contained nondefault and default rates). As in Chapter 11 and 13 cases, the allowed amount of a secured claim is governed by 11 USC §506(a). Chapter 12, however, does not contain an analog to 11 USC §1111(b)(2), allowing an undersecured creditor to elect to be treated as fully secured. See §11.93. Thus, the undersecured creditor's allowed secured claim may be stripped to equal the value of its collateral, and the creditor will have an allowed unsecured claim for the deficiency, assuming the debt is a recourse obligation. See *Harmon v U.S.* (8th Cir 1996) 101 F3d 574 (debtor received benefit of postconfirmation increase in property value); *Zabel v Schroeder Oil, Inc. (In re Zabel)* (Bankr ED Wis 2000) 249 BR 764. The proper valuation standard in a Chapter 12 case for collateral being retained by a debtor under a cram-down plan arguably should be, as it is in a Chapter 13 case, the "replacement value" of that collateral rather than the liquidation value the secured creditor would realize at a foreclosure sale. See §§11.110, 11.129.

The debtor can propose a plan that pays a secured claim over a period of longer than the 3- to 5-year period allowed for other claims, as long as the present value of all payments is equal to the allowed amount of the secured claim. 11 USC §1222(b)(9). In *Travelers Ins. Co. v Bullington* (11th Cir 1989) 878 F2d 354, the Eleventh Circuit approved a 30-year plan, rejecting the argument that the value of the payments made during the administration of the plan (4 years) must equal the value of the secured claim.

PRACTICE TIP: Because it is clear that Congress intended to allow a debtor to pay off a claim secured by farmland over a period longer than the short life of a Chapter 12 plan, the alternative method for challenging such a payment scheme is to attack the feasibility of the plan under 11 USC §1225(a)(6).

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§11.141 c. Cram Down of Unsecured Creditors

The unfortunate secured lender may find itself with an unsecured deficiency claim in a Chapter 12 case. Although unsecured creditors do not vote to accept or reject a Chapter 12 plan, an unsecured creditor may voice its dissent by objecting to confirmation. In that case, the debtor must satisfy the requirements for cram down of the unsecured creditor's claim. 11 USC §1225(b)(1). Cram down is allowed if the plan provides for total payment to the creditor of not less than the amount of the creditor's claim. 11 USC §1225(b)(1)(A). Alternatively, all of the debtor's projected disposable income for the duration of the plan must be applied to making payments under the plan. 11 USC §1225(b)(1)(B). A third alternative exists under BAPCPA amendments to the Bankruptcy Code (see §11.1), which approve cram down by a plan that distributes property of a value over the plan life that is not less than the debtor's projected disposable income for the same period. 11 USC §1225(b)(1)(C). The definition of "disposable income" was also amended in 11 USC §1225(b)(2).

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§11.142 6. Preclusive Effect of Plan Confirmation

A confirmed Chapter 12 plan is binding on the debtor and each creditor whether or not the claim of a creditor is provided for by the plan and regardless of whether a creditor objected to, accepted, or rejected the plan. 11 USC §1227(a). Except as otherwise provided in the plan or confirmation order, confirmation of a plan also vests all property of the bankruptcy estate in the debtor free and clear of any claim or interest of any creditor provided for by the plan. 11 USC §1227(b)-(c). Thus, confirmation of a Chapter 12 plan, as with Chapter 11 and Chapter 13 plans, has a claim-preclusive and issue-preclusive effect. See, *e.g.*, *First Nat'l Bank v Allen* (8th Cir 1997) 118 F3d 1289, 1295 (undersecured lenders who participated in negotiation of and voted for plan that failed to provide for payment on unsecured portion of lenders' claims waived right to seek recognition of unsecured claims). For extensive discussion of preclusion, see §§11.116 (Chapter 11), 11.131 (Chapter 13).

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§11.143 7. Modification of Chapter 12 Plan

Before confirmation, a Chapter 12 plan may be modified at any time as long as the modified plan satisfies the requirements of 11 USC §1222. 11 USC §1223(a). A secured creditor is deemed to continue its acceptance or rejection of the modified plan unless the modification changes the rights of the secured creditor and the creditor then changes its prior acceptance or rejection. 11 USC §1223(c).

After confirmation, and at any time before payments under the plan are completed, a plan may be modified at the request of the debtor, the Chapter 12 standing trustee, or an unsecured creditor to increase or reduce payments to a particular class, extend or reduce the time for payments, or alter the distribution amount to a creditor as needed to take account of any payment on the claim outside the plan. 11 USC §1229(a). The modified plan must still comply with the requirements for a Chapter 12 plan stated in 11 USC §1229(b)-(c). BAPCPA (see §11.1) places new limits on modification. A modification cannot (1) increase payments due before the modification is effective, (2) except as requested by the debtor, increase payments to unsecured creditors beyond the debtor's disposable income based on an increase in disposable income, or (3) in the last year of the plan, except as requested by the debtor, require payments that would leave the debtor with insufficient capital to carry on the farming (and presumably, although not expressly stated, the fishing) operation after completion of the plan. 11 USC §1229(d).

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X. EFFECT OF BANKRUPTCY DISCHARGE

§11.144 A. Effect of Discharge

The effect of a discharge in bankruptcy is governed by 11 USC §524 in combination with specific provisions in Chapters 7, 11, 12, and 13. See 11 USC §§727, 1142, 1228, 1328. Section 524(a) provides that the discharge (1) voids any judgment against the debtor to the extent it is an adjudication of the debtor's personal liability and (2) operates as an injunction against the commencement or continuation of an action to collect or offset a debt. A debtor's discharge in bankruptcy, however, may not prevent a party from filing an action against the debtor seeking only equitable relief. See *Irizarry v Schmidt (In re Irizarry)* (BAP 9th Cir 1994) 171 BR 874 (equitable remedies sought by plaintiff to cancel grant deed given to debtor and related liens were neither "claim" nor "debt" under Bankruptcy Code and therefore were not affected by debtor's discharge).

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§11.145 B. Exceptions to Discharge

Certain debts, detailed in 11 USC §523, are nondischargeable. Among them are loans obtained by means of material false representations or omissions made by the debtor to induce the loan. 11 USC §523(a)(2). The lender will need to show, however, that its reliance on the misstatements or omissions was justifiable. *Field v Mans* (1995) 516 US 59, 133 L Ed 2d 351, 116 S Ct 437; *Candland v Insurance Co. of N. Am. (In re Candland)* (9th Cir 1996) 90 F3d 1466 (material misrepresentations are "substantial inaccuracies" that would generally affect lender's credit decision). The circumstances that may give rise to grounds for objection to a debtor's discharge vary. See, *e.g., Field v Mans* (*In re Mans)* (1st Cir 1998) 157 F3d 35 (fraudulent concealment of debtor's sale of mortgaged property frustrated lender's right to accelerate debt under due-on-sale clause); *Sanford Inst. for Sav. v Gallo* (1st Cir 1998) 156 F3d 71 (bank justifiably relied on debtor's fraudulent statement that he owned property with his wife and forged her signature on loan documents, notwithstanding bank's failure to run title search and bank officer's fabricated witnessing of wife's signature because of bank's long and successful loan history with debtor); *Norris v First Nat'l Bank (In re Norris)* (5th Cir 1995) 70 F3d 27 (misrepresentation of debtor's cash flow in annual renewal of mortgage note constituted fraud); *Loomas v Evans* (*In re Evans)* (Bankr SD Cal 1995) 181 BR 508 (debtor real estate broker falsely represented that lot could be developed). But see *Enterprise Nat'l Bank v Jones* (*In re Jones)* (Bankr MD Ga 1996) 197 BR 949 (40-percent decline in value of real property between loan application and bankruptcy filing did not prove fraudulent representation).

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XI. APPEALS FROM BANKRUPTCY COURT DECISIONS

§11.146 A. Overview

Jurisdiction regarding appeals from bankruptcy court decisions is set forth in 28 USC §158. Procedural rules for bankruptcy appeals are set out in Part VIII of the Federal Rules of Bankruptcy Procedure and the Ninth Circuit's Amended Order Continuing the Bankruptcy Appellate Panel of the Ninth Circuit effective November 18, 1988, as amended through May 9, 1998, cited in §11.148. Other local rules may apply depending on whether the appeal is taken to the district court or the bankruptcy appellate panel of the Ninth Circuit. This discussion highlights basic appellate procedure and issues most applicable to secured loans. It is not intended to be a comprehensive discussion.

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§11.147 B. Expedited Timing for Notice of Appeal

The time to appeal a bankruptcy court decision is abbreviated. The notice of appeal must be filed with the bankruptcy court within 10 days of entry of the order or judgment. Fed R Bankr P 8002(a). The 10-day period includes intervening weekends and holidays. See Fed R Bankr P 9006(a). Failure to file a timely appeal is jurisdictional and grounds for dismissal of the appeal.

The 10-day period is tolled by the filing of a motion (1) to amend or make additional findings, (2) to alter or amend the judgment, (3) for a new trial, or (4) for relief under Rule 9024. See Fed R Bankr P 8002(b). In addition, Rule 8002(c) permits the bankruptcy court to grant a brief extension of the time to file an appeal unless the decision appealed from (1) grants relief from the automatic stay, (2) authorizes the sale or lease of property, (3) authorizes the obtaining of credit, (4) authorizes assumption or assignment of executory contracts or unexpired leases, (5) approves a Chapter 11 disclosure statement, or (6) confirms a plan under Chapter 9, 11, 12, or 13.

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§11.148 C. Appeal to Bankruptcy Appellate Panel or District Court

The judicial council of each circuit is required to establish a bankruptcy appellate panel to hear bankruptcy appeals unless the circuit has insufficient resources or unless establishing a panel would unduly delay or increase the cost to parties in bankruptcy cases. 28 USC §158(b). The Ninth Circuit has established a bankruptcy appellate panel. See Amended Order Continuing the Bankruptcy Appellate Panel of the Ninth Circuit effective November 18, 1988, as amended through May 9, 2002 (the "BAP Order"). The BAP Order is available on the panel's website (http://207.41.19.15/web/bap.nsf/BAPDocumentView/judicial+council+order/$file/baporderrevised.pdf).

All appeals from the bankruptcy court in the Ninth Circuit are automatically referred to the bankruptcy appellate panel. BAP Order §2. Any party may elect, however, to have the appeal heard by the district court instead of the bankruptcy appellate panel. BAP Order §3. The appellant must make such an election at the time the notice of appeal is filed, and any other party must make the election within 30 days after service of the notice of appeal. BAP Order §3. If the appeal is taken to the district court, counsel should become familiar with the local rules of bankruptcy appellate procedure. See, *e.g.,* ND Cal Local Bankr R 8006-1—8011-1; CD Cal Local Bankr R 8001-1—8014-1; ED Cal Local Bankr R 8020-1. The bankruptcy appellate panel has also adopted local rules, which are available on the panel's website given above.

An appeal from a final decision by either the district court or the bankruptcy appellate panel is taken to the circuit court of appeals. 28 USC §158(d).

BAPCPA (see §11.1) adds a procedure for direct appeal of a bankruptcy court decision to the circuit court of appeals, subject to its consent, on certification of any of the following (see 28 USC §158(d)(2)):

- The decision involves a question of law about which there is no controlling decision in the circuit or by the Supreme Court, or the decision involves a matter of public importance;
- The decision involves a question of law that requires resolution of conflicting decisions; or
- An immediate appeal may materially advance the underlying case.

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§11.149 D. Mootness as Grounds for Dismissal

Mootness poses particular difficulties in bankruptcy appeals because the contested decision often involves multiple parties or authorizes actions that are difficult to unwind if an appeal is successful. As a result, if an appellant fails to obtain a stay during the pendency of an appeal, the appeal may be dismissed as moot.

Unless the bankruptcy court orders otherwise, an automatic 14-day stay applies to many decisions of the bankruptcy court. See, *e.g.,* Fed R Bankr P 3020(e) (order confirming Chapter 11 plan), 4001(a)(3) (stay relief order), 6004(h) (order authorizing use, sale, or lease of property), 7062 (on actions to enforce judgment in adversary proceeding, 10-day stay applies). These rules are designed to give an aggrieved party an opportunity to seek a stay during the full pendency of the appeal. A motion for such a stay must first be brought before the bankruptcy court that issued the disputed decision. Fed R Bankr P 8005. If the motion is denied or if a party seeks to contest a stay order, recourse may be had to the district court or bankruptcy appellate panel, whichever is hearing the appeal. Fed R Bankr P 8005.

On various standards for granting stay pending appeal, compare *In re General Credit Corp.* (SD NY 2002) 283 BR 658 (applying "substantial possibility" of success on merits test) with *Lutin v U.S. Bankruptcy Court (In re Advanced Mining Sys., Inc.)* (SD NY 1994) 173 BR 467 (applying "strong likelihood" of success on merits test) and *In re Crosswinds Assocs.* (SD NY, June 25, 1996, No. 96 Civ 4572) 1996 US Dist Lexis 8882 (following *Lutin* and denying stay pending appeal of order granting lender relief from automatic stay).

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§11.150 1. Appeals From Asset Sale Orders

A party that appeals from an order authorizing a sale of property must obtain a stay pending appeal or the appeal will become moot if the purchaser acted in good faith. See 11 USC §363(m). To ensure that §363(m) applies, counsel should request that the court make an express finding that the purchaser acted in good faith. See *T.C. Investors v Joseph (In re M Capital Corp.)* (BAP 9th Cir 2003) 290 BR 743 (factual record must support good faith finding); *Thomas v Namba (In re Thomas)* (BAP 9th Cir 2002) 287 BR 782. Moreover, because facts showing that the buyer did not act in good faith often surface later, a bankruptcy court may decline to make a good faith finding at the time of the sale. *Thomas v Namba, supra*.

Even if no good faith finding is made, the sale may be protected by mootness principles. The Ninth Circuit has repeatedly ruled that failure to obtain a stay pending appeal from an order permitting a sale of a debtor's assets, or from an order granting relief from the automatic stay to permit such a sale, moots the appeal regardless of whether the purchaser has taken irreversible steps following the appeal or whether the buyer—which is often the secured creditor—is a party to the appeal. *National Mass Media Telecommunication Sys. v Stanley (In re Nat'l Mass Media Telecommunication Sys.)* (9th Cir 1998) 152 F3d 1178; *Onouli-Kona Land Co. v Estate of Richards (In re Onouli-Kona Land Co.)* (9th Cir 1988) 846 F2d 1170. This rule has been extended to the appeal of an order confirming a secured creditor's plan and the subsequent auction sale of the debtor's sole asset under the plan. *Vista Del Mar Assocs. v West Coast Land Fund (In re Vista Del Mar Assocs.)* (BAP 9th Cir 1995) 181 BR 422.

There are two recognized exceptions to the mootness rule regarding property sales. The first applies when the debtor has a statutory right of redemption, and the second when other state law would permit the sale to be set aside. *Ewell v Diebert (In re Ewell)* (BAP 9th Cir 1992) 958 F2d 276, 280.

In addition to the exceptions mentioned above, the mootness rule of 11 USC §363(m) is limited by its express terms, according to Ninth Circuit authority. In *Clear Channel Outdoor, Inc. v Knupfer (In re PW, LLC)* (BAP 9th Cir 2008) 391 BR 25, the bankruptcy appellate panel held that the mootness rule does not apply to lien-stripping under 11 USC §363(f) because §363(m) only applies to sales and leases. Thus, a nonconsenting creditor may appeal a bankruptcy court order authorizing a sale of property free and clear of the creditor's lien under §363(f) even after the sale to a good faith purchaser. But see *Official Comms. of Unsecured Creditors v Anderson Senior Living Prop., LLC (In re Nashville Senior Living, LLC)* (BAP 6th Cir 2009) 407 BR 222.

Unless the court orders otherwise, the effectiveness of an order authorizing the use, sale, or lease of property (other than cash collateral) is automatically stayed for 10 days. Fed R Bankr P 6004(h). This gives an aggrieved party an opportunity to seek a stay pending appeal to avoid having the appeal mooted.

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§11.151 2. Appeals From Plan Confirmation Orders

Absent a stay during the pendency of the appeal, an appeal from a plan confirmation order may be dismissed as moot if the plan has been "substantially culminated." *Baker & Drake, Inc. v Public Serv. Comm'n (In re Baker & Drake, Inc.)* (9th Cir 1994) 35 F3d 1348. Mootness in the plan confirmation context derives from the fact that it is difficult to "unscramble the eggs" after implementation of a plan begins. It is appellant's burden to obtain a stay if postconfirmation events could render the appeal moot. *Ederel Sport, Inc. v Gotcha Int'l L.P. (In re Gotcha Int'l L.P.)* (BAP 9th Cir 2004) 311 BR 250.

Failure to obtain a stay may not be fatal, even when it is no longer possible for the appellate court to restore the parties to the positions they previously occupied, if the court can fashion some form of meaningful relief. See *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)* (BAP 9th Cir 2003) 293 BR 489 (plan appeal not moot if effective relief can be fashioned by modifying payments to creditor provided by plan); *Platinum Capital, Inc. v Sylmar Plaza, LP (In re Sylmar Plaza, LP)* (9th Cir 2002) 314 F3d 1070, 1074 (plan appeal not moot if appealing creditor has monetary claim against solvent debtor); *Lowenschuss v Selnick (In re Lowenschuss)* (9th Cir 1999) 171 F3d 673 (appeal not moot if transactions are not complex or difficult to unwind; court granted effective relief by simply ordering return of plan payments received by appealing creditor); *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284 (appeal not moot despite transfers of certain property); *Connecticut Gen. Life Ins. Co. v Hotel Assocs. (In re Hotel Assocs.)* (BAP 9th Cir 1994) 165 BR 470 (appeal not moot despite full payment to four classes of creditors before stay obtained, because creditors would have been paid under either of competing plans). However, if the appeal would directly and materially have an impact on the vested rights of third parties under the plan, then the appeal is moot absent a stay. *Ederel Sport, Inc. v Gotcha Int'l L.P. (In re Gotcha Int'l L.P.), supra* (appellant proposed delaying payments to members of another creditor class but third parties had made financing commitments based on that stream of payments).

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§11.152 3. Appeals From Borrowing Orders

A party appealing from an order that authorizes either a borrowing or the granting of a lien must obtain a stay pending appeal. If a stay is not obtained, a reversal or modification of the order on appeal will not affect the validity of the borrowing or the lien if the lender extended the credit in good faith. See 11 USC §364(e); *Weinstein, Eisen & Weiss, LLP v Gill (In re Cooper Commons, LLP)* (9th Cir 2005) 430 F3d 1215 (finding of good faith was supported by evidence of need for additional financing to complete building, analysis of amount necessary to complete work, and parties' beliefs that loan was negotiated at arm's length and promoted best interests of estate and creditors); *Sulmeyer v Karbach Enters. (In re Exennium, Inc.)* (9th Cir 1983) 715 F2d 1401. To ensure that §364(e) applies, counsel for the lender should request that the court make an express finding that the lender acted in good faith. See *New York Life Ins. Co. v Revco D.S., Inc. (In re Revco D.S., Inc.)* (6th Cir 1990) 901 F2d 1359.

WARNING: The statutory mootness rule codified in §364(e) does not protect authorized loans not yet funded. *Transamerica Commercial Fin. Corp. v Citibank, N.A. (In re Sun Runner Marine, Inc.)* (9th Cir 1991) 945 F2d 1089, 1095. This limitation is particularly important if revolving financing is contemplated.

Another decision, *Resolution Trust Corp. v Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.)* (3d Cir 1994) 16 F3d 552, undermines the clarity of the safe harbor that §364(e) affords. In *Swedeland*, the Third Circuit held that an appeal from a borrowing order should not be dismissed as moot if the appellate "court can fashion *some* form of meaningful relief" (quoting from *Church of Scientology v U.S.* (1992) 506 US 9, 121 L Ed 2d 313, 319, 113 S Ct 447), even if it only partially satisfies the prevailing party and cannot return the parties to their exact original positions. 16 F3d at 560.

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Lender and Broker Liability

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I. THEORIES OF LIABILITY

§12.1 A. Introduction

This chapter was written for lenders and their agents, including loan brokers and loan servicers, as well as for borrowers. Lender liability is one of the largest concerns of the real property secured lender. Lenders must anticipate and take steps to protect themselves from lender liability exposure in virtually all aspects of real property financing, from first discussions with potential borrowers to defending postforeclosure legal actions. This chapter discusses in detail potential lender and broker liability for different phases of loan transactions and will assist lenders' counsel in helping their clients avoid many situations that may create liability. These discussions, strategies, and practice tips are in the following sections:

- Lender liability in loan origination (see §§12.27-12.49);
- Predatory lending (see §§12.50-12.116);
- Lender liability in loan administration (see §§12.117-12.127);
- Lender liability in loan workouts (see §§12.128-12.137);
- Lender liability during foreclosure (see §§12.138-12.154); and
- Lender liability after foreclosure (see §§12.155-12.160).

California and federal courts have implemented the statutory and common law legal theories underlying lender liability for some time; appellate decisions have also developed alternative theories that, together, make up the main thrust of the attacks by borrowers against the secured lender. For California transactions, the primary theories of lender liability are discussed in §§12.2-12.11. Borrowers' counsel should fully understand the law underpinning these primary theories before contemplating any of the secondary (developing) theories of liability because the established theories often may be combined with one or another (or all) of them in a single action against a lender. The developing theories of lender liability in California are discussed in §§12.12-12.26. Predatory lending remedies for borrowers are covered in §§12.50-12.116. In addition, lenders are becoming increasingly exposed to statutory liability for environmental hazards (see §§12.131, 12.151-12.153).

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B. Primary Theories of Lender Liability

§12.2 1. Breach of Contract

Perhaps the most frequently asserted of the primary theories of liability is breach of contract. An agreement is the basis of every lending relationship, so the prevalence of these breach of contract actions should be expected.

WARNING: Reviewing all loan documentation is essential. An action may fail if the borrower sues the lender on a contract that has been superseded by another contract. See, *e.g., U.S. Hertz, Inc. v Niobrara Farms* (1974) 41 CA3d 68, 116 CR 44. On workouts and loan modification processes, see chaps 7, 10.

Other related areas in breach of contract actions are the implied covenant of good faith and fair dealing, which is implied in every contract, the declining availability of tort damages in cases alleging a bad faith breach of the implied covenant, and torts based on control and interference. These theories are examined in §§12.12-12.26.

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§12.3 a. Contract Claim Theories

A breach of contract cause of action has been asserted by borrowers against lenders in a number of contexts, including the following:

- Breach of a loan commitment (*Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162; *999 v C.I.T. Corp.* (9th Cir 1985) 776 F2d 866);
- Refusal to advance funds (*K.M.C. Co. v Irving Trust Co.* (6th Cir 1985) 757 F2d 752);
- Failure to exercise discretion properly when enforcing terms of a contract (violation of duties of good faith and fair dealing in setting charges) (*Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 216 CR 345);
- Wrongful acceleration and demand enforcement actions (*Sahadi v Continental Ill. Nat'l Bank & Trust Co.* (7th Cir 1983) 706 F2d 193; *Brown v Avemco Inv. Corp.* (9th Cir 1979) 603 F2d 1367);
- Failure to provide adequate notice prior to a material change in conduct of lender or enforcement (*K.M.C. Co. v Irving Trust Co., supra*); and
- Failure to provide new financing or to restructure the terms of an existing loan (*Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735).

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§12.4 b. Oral Contracts

Many lender liability cases involve a breach by the lender in which the alleged contract is oral. Courts scrutinize the formation of such contracts, requiring strict proof that an enforceable contract was formed and that all of the conditions precedent have been satisfied. See §§12.33-12.35 on application of Statute of Frauds and parol evidence rules to loan commitments. See §12.134 on defenses to oral statements in context of loan workouts or restructuring agreements.

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§12.5 2. Fraud

California statutes address fraud both as a tort and as an aspect of contract law. The basic tort of fraud is also called "deceit." Civil Code §1709 provides:

> One who willfully deceives another with intent to induce him to alter his position to his injury or risk, is liable for any damage which he thereby suffers.

Deceit, within the meaning of CC §1709, can take any of these forms (CC §1710):

> 1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
> 2. The assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true;
> 3. The suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact; or
> 4. A promise, made without any intention of performing it.

There are two types of fraud in the context of making and enforcing contracts: actual fraud and constructive fraud.

- **Actual fraud.** Civil Code §1572 sets forth four basic types of actual fraud: (1) intentional misrepresentation, (2) negligent misrepresentation, (3) concealment, and (4) a promise without any intention of performing it.
- **Constructive fraud.** Civil Code §1573 provides:

> Constructive fraud consists:
> 1. In any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or any one claiming under him, by misleading another to his prejudice, or to the prejudice of any one claiming under him; or
> 2. In any such act or omission as the law specially declares to be fraudulent, without respect to actual fraud.

Fraud is a frequently pleaded cause of action in lender liability suits, particularly in "predatory lending" situations. See, *e.g., Phleger v Countrywide Home Loans, Inc.* (ND Cal, Mar. 3, 2009, No. C 07-01686) 2009 US Dist Lexis 17419 (upheld TRO to enjoin trustee sale; discussed application of federal and state remedies). See generally §§12.50-12.116. The forms of fraud described above may be pleaded against lenders (and when facts indicate a high level of knowledge of or involvement in the lending process, their lenders, underwriters, and assignees) with regard to loan origination, loan administration, or loan workouts. See, *e.g., Henry v Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)* (9th Cir 2006) 471 F3d 977; *River Colony Estates Gen. Partnership v Bayview Fin. Trading Group* (SD Cal 2003) 287 F Supp 2d 1213; *Auerbach v Great W. Bank* (1999) 74 CA4th 1172, 88 CR2d 718, discussed in §§12.129, 12.133; *Kruse v Bank of America* (1988) 202 CA3d 38, 248 CR 217, discussed in §§12.10, 12.28, 12.36, 12.47, 12.120, 12.134, 12.149. However, constructive fraud is a separate theory: the borrower's assertion that the lender is a fiduciary of the borrower by virtue of the lender-borrower relationship. See §§12.13-12.17.

Class action cases arising out of "subprime" market predatory lending practices have shown limited success with "aiding and abetting" claims against those who have assisted predatory lenders and kept them in business. A jury verdict against a lender who financed and underwrote such a predatory lender was largely upheld in *Henry v Lehman Commercial Paper, Inc., supra*. Although the court approved the class plaintiffs' use of an aiding and abetting fraud theory, the court also reversed the jury verdict on the damages calculation issue and adopted a more conservative measure of recovery.

Closely related to breach of contract is promissory fraud. See, *e.g., Warren v Merrill* (2006) 143 CA4th 96, 49 CR3d 122, discussed in §12.15. The supreme court reaffirmed that a judgment for promissory fraud will support damages in tort, including emotional distress and punitive damages. See *Lazar v Superior Court* (1996) 12 C4th 631, 49 CR2d 377. In loan transactions, complaints for promissory fraud typically allege that the lender made a promise to restructure a loan, without intending to perform, to induce the borrower to grant additional collateral or take other actions that would benefit the lender at the expense of the borrower. Oral communications between the parties that directly contradict

language in the deed of trust, coupled with conflicting provisions in the note and deed of trust, may support a cause of action for promissory fraud. See, *e.g., Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162. Although these cases are always fact specific, appellate courts are paying increased attention to the essential elements of the tort, particularly causation and justifiable reliance.

EXAMPLE: In *Runnemede Owners, Inc. v Crest Mortgage Corp.* (7th Cir 1988) 861 F2d 1053, the court found that a borrower was not justified in relying on the loan officer's boastful statements that loan committee approval of a proposed loan was merely a formality, because they flatly contradicted the express terms of the written commitment letter. Similarly, in *Delcon Group, Inc. v Northern Trust Corp.* (Ill App 1989) 543 NE2d 595, the court held as a matter of law that the plaintiff was not entitled to rely on an oral promise to make a loan, because the parties had not agreed on the essential loan terms.

A lending officer's fraudulent and unauthorized representations to lend at an interest rate lower than that contained in the signed loan documents may subject the loan to rescission under the federal Truth in Lending Act (TILA) (15 USC §§1601-1667f), discussed in §12.59. See §§7.36, 8.33, 8.46. See also *Grimes v New Century Mortgage Corp.* (9th Cir 2003) 340 F3d 1007.

PRACTICE TIP: Rescission or cancellation is an alternative remedy to damages in fraud actions brought under California law and may be a viable alternative to rescission under TILA, on which the courts strictly apply the 3-year statute of limitations. See §12.63A. In fraud actions brought under California law, the statute of limitations is tolled until the plaintiff discovers the fraud. See CCP §337(3); *Alfaro v Community Hous. Improvement Sys. & Planning Ass'n* (2009) 171 CA4th 1356, 89 CR3d 659. See also CCP §338(d).

See §§12.33-12.35 on oral commitments in loan transactions. See §12.134 on liability for negligently made oral misrepresentations during workout negotiations. For extensive discussion of actionable fraud in real property transactions under California statutory and common law, including remedies such as recoverable damages as well as rescission, reformation, or cancellation of instruments, see California Real Property Remedies and Damages, chaps 1-3, 6 (2d ed Cal CEB 2002).

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§12.6 3. Duress

In some jurisdictions, duress is receiving significant attention as a basis for lender liability. See, *e.g., State Nat'l Bank v Farah Mfg. Co.* (Tex App 1984) 678 SW2d 661. In California, duress consists of the unlawful confinement or detention of a person or property. CC §1569. Menace is a threat of duress or of injury to the person, property, or character of another. CC §1570. Apparent consent is not real or free when it is obtained through duress or menace. CC §1567.

Duress can occur without threat of bodily harm; it may take the form of threats to reputation or to business or property interests. *Leeper v Beltrami* (1959) 53 C2d 195, 1 CR 12 (threat to take legal action to foreclose on mortgage on basis of claim defendant knew was false). See *Goldstein v Enoch* (1967) 248 CA2d 891, 57 CR 19 (threat to reputation).

Duress may serve as a last resort to correct aberrations when conventional remedies are not available. Thus, in *San Diego Hospice v County of San Diego* (1995) 31 CA4th 1048, 37 CR2d 501, the court held that it would apply the theory of "economic duress" only in limited circumstances and as a last resort, and it declined to set aside a release given by a purchaser to a seller of land with unknown contamination. See *Rich & Whillock, Inc. v Ashton Dev., Inc.* (1984) 157 CA3d 1154, 204 CR 86 (duress found in coercive action taken by developer to force settlement agreement and release from grading contractor).

Duress is also alleged by borrowers to negate lenders' defenses based on the terms of the contract (*i.e.,* no borrower consent to terms of contract because of duress or coercion). Duress is further used by borrowers to defend against lender counterclaims, such as that the *borrower* breached the covenant of good faith and fair dealing.

For further discussion of duress and menace in the real property litigation context, including recoverable damages as well as rescission, reformation, or cancellation of instrument remedies, see California Real Property Remedies and Damages, chaps 1-3, 6 (2d ed Cal CEB 2002).

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§12.7 4. Negligence

Lenders can be held liable for simple negligence in California. A seminal case is *Connor v Great W. Sav. & Loan Ass'n* (1968) 69 C2d 850, 73 CR 369. In *Connor*, the lender failed to properly supervise construction of a project it had financed. Because the lender became an active participant in the construction enterprise of the borrower, it was held liable for its own negligence in exercising its powers of control over the enterprise. The lender's conduct had gone beyond that of the usual money lender in its involvement with the project, and the borrower and the lender consequently became liable to third parties (purchasers of defective tract houses). See further discussion of *Connor* in §§12.25, 12.125.

A construction lender may also be liable to the borrower and to the surety for negligently disbursing funds. In *Commercial Standard Ins. Co. v Bank of America* (1976) 57 CA3d 241, 129 CR 91, a surety successfully argued that the lender should be held liable for making disbursements in excess of the project's stage of completion because, on default, there were insufficient construction loan proceeds to complete the project.

The pivotal issue in negligence cases by borrowers against lenders who make inappropriate and insupportable loans is whether the lender owed a duty of care to the borrower to refrain from making the unsuitable loan. The case law on such a duty of care continues to reflect ambivalence on the part of courts. The fundamental issue is whether lenders are to any extent obligated to decline to make risky loans, at least to certain borrower populations such as the elderly, non-English speakers, or the poor or unsophisticated. For example, compare *Jacques v First Nat'l Bank* (Md Ct App 1986) 515 A2d 756 (when bank begins to process loan application, bank owes customer duty of reasonable care in processing application; failure to follow federal loan underwriting guidelines breaches that duty) with *Biggs v Eaglewood Mortgage, LLC* (D Md 2008) 582 F Supp 2d 707 (elderly couple who had refinanced home ten times in 28 years could not prove reasonable reliance on lender's misrepresentations of adjustable-rate loan terms; court dismissed RICO (Racketeer Influenced and Corrupt Organizations Act), fraud, and negligent misrepresentation claims). The social and economic cost of the "subprime" mortgage crisis in 2008 to unsuspecting assignees of the loan as well as to borrowers suggests that such a duty might be recognized.

A lender acting within the scope of its conventional activities as a lender of money, however, owes no duty of care to the borrower in preparing an appraisal of the security for the loan because the purpose of the appraisal is to protect the lender, not the borrower. *Nymark v Heart Fed. Sav. & Loan Ass'n* (1991) 231 CA3d 1089, 283 CR 53 (borrower not allowed to bring negligence claim against lender after discovering after close of loan that property needed repairs). *Nymark* was distinguished and held inapposite to a claim of negligent misrepresentation (as distinct from simple negligence) in a recent unpublished case, *Lowes v Hill & Co. Real Estate* (ND Cal, Feb. 23, 2006, No. 04-4854 SC) 2006 US Dist Lexis 10152. However, the distinction drawn by the *Lowes* court may be more theoretical than real, given that the court ultimately concluded that the lender had not intended to induce the borrower's reliance on the appraisal and that it would be difficult to see why any lender would intend to induce such reliance. Intent to induce reliance is an essential element of a claim for negligent misrepresentation. However, for the protection of both the borrower and the federal government, a lender is accountable for the quality of appraisals on real property securing federally insured mortgages under 24 CFR §§25.6(ee) and 203.5(e).

A lender's breach of contract does not necessarily support a negligence action against the lender. In California, contract and tort are different branches of law. *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 683, 254 CR 211. Conduct amounting to a breach of contract is tortious only when it also constitutes promissory fraud or violates an independent duty arising under tort law. See *Lazar v Superior Court* (1996) 12 C4th 631, 49 CR2d 377; *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 515, 28 CR2d 475. In *North Am. Chem. Co. v Superior Court* (1997) 59 CA4th 764, 69 CR2d 466, the court held that a contract to provide services (in contrast to one for the sale of goods) gives rise to a duty of care, which requires that the services be performed in a competent and reasonable manner and that a negligent failure to do so may be both a breach of contract and a tort. 59 CA4th at 774.

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§12.8 5. Conversion

In California, conversion is the wrongful exercise of dominion over the personal property of another. *Gruber v Pacific States Sav. & Loan Co.* (1939) 13 C2d 144, 88 P2d 137. The property does not have to be taken and used by the defendant; it can be destroyed or merely damaged. See *Staley v McClurken* (1939) 35 CA2d 622, 96 P2d 805. A lender may incur lender liability sounding in conversion if it wrongfully repossesses security. *Varela v Wells Fargo Bank* (1971) 15 CA3d 741, 93 CR 428. However, where *no* personal property collateral is involved, a conversion action will not lie. (See discussion of wrongful foreclosure of real property in §§12.139-12.149.)

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§12.9 6. Defamation

In California, "defamation" is defined as an invasion of the interest in reputation. To be defamatory, a statement must be false. *Francis v Dun & Bradstreet, Inc.* (1992) 3 CA4th 535, 4 CR2d 361. Borrowers may recover for damage to their reputation. Defamation can be in the form of libel or slander. CC §44. "Libel" is defined by CC §45 as

> false and unprivileged publication by writing, printing … which exposes any person to hatred, contempt, ridicule, or obloquy, or which causes him to be shunned or avoided, or which has a tendency to injure him in his occupation.

"Slander" is defined by CC §46 as a "false and unprivileged publication, orally uttered, and also communications by radio or any mechanical or other means," which

> [t]ends directly to injure [a person] in respect to his office, profession, trade or business, either by imputing to him general disqualification in those respects which the office or other occupation peculiarly requires, or by imputing something with reference to his office, profession, trade, or business that has a natural tendency to lessen its profits

or that "by natural consequence, causes actual damage."

Libel and slander are intentional torts; therefore, the defendant must have intended the publication. But malice or actual ill will is not an element of defamation.

A lender's disparaging remarks about a manager's competency to conduct the affairs of a borrowing company could constitute libel or slander. See *Stoneking v Briggs* (1967) 254 CA2d 563, 62 CR 249 (involving newspaper report about labor union managers).

A qualified privilege exists for a lender who does not act maliciously to exchange credit information. CC §47(c). However, a lender could be liable for furnishing false information that is *too* favorable to the borrower. *Central States Stamping Co. v Terminal Equip. Co.* (6th Cir 1984) 727 F2d 1405. For an example of similar "Pollyannaish" referral exposure, see *Lease & Rental Mgmt. Corp. v Arrowhead Cent. Credit Union* (2005) 126 CA4th 1052, 24 CR3d 483 (finding no basis for liability when lender gives "subjective" opinion of borrower's creditworthiness).

Under CC §2924, the mailing, publication, and delivery of notices and the "performance of the procedures" for a nonjudicial foreclosure are "privileged communications" under CC §47. Civil Code §2924(b) also provides the trustee with limited immunity for acts taken in good faith reliance on information provided in good faith by the beneficiary. This language seems to suggest that the trustee's protection against liability must be based not only on its own good faith but also on the good faith of the beneficiary. It seems more likely that the language is intended to allow the trustee to rely on plausible information from the beneficiary that the trustee has no reason to disbelieve.

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§12.10 7. Infliction of Emotional Distress

California requires five elements for an action for intentional infliction of emotional distress (*Cervantez v J.C. Penney Co.* (1979) 24 C3d 579, 593, 156 CR 198):

(1) Extreme and outrageous conduct by the defendant.

(2) Such conduct was intended or done in reckless disregard of the probability of causing severe emotional distress.

(3) The plaintiff in fact suffered severe emotional distress.

(4) The distress was proximately caused by the defendant's conduct.

(5) The defendant's conduct was unprivileged.

Borrowers can bring actions against lenders for emotional distress caused by the lender's intentional or reckless conduct that it should have known would cause such distress. See, *e.g.*, *Sanchez-Corea v Bank of America* (1985) 38 C3d 892, 215 CR 679; *Kendall Yacht Corp. v United Cal. Bank* (1975) 50 CA3d 949, 123 CR 848. See also *Gaffney v Downey Sav. & Loan Ass'n* (1988) 200 CA3d 1154, 246 CR 421. The intentional or reckless conduct must be outrageous and the distress must be severe, or recovery will be denied. *Kruse v Bank of America* (1988) 202 CA3d 38, 248 CR 217; *Commercial Cotton Co. v United Cal. Bank* (1985) 163 CA3d 511, 209 CR 551.

A claim for negligent infliction of emotional distress can be stated in California under one of two theories:

(1) Plaintiff is a bystander who observes injury to a family member (*Bird v Saenz* (2002) 28 C4th 910, 123 CR2d 465; *Dillon v Legg* (1968) 68 C2d 728, 69 CR 72).

(2) Plaintiff is a "direct victim" of a defendant's negligence (*Molien v Kaiser Found. Hosps.* (1980) 27 C3d 916, 167 CR 831).

Although the supreme court reiterated that damages for mental suffering and emotional distress are generally not allowed in contract actions (see *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 28 CR2d 475), it recognized that such damages, along with punitive damages, are recoverable in promissory fraud actions (see *Lazar v Superior Court* (1996) 12 C4th 631, 49 CR2d 377). Negligent infliction of emotional distress has not been recognized in California as a source of liability in a commercial financing context. See, *e.g., Sutherland v Barclays Am./Mortgage Corp.* (1997) 53 CA4th 299, 61 CR2d 614. In *Sutherland*, the plaintiff pleaded *negligent* infliction of emotional distress when the lender demanded payment of three monthly payments at the end of a 3-month forbearance period. The court held that the claim was not a tort claim but remained a breach of contract claim. As such, it did not permit a recovery of damages for emotional distress. However, the court implied that plaintiff could have stated a cause of action in tort if she had alleged an *intentional* infliction of emotional distress. 53 CA4th at 317 n9.

The courts do occasionally allow actions against lenders for emotional distress under other circumstances. See, *e.g., Green v Rancho Santa Margarita Mortgage Co.* (1994) 28 CA4th 686, 33 CR2d 706 (lender could be held liable for emotional distress caused by discriminatory failure to lend on basis of race). In *Pintor v Ong* (1989) 211 CA3d 837, 259 CR 577, the beneficiary under a deed of trust was found liable in tort for emotional distress damages arising from the beneficiary's wrongful refusal to reconvey a deed of trust. In reaching this result, the court noted that CC §2941(d) specifically provides that anyone who violates CC §2941 (which requires the beneficiary to reconvey the deed of trust on payment of the underlying debt) is liable "for all damages which [the trustor] may sustain by reason of such violation." 211 CA3d at 840.

By contrast, in *Panagotacos v Bank of America* (1998) 60 CA4th 851, 70 CR2d 595, the appellate court upheld summary judgment in favor of the lender-beneficiary on the trustors' complaint for damages for infliction of emotional distress under CC §2941. The court found that because the lender had reconveyed its deed of trust within a few days of the trustors' demand, the trustors had not established such egregious delay as to constitute the proximate cause of their failure to close a purchase of new property, which was the basis for their claim for emotional distress. The statutory penalty for the technical violation was upheld. See §12.126.

For a current review of California law on negligent infliction of emotional distress, see *Erlich v Menezes* (1999) 21 C4th 543, 87 CR2d 886 (supreme court denied homeowners recovery for emotional distress damages for negligent

construction because they suffered only economic and property damage—not personal injury—and no independent tort duty was breached). For more on *Erlich*, the "economic loss rule," and the subject of actionable tort in a breach of contract context, see *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352. The supreme court's extensive discussion seems to presage an easing of more restrictive versions of the economic loss rule.

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§12.11 8. Potential Statutory Liability: Summary of Federal and State Law

In both federal and California law, numerous statutory bases for lender liability can be asserted by borrowers against their lenders, including the following:

- *Environmental hazards.* In certain cases, a lender can become liable for the costs of cleaning up contaminated property. See §§12.151-12.153.
- *Securities laws.* Investors in a failed enterprise often seek to charge lenders with securities law violations committed by the borrower. One frequently asserted theory is that the lender was a "control person" under §15 of the Securities Act of 1933 (15 USC §77o) and under §20(a) of the Securities Exchange Act of 1934 (15 USC §78t(a)). Another theory is that the lender "aided and abetted" its borrower in violating the securities laws.
- *Antitrust laws.* When the lender is a state or national bank, the practitioner should consider whether the antitying provisions of 12 USC §1972 or the Sherman Act (15 USC §§1-7) are applicable. See *B.C. Recreational Indus. v First Nat'l Bank* (1st Cir 1981) 639 F2d 828 (appropriate traditional banking practices do not violate antitying provisions).
- *Bankruptcy laws.* A lender who becomes overly involved in the management of its borrower's affairs risks being treated as an "insider" in a case brought under the bankruptcy laws. 11 USC §101(31). The consequences of becoming an insider include (1) an extended period during which payments to the lender may be attacked as preferential (11 USC §547(b)(4)(B)) and (2) strict court scrutiny of the dealings between the borrower and the lender. *Pepper v Litton* (1939) 308 US 295, 84 L Ed 281, 60 S Ct 238. If the lender's conduct is found to have been inequitable, the bankruptcy court may also subordinate the lender's claim to the claims of other creditors. 11 USC §510(c). For further discussion, see chaps 7, 11.
- *Truth in lending laws.* The Truth in Lending Act (TILA) (15 USC §§1601-1667f), together with Regulation Z (12 CFR pt 226), requires lenders to make detailed disclosures to borrowers in consumer credit transactions. These provisions apply to loans secured by residential real property. Failure to comply with the disclosure requirements can support a rescission or cause a lender to be liable for both damages and statutory penalties. 15 USC §§1635, 1640. Debtor's counsel needs to be mindful of the relatively short 1-year limitations period for a private right of action under TILA for statutory damages (*Pacific Shore Funding v Lozo* (2006) 138 CA4th 1342, 42 CR3d 283) and that this period will typically begin to run on the execution of the loan documents (*Meyer v Ameriquest Mortgage Co.* (9th Cir 2003) 331 F3d 1028, amended and superseded on denial of rehearing, 342 F3d 899). The statute of repose for rescission under TILA is 3 years. 15 USC §1635(f); 12 CFR §§226.15(a)(3), 226.23(a)(3). Attorney fees are available under TILA. 15 USC §1640(a)(3). For extensive discussion of TILA and Regulation Z, see §§12.59-12.73. See also chaps 7-9.

NOTE: At the time of publication, HR 1106, 111th Cong, 1st Sess (2009) and S 61, 111th Cong, 1st Sess (2009) are pending before the United States Congress to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence. Proposed language also may provide additional remedies for violations of TILA or other consumer statutes. Counsel for all parties in interest—debtors, lenders, bankruptcy trustees, trustors, beneficiaries, trustees, and foreclosure trustees, as well as such entities as MERS—must be aware of the impact that the passage of such legislation may have on their clients' rights and remedies. For further information, go to http://www.govtrack.us/congress/bill.xpd?bill=h111-1106 and http://www.govtrack.us/congress/bill.xpd?bill=s111-61.

- *Loan settlement fees and procedures law.* Under the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617), a lender that charges the borrower substantially more than it pays to the provider of loan services, such as wire transfers, tax services, and underwriting, may be liable for violating RESPA's prohibitions on kickbacks and unearned fees. *McKell v Washington Mut., Inc.* (2006) 142 CA4th 1457, 49 CR3d 227. But borrowers and borrower classes have sought (unsuccessfully) to use the antikickback provisions of

RESPA to challenge yield spread premiums (YSPs) and service release premiums (SRPs) paid to loan brokers in connection with mortgage-secured loans. *Bjustrom v Trust One Mortgage Corp.* (9th Cir 2003) 322 F3d 1201; *Byars v SCME Mortgage Bankers, Inc.* (2003) 109 CA4th 1134, 135 CR2d 796. See Bernhardt, *The Yield Spread Premium Controversy,* 25 CEB Real Prop L Rep 128 (May 2002). Attorney fees are available under RESPA. 12 USC §2607(d). For further discussion of RESPA, see §§12.74-12.83.

- *Equal credit opportunity laws.* The Equal Credit Opportunity Act (15 USC §§1691-1691f) prohibits discrimination against any loan applicant on the basis of race, color, religion, national origin, sex, marital status, or age. This act applies to both consumer and business loans. See §§12.28-12.29.
- *Elder Abuse Act* (Welf & I C §§15600-15660). Because of the enhanced and often punitive remedies that they make available, California's elder abuse laws are increasingly being invoked, particularly in cases involving reverse mortgages, "life care" arrangements, foreclosure "rescue" schemes, and other types of equity-stripping and predatory lender conduct. See, *e.g., Wood v Jamison* (2008) 167 CA4th 156, 83 CR3d 877; *Labrador v Seattle Mortgage Co.* (ND Cal, Oct. 29, 2008, No. 08-2270 SC) 2008 US Dist Lexis 90698.
- *Other federal civil rights laws.* Borrowers and would-be borrowers may pursue claims against lenders or their agents under other civil rights provisions of the United States Code, in particular 42 USC §1982, when the lender is an agency of local or state government (or a private party acting as an agent for such a public entity) acting under color of local or state law. For an example of this theory of liability after foreclosure by a city housing agency and a county, see *Dodge v Johnson* (9th Cir 2004) 92 Fed Appx 404 (unpublished opinion) (lender's policy of not selling back after foreclosure to borrower who had defaulted).
- *Tax laws.* Lenders who are lending money for the borrower's payroll can be held liable for a portion of any unpaid withholding taxes. IRC §3505(b). Additionally, a lender that exerts significant control over its borrower risks becoming liable for *all* unpaid taxes. IRC §6672.
- *Labor laws.* When employees are left unpaid, the "hot goods" provisions of the Fair Labor Standards Act of 1938 (29 USC §215(a)) may prevent a creditor from foreclosing on its collateral. See *Citicorp Indus. Credit, Inc. v Brock* (1987) 483 US 27, 97 L Ed 2d 23, 107 S Ct 2694.
- *Commercial Code requirements to act in good faith.* Commercial Code §1304 imposes on every contract subject to the Uniform Commercial Code "an obligation of good faith in its performance and enforcement." The Code defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing" unless otherwise provided in Division 5 of the Commercial Code. Com C §1201(20).
- *California consumer loan protection laws.* Financial Code §§4970-4979.8 protect consumers against certain predatory lending practices. This law only covers residential real property secured loans in an amount less than or equal to the most current conforming loan limit for a single-family first mortgage established by the Federal National Mortgage Association and that meet additional criteria specified in Fin C §4970. Attorney fees are available under this law. Fin C §4978(a). For further discussion, see §12.56.
- *California Consumers Legal Remedies Act (CLRA)* (CC §§1750-1784). The CLRA provides consumer remedies for unlawful competition and unfair and deceptive trade practices. The case law continues to develop with regard to whether the CLRA applies only to the sale of goods and services or may also be applied to credit and mortgage transactions. Well-reasoned and recent cases can be found both applying and declining to apply the CLRA to real estate and real estate secured transactions and services relating to such transactions. Compare *McKell v Washington Mut., Inc.* (2006) 142 CA4th 1457, 49 CR3d 227, with *Knox v Ameriquest Mortgage Co.* (ND Cal 2005) Case No. 05-0240 SC, 2005 US Dist Lexis 40709, and *Labrador v Seattle Mortgage Co.* (ND Cal, Oct. 29, 2008, No 08-22270 SC) 2008 US Dist Lexis 90698. It is sufficiently likely that the CLRA does apply to mortgage transactions; the legislation should be reviewed as part of any comprehensive analysis of potential lender liability claims when unfair or deceptive practices appear to be involved. On additional remedies for unfair business practices, see §12.23.
- *Statutory and common law translation requirements*. Residential lenders who know that their borrowers do not speak English may have a duty to provide the borrowers with translation documents. *Reyes v Superior Court* (1981) 118 CA3d 159, 173 CR 267. But see *Nymark v Heart Fed. Sav. & Loan Ass'n* (1991) 231 CA3d 1089, 283 CR 53. This duty to provide translation documents in the major languages spoken in California (Chinese, Tagalog, Korean, Vietnamese, and Spanish) is recognized in California statutory law. See CC §1632.
- *Consumer Credit Reporting Agencies Act*. Civil Code §§1785.1-1785.36 protect consumers against, among other

things, inaccurate reports to credit reporting agencies. The statute applies to real property secured loans. See, *e.g., Hussey-Head v World Sav. & Loan Ass'n* (2003) 111 CA4th 773, 4 CR3d 171. Attorney fees are available under this Act. CC §1785.31.

- *California fair housing laws*. The California Fair Employment and Housing Act (FEHA) (Govt C §§12900-12996) expressly prohibits a landlord from using the *source* of income as a basis for rejecting a prospective tenant. Govt C §12955. A court of appeal interpreted this section to protect residential mortgage loan applicants. See *Sisemore v Master Fin., Inc.* (2007) 151 CA4th 1386, 60 CR3d 719. The *Sisemore* decision allowed an alternative cause of action under FEHA on allegations that the lender's policies had a disparate impact on women and families with children, and the court allowed another cause of action to proceed under the Unruh Civil Rights Act (CC §51).
- *California Residential Mortgage Lending Act*. Financial Code §§50000-50706 prohibit the charging of interest in excess of 1 day before the disbursement of loan proceeds in residential mortgage transactions. See Fin C §50204; CC §2948.5. Attempts at federal preemption of these provisions under the Depository Institutions Deregulation and Monetary Control Act of 1980 (Pub L 96-221, 94 Stat 132) have been unsuccessful. See, *e.g., Quicken Loans, Inc. v Wood* (9th Cir 2006) 449 F3d 944.
- *Racketeer Influenced and Corrupt Organizations Act (RICO)*. A lender's conduct in making, administering, or enforcing loans may constitute a pattern of "racketeering" activity subject to the provisions of RICO (18 USC §§1961-1968), including the treble damages provisions (18 USC §1964(c)). For further discussion, see §12.85.
- *Usury laws.* Although California's usury laws (*e.g.,* Cal Const art XV, §1) are subject to many exceptions (see, *e.g., Jones v Wells Fargo Bank* (2003) 112 CA4th 1527, 5 CR3d 835), the complicated nature of these provisions creates many pitfalls for the unwary lender (see Rabin & Brownlie, *Usury Law in California: A Guide Through the Maze,* 20 UC Davis L Rev 397 (1987)). A junior lienholder who pays off a senior lien to avoid foreclosure may not assert a claim for usury. *Roes v Wong* (1999) 69 CA4th 375, 81 CR2d 596. For further discussion, see California Real Estate Finance Practice: Strategies and Forms §§3.37-3.44 (Cal CEB 2000).

NOTE: Usury law does not govern credit sales. This exception was held to apply to a note given to settle a dispute over a purchase money obligation. *Ghirardo v Antonioli* (1994) 8 C4th 791, 35 CR2d 418. A "usury savings" clause stating that legally excessive interest will be deemed a reduction of principal can shield the nonexempt lender from penalties. *Smith v Miller (In re Dominguez)* (9th Cir 1993) 995 F2d 883 (applying California law). Usury savings clauses should not, however, be relied on as protection for intentional usury.

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§12.12 C. Developing Theories of Lender Liability

In lender liability cases, plaintiffs frequently group the primary theories (see §§12.2-12.11) in a single action against a lender together with one or another of developing theories (see §§12.12-12.26). Thus, another theory is often created by redefining and expanding the application of an existing theory. For example, constructive fraud is being increasingly asserted, with the lender alleged to be a fiduciary or quasi-fiduciary of the borrower if the lender has a special relationship with the borrower. See §§12.13, 12.119. Other theories being relied on in lender liability cases are breach of the covenant of good faith and fair dealing and wrongful control and interference, but these theories have limited application. See §§12.18-12.26.

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§12.13 1. Constructive Fraud on Basis of Fiduciary Duty

Constructive fraud is an old theory of liability. See CC §1573. See also §12.5. In a loan transaction, it may serve as the basis for liability if the borrower shows that the lender or its agent, such as a loan broker, is a fiduciary or quasi-fiduciary of the borrower. For further discussion, see §§12.14-12.17. See also §§12.87, 12.119. On available damages in breach of fiduciary duty actions, see §12.99.

NOTE: If the plaintiff is an elder or a dependent adult and the contract was obtained as a result of "financial abuse," as defined in Welf & I C §15610.30, in addition to compensatory damages and all other remedies provided by law, the plaintiff is entitled to recover attorney fees, litigation costs, and fees for the services of a conservator ad litem. If the plaintiff further shows by clear and convincing evidence that the defendant is guilty of recklessness, oppression, fraud, or malice, the plaintiff is also entitled to other enhanced remedies, including punitive damages. See Welf & I C §§15657-15657.5. For further discussion, see §§12.90-12.91, 12.102. See also California Elder Law Litigation: An Advocate's Guide, chap 6 (Cal CEB 2003).

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§12.14 a. When Loan Broker Acts as Fiduciary

Under general principles of agency and statutory real estate law, a fiduciary relationship may exist between a real estate loan broker and the borrower. See, *e.g., Buick v World Sav. Bank* (ED Cal 2008) 565 FS2d 1152; *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392 (broker's failure to orally disclose actual interest rate, late payment penalty, and correct amount of balloon payment was breach of fiduciary duty). See also *Stetler v Greenpoint Mortgage Funding, Inc.* (ED Cal, Jan. 23, 2008, No. 1:07cv0123 DLB) 2008 US Dist Lexis 4880 (refusing to extend *Wyatt* in transaction in which loan broker made no affirmative misrepresentations to borrower). Under the reasoning in *Wyatt*, a lender could become liable along with the loan broker if the lender or its authorized agents "directly ordered, authorized or participated in" the broker's tortious conduct. 24 C3d at 785.

An attorney acting as a loan broker who knowingly assists its client in becoming a party to an inappropriate or predatory loan may be liable for breach of fiduciary duty. See *Wood v Jamison* (2008) 167 CA4th 156, 83 CR3d 877, analyzed in Bernhardt, *Three Lessons for Lawyers,* 31 CEB Real Prop L Rep 188 (Nov. 2008).

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§12.15 b. When Lender Acts as Fiduciary

A private lender acting in a fiduciary capacity toward the borrower may be liable for constructive fraud. In *Warren v Merrill* (2006) 143 CA4th 96, 49 CR3d 122, the court ruled that a real estate broker was liable for both actual and constructive fraud because she lent money to her client for part of the downpayment, which she combined with her client's funds to purchase a home. She instructed the escrow company to put title in her own daughter's name and refused to convey title to the client as promised after the closing. The defrauded client was permitted to quiet title against the offending parties and recover damages, and the court also ruled that the absence of a written contract was not a defense when a fiduciary commits fraud. See California Real Property Remedies and Damages, chaps 3, 7, 15 (2d ed Cal CEB 2002).

Under general principles, a lender in an ordinary relationship with a borrower is not a fiduciary. See, *e.g., River Colony Estates Gen. Partnership v Bayview Fin. Trading Group* (SD Cal 2003) 287 F Supp 2d 1213. In *Rickel v Schwinn Bicycle Co.* (1983) 144 CA3d 648, 654, 192 CR 732, the court, stating that "parties to a contract, by that fact alone, have no fiduciary relationship toward one another," ruled that the contract in question, which provided for nonmutual profit as between the contracting parties, did not as a matter of law create a fiduciary relationship. 144 CA3d at 655. Moreover, the unilateral expectations of the borrower may not change this rule. A fiduciary relationship is not created simply because one places his or her trust in another. *Zumbrun v University of S. Cal.* (1972) 25 CA3d 1, 13, 101 CR 499.

In *Committee on Children's Television, Inc. v General Foods Corp.* (1983) 35 C3d 197, 197 CR 783, superseded by statute on other grounds as stated in *Gartin v S&M NuTec LLC* (CD CA 2007) 245 FRD 429, 437 n6, the California Supreme Court stated basic rules for finding a fiduciary relationship in a commercial setting. First, the court eliminated the "ability to exploit a disparity of bargaining power" as a test for finding a fiduciary duty. 35 C3d at 221 n21. In the context of sellers of products who use media commercials to sell their products, plaintiffs alleged that the sellers were profiting from the trust of consumers. The court said that the ability to exploit a disparity was not enough to create a fiduciary duty. 35 C3d at 221. The court then observed that, in contrast to the relationship of seller to buyer, a fiduciary (35 C3d at 222)

> assumes duties beyond those of mere fairness and honesty in marketing its product—he must undertake to act on behalf of the beneficiary, giving priority to the best interest of the beneficiary. [Citations.] A fiduciary's power to transact business with his beneficiary is severely limited; he must use the utmost good faith and, if he profits from the transaction, the law presumes the agreement was entered into by the beneficiary "without sufficient consideration and under undue influence." [Citations.] Such principles are generally inappropriate in a buyer-seller context, however disparate the party's resources.

Every lender makes loans to borrowers for profit. If the lender were a fiduciary, every loan made by a bank would be presumed to have been entered into "without sufficient consideration and under undue influence." It is only in the *exceptional* case, with something more involved than a basic commercial relationship, that a court will impose fiduciary duties on the lender.

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§12.16 c. *Barrett* and *Commercial Cotton*

Earlier California cases discussed the possibility of a fiduciary relationship between parties to commercial transactions. Two of those are *Barrett v Bank of America* (1986) 183 CA3d 1362, 229 CR 16, and *Commercial Cotton Co. v United Cal. Bank* (1985) 163 CA3d 511, 209 CR 551, though neither held that a fiduciary relationship arises solely out of the lender-borrower relationship, without anything more. See also Note, *The Fiduciary Controversy: Injection of Fiduciary Principles into the Bank-Depositor and Bank-Borrower Relationship,* 20 Loy LA L Rev 795 (1987).

In *Barrett*, the plaintiffs had executed and delivered to the bank their personal guaranties of a corporation's debts, which were secured by deeds of trust against their homes. After a default and an attempted workout, the plaintiffs sold their residences to satisfy their obligations under the guaranties. The plaintiffs then sued the bank on several theories, including fraud and conspiracy to defraud. Based on a special jury verdict, the trial court entered judgment for the bank. The court of appeal reversed because the trial court had failed to instruct the jury on the theory of constructive fraud. The court stated that constructive fraud "usually arises from a breach of duty where a relation of trust and confidence exists." 183 CA3d at 1369. The court held that a fiduciary relationship may arise in the lender-borrower relationship if there is evidence that (1) the lender or lender's officers gave business advice to a borrower, (2) the lender or its officer had a "personal stake" in the borrower's action on that advice, and (3) because of a close personal relationship of trust and confidence, the borrower shared confidential information about its business with the lender or its officers and "implicitly relied" on the business advice given. 183 CA3d at 1369.

The *Barrett* court said the facts supporting a constructive fraud theory in that case were that (1) the plaintiff perceived his relationship with the loan officer as being very close, (2) the plaintiff implicitly relied on the loan officer's financial advice, (3) because of a feeling of trust and reliability, the plaintiff shared confidential information concerning unfavorable developments in the industry, (4) the plaintiff relied on the loan officer's advice regarding mergers, (5) the loan officer told other parties to the merger that the bank would never agree to release the plaintiffs' personal guaranties (the plaintiff did not learn of this alleged conversation until years later, and the loan officer had promised plaintiffs that their personal guaranties would be released if they consummated the merger), and (6) the bank stood to benefit from the merger.

Barrett, therefore, relies on the traditional notions that a fiduciary relationship can be created when a party seeks and relies on advice from a confidant or adviser and shares its own confidential information with the confidant or adviser in the process (*e.g.,* as attorneys and clients do) and that such an adviser or confidant may not use the shared confidential information to its own pecuniary advantage. See, *e.g., In re Burris* (1894) 101 C 624, 36 P 101. Thus, *Barrett* does not extend fiduciary status to a lender in the lender-borrower relationship absent the establishment of a confidant or adviser role by the lender *and* benefit by the lender from the use of information obtained in the role.

The relationship between a bank and its borrower has long been deemed to be a creditor-debtor relationship. Indeed, by definition and logic, it is a creditor-debtor relationship. Problems arise, however, when other factors, such as business advice or personal financial advice given by the loan officer, distinguish the relationship. In such a case, the borrower can be counted on to claim that he or she had reposed "trust and confidence" in the bank officer and that, as a result, the bank had fiduciary duties to the borrower. See authorities cited in *River Colony Estates Gen. Partnership v Bayview Fin. Trading Group* (SD Cal 2003) 287 F Supp 2d 1213.

In California, the trend of trying to find at least a "quasi-fiduciary" relationship between a bank and its customer was apparent not only in *Barrett,* in which plaintiffs were guarantors of a corporate borrower, but also in *Commercial Cotton Co. v United Cal. Bank* (1985) 163 CA3d 511, 209 CR 551, in which the plaintiff maintained a demand deposit checking account at the defendant bank. The court in *Barrett* relied in part on *Commercial Cotton* in finding a quasi-fiduciary relationship between a bank and the guarantors of its borrower. *Barrett v Bank of America* (1986) 183 CA3d 1362, 1369, 229 CR 16.

In *Commercial Cotton*, the court held that the bank had breached a "quasi-fiduciary" obligation to a *depositor* (not a borrower or even a guarantor) holding a noninterest-bearing checking account by honoring a check drawn against that account over a forged endorsement. 163 CA3d at 516. The court said that the relationship of a bank with its depositor

is "at least quasi-fiduciary." But see *Lawrence v Bank of America* (1985) 163 CA3d 431, 437, 209 CR 541, in which the court affirmed the sustaining of a demurrer because appellant failed to allege any facts (other than being a depositor) to support a finding of a fiduciary relationship. (Note that after *Commercial Cotton* was decided, the supreme court in *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 44 CR2d 420, held that bad faith denial of the existence of a contract is not a tort and therefore does not support tort damages.)

Commercial Cotton comports with traditional notions that a fiduciary relationship arises when (1) one entrusts his or her property to another (*People v Darling* (1964) 230 CA2d 615, 621, 41 CR 219, superseded by statute on other grounds as stated in *Bradwell v Superior Court* (2007) 156 CA4th 265, 273, 67 CR3d 163) and (2) the contract bears a mutual profit or not-for-profit motive (*Rickel v Schwinn Bicycle Co.* (1983) 144 CA3d 648, 654, 192 CR 732). Therefore, *Commercial Cotton* supports only the existence of a "quasi-fiduciary" relationship between a bank and a depositor, not between a lender and a borrower. See, *e.g., Gomez v Volkswagen of Am.* (1985) 169 CA3d 921, 925, 215 CR 507, which cites *Commercial Cotton* for that proposition only.

Later cases refused to extend the reasoning of *Commercial Cotton* and *Barrett*. For example, in *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735, the court squarely held that there is no fiduciary or quasi-fiduciary relationship between a lender and its borrower in an ordinary commercial transaction. Citing *Price*, the court in *Kim v Sumitomo Bank* (1993) 17 CA4th 974, 21 CR2d 834, held that, as a matter of law, in a normal commercial lender-borrower relationship, the lender does not owe a fiduciary duty to the borrower. 17 CA4th at 981. See also *Mitsui Mfrs. Bank v Superior Court* (1989) 212 CA3d 726, 731, 260 CR 793 (specifically rejecting contention that *Commercial Cotton* is applicable to borrower-lender relationship).

In *Copesky v Superior Court (San Diego Nat'l Bank)* (1991) 229 CA3d 678, 280 CR 338, the court expressly rejected the holding of *Commercial Cotton*, ruling instead that no special relationship exists between a bank and its depositor. In particular, the court held that it is inappropriate to characterize the bank-depositor relationship as quasi-fiduciary.

On special relationship that may be created between lender and borrower during loan administration, see §12.119. For additional cases rejecting existence of special relationship in lending transactions, see §12.20.

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§12.17 d. Loan Assignments and Participation Contracts

Citing to *First Citizens Fed. Savs. & Loan Ass'n v Worthen Bank & Trust Co.* (9th Cir 1990) 919 F2d 510, 513, the court in *Southern Pac. Thrift & Loan Ass'n v Savings Ass'n Mortgage Co.* (1999) 70 CA4th 634, 82 CR2d 874, ruled that lenders who purchase participation in loans do not have a common law fiduciary relationship with loan originators and servicers (such as an attorney-client relationship, which is status-based). Their relationship is determined by the terms of their contract. In *Southern Pac.*, the court found that the participation agreement did not create a fiduciary relationship for the servicing of the loan but that the agreement did create a fiduciary duty with regard to certain express activities of the defendant as a seller (such as the holding of loan documents, legal title, and loan receipts for loan participants). The defendant's activities as a seller, however, were not the acts that gave rise to the action.

Similarly, a person who, with the intent of ultimately purchasing a loan, is substantially involved with the original lender and the borrowers' fiduciary in the making of the loan may be liable to the borrower in tort even if that person is not a fiduciary. See, *e.g., River Colony Estates Gen. Partnership v Bayview Fin. Trading Group* (SD Cal 2003) 287 F Supp 2d 1213 (loan purchaser's knowledge that fiduciary and original lender failed to disclose material differences in interest rate (and other loan terms) coupled with substantial assistance given by purchaser in lending process supported cause of action for aiding and abetting breach of fiduciary duty).

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2. Covenant of Good Faith and Fair Dealing

§12.18 a. Basis and Scope

One of the more celebrated developing theories of lender liability is breach of the covenant of good faith and fair dealing. California courts have long recognized that a covenant of good faith and fair dealing is implied in every contract. *Egan v Mutual of Omaha Ins. Co.* (1979) 24 C3d 809, 169 CR 691. This covenant requires that neither party to a contract take actions that deprive the other of the benefits of the agreement. *Koehrer v Superior Court* (1986) 181 CA3d 1155, 226 CR 820. Recognizing the existence of the implied covenant of good faith and fair dealing also necessarily creates the availability of a breach of contract remedy for a breach of the implied covenant.

In California, the covenant was recognized in earlier cases involving secured lending and was applied to require the lender in certain circumstances to show impairment of the security before exercising its rights under a favorable contract provision. See, *e.g., Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57; *Milstein v Security Pac. Nat'l Bank* (1972) 27 CA3d 482, 103 CR 16, discussed in §12.142.

In later cases in California, the scope of the covenant under general law was narrowed. The implied covenant of good faith and fair dealing cannot *create* rights contrary to those found within the four corners of a contract. In *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467, the supreme court held that the implied covenant does not prohibit conduct that is specifically permitted by the terms of a contract. 2 C4th at 374. The scope and applicability of the implied covenant is determined in accordance with the purposes and terms of a contract. 2 C4th at 373. The court reasoned that, as a general rule, implied terms should not be created when to do so would result in the contravention of express terms.

Under *Carma*, the covenant of good faith and fair dealing cannot be implied so as to prohibit a lender from doing what the loan agreement expressly allows the lender to do. Further, if the loan agreement allows the lender to withhold loan funds when conditions precedent to its performance were not fulfilled to its satisfaction, the lender has no duty to act in good faith when making its determination of satisfaction; it need only make an objectively reasonable decision. *Storek & Storek v Citicorp Real Estate* (2002) 100 CA4th 44, 122 CR2d 267. See *Racine & Laramie, Ltd. v Department of Parks & Recreation* (1992) 11 CA4th 1026, 14 CR2d 335 (covenant of good faith and fair dealing cannot be used to create new obligations under existing contract; duty to negotiate modification of contract will not be found unless it has been expressly agreed to or is very purpose of express agreement). In some trial courts and unreported decisions of the courts of appeal, the implied covenant of good faith and fair dealing is still receiving a fairly broad application. See, *e.g., Lauer v Schaefer* (Nov. 20, 2003, D039675; not certified for publication) 2003 Cal App Unpub Lexis 11005, 2003 WL 22725739 (challenge to jury instruction that party to note and trust deed transaction breached the implied covenants of good faith and fair dealing if it did "anything" that destroyed or injured other party's rights to receive benefits of contract).

Claims for breach of the covenant of good faith and fair dealing are not limited to claims by borrowers against lenders. In *Riveredge Assocs. v Metropolitan Life Ins. Co.* (D NJ 1991) 774 F Supp 897, the court found that the lender stated a claim for breach of the implied covenant of good faith and fair dealing when the lender alleged that the borrower sued on a theory of contract interpretation that the borrower knew was incorrect.

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b. Damages: Tort Versus Contract

§12.19 (1) Tort: Special Relationship Required

The current question surrounding the covenant of good faith and fair dealing is not whether the covenant exists but rather whether a tort remedy continues to exist for breach in a noninsurance case after the ruling in *Seaman's Direct Buying Serv., Inc. v Standard Oil Co.* (1984) 36 C3d 752, 768, 206 CR 354. After *Seaman's*, the supreme court decided *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211, eliminating tort damages for breach of the implied covenant of good faith and fair dealing in an employment contract. 47 C3d at 693.

In holding that an employment relationship was not sufficiently similar to an insurance contract for a "special relationship" to be deemed to exist, the *Foley* court called into question whether a "special relationship" can ever exist outside the insurance context. The court emphasized that the implied covenant is an implied *contract* term, and so ordinarily a breach of the covenant will give rise only to contract damages; "because the covenant is a contract term … compensation for its breach has almost always been limited to contract, rather than tort remedies." 47 C3d at 684. The court noted, "An exception to this general rule has developed in the context of insurance contracts where, for a variety of policy reasons, courts have held that a breach of the implied covenant will provide the basis for an action in tort." 47 CA3d at 684. The court went on to severely criticize cases that extended this exception beyond the insurance context, noting, "The covenant of good faith is read into contracts in order to protect the express covenants or promises of the contract, not to protect some general public policy interest not directly tied to the contract's purpose." 47 C3d at 690.

It must be concluded, on the basis of the *Foley* decision, that the California Supreme Court will almost certainly refrain from extending tort remedies for a breach of the implied covenant of good faith and fair dealing to the commercial context, such as the lender-borrower context.

Even before *Foley*, California case law provided that when pursuing a tort remedy for breach of the implied covenant of good faith and fair dealing in a commercial context, a California plaintiff has a strict standard to meet. As set forth in *Multiplex Ins. Agency v California Life Ins. Co.* (1987) 189 CA3d 925, 932, 235 CR 12, the tort remedy for breach of the implied covenant of good faith and fair dealing in a commercial setting may be asserted only by a party's demonstrating that his or her contract arises from a "special relationship" comprising all five of the following factors:

(1) The parties must be in inherently unequal bargaining positions at the inception of the contract (*Quigley v Pet, Inc.* (1984) 162 CA3d 877, 208 CR 394).

(2) The motivation for entering the contract must be a nonprofit motivation, *i.e.,* to secure peace of mind, security, or protection from calamity (*Egan v Mutual of Omaha Ins. Co.* (1979) 24 C3d 809, 819, 169 CR 691).

(3) Ordinary contract damages are not adequate because they do not (a) require the party in the superior position to account for its actions and (b) make the inferior party "whole" (*Wallis v Superior Court* (1984) 160 CA3d 1109, 1118, 207 CR 123).

(4) One party is especially vulnerable because of the type of harm it may suffer and the trust it necessarily places in the other party to perform (*Wallis v Superior Court, supra*).

(5) The other contracting party is aware of this vulnerability (*Wallis v Superior Court, supra*).

A plaintiff who fails to allege all five of these factors cannot state a viable claim for tortious breach of the implied covenant in a commercial context. See *Wallis v Superior Court, supra* (these five factors must be alleged only for breach of noninsurance contract). See also *Elxsi v Kukje Am. Corp.* (ND Cal 1987) 672 F Supp 1294, 1299 (applying California law).

For cases acknowledging special or fiduciary relationship between lender and borrower, see §§12.13, 12.119.

NOTE: A "special relationship" may be one-sided; *i.e.*, the benefit of tort damages may inure only to one party and not the other. For example, an insurer's exposure to tort liability for bad faith, based on the "special relationship" between insurer and insured, does not apply to the insured. In *Agricultural Ins. Co. v Superior Court* (1999) 70 CA4th 385, 82 CR2d 594, the court denied the insurer a "reverse bad faith" claim when the insured allegedly filed a fraudulent claim under an earthquake policy. The court held, however, that the insurer could sue for breach of

the covenant of good faith and fair dealing for contract damages; the court also held that the insurer could pursue its fraud claims.

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§12.20 (2) Lending Cases Denying Tort Damages

In ordinary commercial loan transactions, several courts of appeal ruled that a breach of the implied covenant of good faith and fair dealing gives rise to contract rather than tort damages. For example, in *Sutherland v Barclays Am./Mortgage Corp.* (1997) 53 CA4th 299, 61 CR2d 614, the court stated that tort recovery for noninsurance contract breach of the covenant of good faith and fair dealing is generally not permitted, at least absent a violation of an independent duty arising from principles of tort law. Similarly, and relying largely on the California Supreme Court's indication in *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211, that tort damages are not available for breaches of the implied covenant of good faith and fair dealing outside of a special relationship, the court in *Mitsui Mfrs. Bank v Superior Court* (1989) 212 CA3d 726, 731, 260 CR 793, held that an ordinary commercial contract between a borrower and a lender does not create a "special relationship." 212 CA3d at 730. Consequently, the court denied tort damages to the borrower after the lender refused to honor an oral commitment to extend or "roll over" a short-term loan.

After *Foley* and *Mitsui,* it does not appear that breach of the implied covenant of good faith and fair dealing is a source of tort liability exposure for lenders in transactions with commercial customers. See *Careau & Co. v Security Pac. Bus. Credit, Inc.* (1990) 222 CA3d 1371, 272 CR 387 (holding that relationship of bank to commercial borrower is not special relationship for purposes of tortious breach of covenant of good faith and fair dealing); *Okun v Morton* (1988) 203 CA3d 805, 826, 250 CR 220 (suggesting that no contractual relationship other than insurer-insured warrants special relationship treatment).

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§12.21 (3) Denial of Existence of Contract

Because there is no independent duty under tort law to affirm the existence of a valid contract, a denial of the existence of the contract, whether in bad faith or not, gives rise to only contract and not tort damages. In *Freeman & Mills, Inc. v Belcher Oil Co*. (1995) 11 C4th 85, 44 CR2d 420, the California Supreme Court specifically overruled *Seaman's Direct Buying Serv., Inc. v Standard Oil Co.* (1984) 36 C3d 752, 206 CR 354, which had held that a tort cause of action might lie "when, in addition to breaching the contract [defendant] seeks to shield itself from liability by denying, in bad faith and without probable cause, that the contract exists." 36 C3d at 769. In *Freeman*, the court noted the numerous sources of criticism for the *Seaman's* decision and stated that *Seaman's* should be overruled in favor of a general rule precluding tort recovery for noninsurance contract breach, at least in the absence of violation of "an independent duty arising from principles of tort law" other than the bad faith denial of the existence of, or liability under, the breached contract. 11 C4th at 102 (citing *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 515, 28 CR2d 475). Thus, in California, there can be no recovery of tort damages for a breach of contract unless it is an insurance contract or other kind of special relationship. In *Sutherland v Barclays Am./Mortgage Corp.* (1997) 53 CA4th 299, 61 CR2d 614, the court held that the decision in *Freeman & Mills, Inc. v Belcher Oil Co., supra,* following the general rule, has retroactive effect.

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§12.22 c. Lending Cases Denying Contract Damages

The California Supreme Court, in *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29, advanced the concept of not permitting actions beyond express terms of the contract (as it did in *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467; see §12.18) and held that underbidding by a lender at a foreclosure sale, without more, does not violate the implied covenant of good faith and fair dealing. Under the loan agreement, which expressly provided that on default the lender could foreclose on the real property in any order it chose, and under settled principles of law (*Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557), even if the foreclosure sale price was less than what the fair market value of the property would have been under ordinary marketing conditions, the lender was entitled to make a credit bid in whatever amount the lender thought the property was worth.

Similarly, in *Hicks v E.T. Legg & Assocs.* (2001) 89 CA4th 496, 108 CR2d 10, a court of appeal upheld the jury's verdict that the lender's choice of serial oral postponements of a trustee sale, which effectively blocked a revival of the borrower's statutory reinstatement rights, was not a breach of the covenant of good faith and fair dealing. The court also rejected the borrower's contention that the legislature intended to prohibit repeated trustee sale postponements of 5 or fewer business days.

In *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting* (7th Cir 1990) 908 F2d 1351, the court reversed a bankruptcy court decision subordinating the bank's postpetition superpriority claim to the claims of an unsecured creditor. In that case, the bank had entered into a postpetition financing agreement with the debtor that expressly provided that the bank could stop making advances at any time. When the bank elected to stop making advances, the debtor charged that the bank had acted in bad faith, and the lower court agreed.

In reversing the bankruptcy court's ruling, the court of appeals noted (908 F2d at 1357):

> Bank did not break a promise at a time Debtor was especially vulnerable, then use the costs and delay of obtaining legal enforcement of the contract as levers to a better deal. Debtor and Bank signed a contract expressly allowing the Bank to cease making future advances.… The Bank … made a clean break and did not demand improved terms. It had the right to do this for any reason satisfactory to itself.

The court then went on to expressly disagree with the holding of *K.M.C. Co. v Irving Trust Co.* (6th Cir 1985) 757 F2d 752, noting that "the Bank was entitled to advance its own interests, and it did not need to put the interests of Debtor and Debtor's other creditors first." 908 F2d at 1358.

In *Auerbach v Great W. Bank* (1999) 74 CA4th 1172, 88 CR2d 718, the borrower entered into a pre-workout agreement with the lender for the purpose of negotiating a modification of the loan, but the lender never intended to modify the loan. The court found that the borrower's claim for contract damages for breach of the covenant of good faith and fair dealing was not supported by the evidence and reversed the award for damages for breach of contract. The implication is that the court would have awarded contract damages for breach of the covenant of good faith and fair dealing if the borrower had introduced adequate evidence of contract damages at trial. The court, citing *Phoenix Mut. Life Ins. Co. v Shady Grove Plaza Ltd.* (D Md 1990) 734 F Supp 1181, 1190, aff'd (4th Cir 1991) 937 F2d 603 (unpublished opinion), explained that good faith does not require a party to accede to a one-sided modification. The court also stated that a party is not prohibited from bargaining for its own economic advantage. See also §§12.5, 12.129, 12.133.

PRACTICE TIP: Counsel for a lender that is considering negotiating with a borrower for a loan modification should caution the client that before signing a pre-workout agreement, the lender must, in good faith, intend to negotiate. Some lenders attempt to limit liability under the good faith doctrine by sending a pre-workout letter with a reservation of rights. See §10.3.

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§12.23 3. Unfair Business Practices

The California Unfair Business Practices Act (Bus & P C §17500) prohibits the making of false or misleading statements intended to induce any person to dispose of real or personal property, perform services, or enter into any other related obligation. See, *e.g., Fletcher v Security Pac. Nat'l Bank* (1979) 23 C3d 442, 153 CR 28. A related law, Bus & P C §17200 (informally referred to as the "unfair competition law" (UCL)), similarly prohibits a wide range of conduct, such as unlawful, unfair, or fraudulent business acts or practices. *McKell v Washington Mut., Inc.* (2006) 142 CA4th 1457, 49 CR3d 227; *Sisemore v Master Fin., Inc.* (2007) 151 CA4th 1386, 60 CR3d 719; *Gibson v World Sav. & Loan Ass'n* (2002) 103 CA4th 1291, 128 CR2d 19. Remedies under these statutes include criminal prosecution and fines (see, *e.g.,* Bus & P C §§17203, 17500) and injunctive relief and restitution (see, *e.g., Colgan v Leatherman Tool Group* (2006) 135 CA4th 663, 38 CR3d 36). Attorney fees are obtained on actions under these laws under CCP §1021.5.

WARNING: In evaluating potential claims against lenders under California unfair business practices statutes, counsel must consider federal preemption issues, including preemption by legislation such as the Home Owners' Loan Act (HOLA) (12 USC §§1461-1470) and the comprehensive regulations issued under the authority of such statutes. Compare, *e.g., McKell v Washington Mut., Inc., supra* (UCL not preempted by federal law), with *Silvas v E*Trade Mortgage Corp.* (SD Cal 2006) 421 F Supp 2d 1315, aff'd (9th Cir 2008) 514 F3d 1001 (UCL preempted). *Silvas* suggests that state statutes and judicially created rules will not be preempted if those state laws are used to enforce "general legal duties applicable to all businesses" but that they will be preempted if used to create remedies to enforce duties originating in federal home loan statutes and regulations. 421 F Supp at 1320.

With the restrictions on lender liability claims for tort damages based on a lending or contractual relationship (see §§12.13-12.22), borrowers have been asserting lender violations under the UCL. See, *e.g., Sisemore v Master Fin., Inc., supra; Black v Financial Freedom Sr. Funding Corp.* (2001) 92 CA4th 917, 112 CR2d 445 (reverse mortgage fraud action); *Prata v Superior Court* (2001) 91 CA4th 1128, 111 CR2d 296; *Buick v World Sav. Bank* (ED Cal 2008) 565 FS2d 1152. Some courts are requiring strict adherence to the requirements for relief under §17200. See *Prudential Home Mortgage Co. v Superior Court* (1998) 66 CA4th 1236, 78 CR2d 566 (statutory remedies under CC §2941 are adequate, and equitable relief under Bus & P C §17200 is unnecessary).

Section 17200 is construed broadly, however, in misleading advertising and nondisclosure cases. See, *e.g., Prata v Superior Court, supra* (plaintiff need not plead damages or other elements of tort action for fraud or deceit; plaintiff need only show that public is likely to be deceived). In addition, in *Washington Mut. Bank v Superior Court* (1999) 75 CA4th 773, 89 CR2d 560, in which mortgage loan customers alleged that the bank failed to disclose inflated charges, the court held that the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617) and Regulation X (24 CFR pt 3500) do not preempt state law actions for violation of the UCL. For further discussion of *Washington Mut. Bank*, see §12.29.

PRACTICE TIP: By defining "unfair competition" to include any unlawful business act or practice, the UCL permits violations of other laws (whether federal, state, or local) to be independently actionable under the UCL. See *Kasky v Nike, Inc.* (2002) 27 C4th 939, 119 CR2d 296; *Washington Mut. Bank v Superior Court, supra*. This principle may allow an injunction action under state law to proceed even if the statute of limitations has expired on a federal remedy such as rescission. See §12.69B.

Another California statute that protects consumers against unfair and deceptive business practices and may apply to real property secured loans is the Consumers Legal Remedies Act (CC §§1750-1784), cited in §12.11. See, *e.g., Ansley v Ameriquest Mortgage Co.* (9th Cir 2003) 340 F3d 858. But see *McKell v Washington Mut., Inc.* (2006) 142 CA4th 1457, 49 CR3d 227 (act does not apply to real property sales and financing transactions). Attorney fees are available under this Act. CC §1780(e).

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§12.24 4. Improper Control Over Borrower

Liability for lenders may also be found by the courts on the basis of the lender's exercising control over or interfering with the corporate governance of the borrower or the borrower's management of its operations. There are various underpinnings for this liability: tort laws, securities laws, antitrust laws, environmental laws, and insolvency laws. See Lundgren, *Liability of a Creditor in a Control Relationship With Its Debtor,* 67 Marq L Rev 553 (1984). The tort theories of liability are the ones most often asserted against real property lenders. Conduct involving control and interference giving rise to lender liability under any one of the various theories has a great deal in common with the type of conduct involved under any of the other theories. Lenders' conduct that goes beyond that of lending money is usually at the root of control and interference claims. Accordingly, in their relationships with their borrowers or their borrowers' businesses, lenders must be careful not to require or be given roles that put them in the place and stead of their borrowers.

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§12.25 a. Construction Lending

In California, the concept of liability for improperly controlling a borrower's affairs initially arose out of construction lender liability actions brought by third parties. It was later extended to actions brought by the borrowers themselves. This concept of liability for being "more than a lender" in the relationship first appeared in *Connor v Great W. Sav. & Loan Ass'n* (1968) 69 C2d 850, 73 CR 369. In *Connor*, the California Supreme Court held a construction lender liable to third party purchasers of homes when, in addition to making the construction loan, the lender "warehoused" the parcels on which the houses were to be built, hired geologists to determine water availability, obtained a market study of the property, reserved the right to make permanent loans to the buyers, and was engaged in other activities beyond those of being "only a money lender." The *Connor* court extended the duty the corporation had to its shareholders to the home-buying public and said that while these third parties were not in privity of contract and while the venture was not a joint venture, the lender had engaged in activities beyond those of the usual money lender and was thereby liable to third parties harmed by these activities.

In *Bradler v Craig* (1969) 274 CA2d 466, 79 CR 401, the *Connor* decision was squarely shown to be based on the extra activity of Great Western beyond that of being a mere lender of money. The *Bradler* court found that the lender in that case had not engaged in being "more than a lender" with regard to its activities and held that the duty to the purchaser exists only when the lender takes an active part in the construction process and the financial relationship goes beyond that of the usual lender-borrower.

Civil Code §3434, passed in 1969, mandates that its provisions are the sole basis for a construction lender's liability to third parties due to failures of the developer. This statute codifies *Connor* but limits liability to those facts. It provides that construction lenders are liable to third parties for construction defects only if "such loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money or unless the lender has been a party to misrepresentations with respect to such real or personal property." It does not apply to actions by borrowers against lenders.

In *Kinner v World Sav. & Loan Ass'n* (1976) 57 CA3d 724, 129 CR 400, the court considered a lender's liability to its borrower for making a construction loan in an amount that was insufficient to complete the project. Although lenders are not liable to borrowers under §3434, the court examined the lender's conduct under the *Connor* standard to see if the lender was acting as more than a lender. The *Kinner* court concluded that the lender was not being more "than only a lender" and was therefore not liable to its borrower.

For further discussion of lender liability in the construction lending context (including common law as well as statutory stop notice claims), see California Mechanics' Liens and Related Construction Remedies, chaps 1-4, 11 (3d ed Cal CEB 1998). See also California Construction Contracts, Defects, and Litigation (Cal CEB 2008).

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§12.26 b. Business Lending

The basic concept of liability of lenders for "being more than a lender" and engaging in activities beyond that of only lending money has gained judicial support outside the construction loan context. In *Credit Managers Ass'n v Superior Court* (1975) 51 CA3d 352, 124 CR 242, the court specifically characterized the conduct of the lender and a management consultant urged on the borrower by the lender as exercising dominion and control over the management of the borrower. The court held that the consultant, who had been hired by the borrower at the insistence of the borrower's lender and who exercised substantial dominion and control over the management of the business to such a degree as to supplant the board of directors, could be held to the same fiduciary obligations to stockholders and creditors that the directors and officers had. 51 CA3d at 360.

In a non-construction loan context, probably the most famous lender liability case is *State Nat'l Bank v Farah Mfg. Co.* (Tex App 1984) 678 SW2d 661. It was decided on the basis of the lender's not acting only as a money lender but extending its activities to areas involving the corporate governance and business operations of the borrower. After Farah had been replaced as chief executive officer (CEO) due to business setbacks, the lenders amended their loan agreements to provide that a subsequent change in management would constitute a default under the agreements. When Farah sought reinstatement as CEO, the lenders, although not actually calling the loan, gave the impression that the loan would be called if Farah were reinstated. This possibility influenced votes, and a director sympathetic to State National Bank was elected chairman. Eventually, Farah won back managerial control of the company, paid off the loan, and sued the lenders, alleging misrepresentation constituting fraud regarding calling the loan if he returned, duress, and interference with business relations.

The court upheld the jury verdict for the company in excess of $18 million, affirming the decision on all significant issues with regard to control and interference issues. The court cited *Light v Transport Ins. Co.* (Tex App 1971) 469 SW2d 433, 439, for the proposition that interference is wrongful "if there is sharp dealing or overreaching or other conduct below the behavior of fair men similarly situated." 678 SW2d at 689. Hence, the *Farah* case appears to require that lenders be "fair" in their dealings even if the loan agreement permits the actions taken.

At the core of the offending conduct in both *Farah* and *Light* is a lender that did not remain simply a money lender. The greatest concern facing a lender who has been compelled by circumstances to undertake other than the usual money-lending activity is that it has exercised excess control over the management and operation of the borrower, which can ultimately result in the liability of the lender to both the borrower and other creditors.

In a dramatic about-face, the Fifth Circuit Court of Appeals in *Smith v Associates Commercial Corp. (In re Clark Pipe & Supply Co.)* (5th Cir 1990) 893 F2d 693, reversing its earlier opinion at (5th Cir 1989) 870 F2d 1022, initially held that a lender was liable for exercising excessive control over its borrower when the lender began reducing its advance rates (as was permitted under the loan documents) in order to force the borrower to conduct an orderly liquidation of its assets. On reconsideration, the court of appeals found that the lender did not exercise sufficient control over the borrower to justify subordinating its claims because the lender was acting within the purview of its loan documents. See 893 F2d at 702.

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§12.27 II. LIABILITY IN LOAN ORIGINATION

Loan origination usually goes through three phases: (1) the application phase (see §§12.28-12.29), (2) the loan commitment phase (see §§12.30-12.39), and (3) the loan documentation and disclosure phase (see §§12.40-12.49). Lenders may be sued by borrowers under lender liability theories for their handling of even the very first phase, application, but it is in the second phase, loan commitment, that some of the largest lender liability judgments have occurred. Both of these stages of a loan are usually viewed casually by the lender's "marketers" and lending officers as preliminary stages in which they have not really committed their institutions. In some cases this is true, but in many other cases it is not true, especially when the prospective borrower has paid an application fee or commitment fee.

If the first two stages are completed, then the lender usually will be making a loan, and the lender and the borrower enter the third phase of the loan origination process—loan documentation. This phase has long been viewed by lenders as the key element to avoiding lender liability, but documenting the loan may itself provide factual underpinnings for lender liability lawsuits. Documenting the loan no longer provides the complete "fail-safe" protection for lenders that many lenders believe it does. However, proper documentation can provide a lender extensive protection against lender liability and should be carried out with an appreciation of the developing theories of liability discussed in §§12.12-12.26.

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A. Liability in Loan Application Phase

§12.28 1. State Tort and Contract Law

The first event of significance in the usual real property loan transaction occurs when the borrower submits an application to a lender for a loan. The handling of the application by the lender, including the determination of whether to issue a commitment, is at the core of many of the current lender liability lawsuits. In large part, the cases turn on the question of whether a bank, having agreed to process an application for a loan, owes to its customer a duty of reasonable care in the processing and approving or disapproving the application.

The first problem for a lender is determining whether an application for a loan commitment (or a loan) has been made. A good practice for a lender is to have a policy requiring every application to be in writing and date-stamped by the lender with the date it is received. The requirement that applications be in writing usually will result in the size, nature, and other important features of the desired loan being fixed by the borrower and in these facts being presented to the lender in such a form that the application can be processed promptly. These practices will also eliminate later disputes about when a loan application was made, what information was provided, and what was requested.

If a borrower applies for a loan with a lender and the lender does not desire to accept or process the application, the law has generally held that the lender does not have a duty to do so. There have been cases in which prospective customers simply submitted an application for a loan (or for insurance) and thereafter claimed that the unilateral act of submitting the application gave rise to a duty on the part of the recipient to act on it without delay. The courts have generally held in those instances that the bank (or insurance company) has not undertaken any duty to process the application and therefore has no duty to do promptly that which it has no duty to do at all. See, *e.g., Patten v Continental Cas. Co.* (Ohio 1954) 120 NE2d 441; *Zayc v John Hancock Mut. Life Ins. Co.* (Pa 1940) 338 Pa 426, 13 A2d 34. But see *United States Fire Ins. Co. v Cannon* (8th Cir 1965) 349 F2d 941 (applying Nebraska law). (The lender, however, may have an obligation under federal statutes to notify the applicant of its actions on the application in a timely manner. See, *e.g.,* the Equal Credit Opportunity Act (15 USC §§1691-1691f), cited in §§12.11, 12.29.)

If there has been a prior relationship between the borrower and the lender, a contract or tort duty to use reasonable care in processing an application could be found to exist; if so, the lender would have lost its right not to process the application. The lender, through conduct in an existing relationship with the borrower, may have held itself out as willing to consider a long-term take-out loan or credit facility. If a borrower relies on this indication from a lender with which the borrower already has an existing relationship, this reliance can form the basis of a damages award against the lender.

In one case, the combination of these factors resulted in a significant jury verdict against a lender. The appellate court, however, reversed on the grounds that there was no substantial evidence to support the judgment and that the borrower could not have reasonably relied on the alleged promise of the bank to provide long-term financing. *Kruse v Bank of America* (1988) 202 CA3d 38, 248 CR 217.

If a lender has accepted a fee with the application, the lender has at least a contractual duty to process the application. One court discussed both a contractual duty and a tort duty in an instance in which these facts substantially existed. *Jacques v First Nat'l Bank* (Md Ct App 1986) 515 A2d 756. The court in *Jacques* said that although the proof required and the measure of compensatory damages allowable may be essentially the same under either cause of action, punitive damages may be awarded when actual malice is shown in a tort action but not in an action for breach of contract. The jump from a contract cause of action to a tort cause of action can be made by alleging that when a lender accepts a "processing" or "loan application" fee, it implicitly agrees to process the loan application and therefore implicitly has a duty to do so with reasonable care. If the lender has breached this duty of care, the prospective borrower may be able to state a cause of action for simple negligence, which in turn leaves open the possibility of punitive damages. See also discussions of bad faith theories in §§12.18-12.22.

The principal issue is simply whether a commitment was made to process the application, either expressly or by the lender's conduct. This frequently arises when a borrower who could not qualify for a loan and is turned down had to

wait while the application was being processed and in the meantime had taken other steps with regard to the project, so that the borrower truly suffers losses without a loan. See, *e.g., Landes Constr. Co. v Royal Bank of Canada* (9th Cir 1987) 833 F2d 1365. The lender and its representatives must exercise care from the very first contact with a prospective borrower. The lender may well be held to have a duty to process the application promptly and with reasonable care, whether or not the application fee has been paid, and certainly will have such a duty if it accepts a fee.

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§12.29 2. Federal Law; Preemption

A number of federal statutes discussed in §12.11 apply to loan applications. Additionally, a lender can be liable for both compensatory and punitive damages under provisions of the Equal Credit Opportunity Act (15 USC §§1691-1691f) for rejecting a loan application because of the applicant's race or membership in another protected class. See *Barber v Rancho Mortgage & Inv. Co.* (1994) 26 CA4th 1819, 32 CR2d 906 (lender alleged rejection was due to doubts of applicants' intent to be owner-occupants, but lender failed to provide applicants with written explanation of its decision). See also *Green v Rancho Santa Margarita Mortgage Co.* (1994) 28 CA4th 686, 33 CR2d 706 (loan broker failed to find loan for two qualified buyers because of their race).

The Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617) and Regulation X (24 CFR pt 3500) require that lenders make certain disclosures to borrowers at the time of both application and closing of a loan. Both RESPA and Regulation X expressly preempt state laws that are inconsistent with those federal laws. See 12 USC §2616; 24 CFR §3500.13. However, in *Washington Mut. Bank v Superior Court* (1999) 75 CA4th 773, 89 CR2d 560, the court held that the bank customers' private action under state law (Bus & P C §17200) was not preempted by RESPA and Regulation X; indeed, the state claims complemented the federal law by promoting full compliance with federal requirements. See *McKell v Washington Mut., Inc.* (2006) 142 CA4th 1457, 49 CR3d 227.

For further discussion of preemption decisions, see §§12.23, 12.95.

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§12.30 B. Liability in Loan Commitment Phase

A loan commitment is an agreement by a lender to make a loan to a borrower; generally, it must meet certain requirements to be enforceable. See CC §1624(a)(7). For general discussion of loan commitments and forms, see California Real Estate Finance Practice: Strategies and Forms, chap 2 (Cal CEB 2000). Loan commitments are regularly used by most lenders with regard to commercial real estate construction loans and permanent or take-out loans. This step is one of the most difficult to achieve for borrowers; obtaining the commitment letter itself has become a coveted accomplishment. The standards for enforcing loan commitments (assuming a contract to lend has been found) are like those for enforcing any other contract. *Laks v Coast Fed. Sav. & Loan Ass'n* (1976) 60 CA3d 885, 131 CR 836. The new lender liability theories are frequently being used by borrowers in connection with this aspect of the loan origination process.

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§12.31 1. Loan Commitment as Contract

Many of the nettlesome cases for a lender arise out of instances in which the lender denies that a would-be borrower claiming to have a loan commitment actually has one. The commitment is usually alleged to be oral or implied by the conduct of the lender in conjunction with related statements or writings. (See §§12.33-12.35 for discussion of oral commitments.) This assertion usually occurs when there is an existing relationship (usually a long-term loan or a short-term construction loan or other short-term financing such as a land loan) between the lender and borrower. See, *e.g., Conrad v Bank of America Nat'l Trust & Savs. Ass'n* (1996) 45 CA4th 133, 53 CR2d 336.

Ordinarily, first-time borrowers must prepare a written application containing basic information about themselves; otherwise, the lender has no history with a first-time borrower to provide a basis for its assent to a loan and accordingly should document each contact it has with the borrower regarding the extending of financing. Keeping such contact records is important even when there has been an existing relationship between a borrower and a lender. The writing or part of it may also be copied to the borrower so there is no misunderstanding later about what was said. Simple written call reports or short confirming letters can be used. Such documentation can establish the terms of the commitment, if one is made, or establish the fact that a commitment was not made. Even a mere loan application can constitute a binding contract between borrower and lender, at least under the law of neighboring states, when the terms of the application are dictated by the lender and the borrower is required to "accept" those terms in making the application. *Goodhue v Catalina Mortgage Co.* (9th Cir 2003) 76 Fed Appx 781 (unpublished opinion).

There cannot be a breach of a contract that never existed. To make the loan commitment binding, the lender must set forth with specificity the basic terms of the agreement. See, *e.g., Peterson Dev. Co. v Torrey Pines Bank* (1991) 233 CA3d 103, 284 CR 367 (denied developer's claim against bank for failing to provide permanent financing for developer's project because commitment letter lacked so many material terms that it did not constitute enforceable contract). See also California Real Estate Finance Practice: Strategies and Forms §2.3 (Cal CEB 2000).

PRACTICE TIP: Although an enforceable loan commitment is a contract and the lender must therefore manifest mutual assent in some way in order to form a contract, the lender nevertheless needs to be careful to prevent the borrower from asserting a commitment that was not intended.

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§12.32 2. Option to Borrower Versus Opportunity to Borrow

Mutuality in a loan commitment creates the typical contract, with the lender promising to lend and the borrower promising to borrow. In some cases, lenders have successfully recovered damages from prospective borrowers who breach such a contract to borrow. See, *e.g., Teachers Ins. & Annuity Ass'n v Butler* (SD NY 1986) 626 F Supp 1229 ($3 million judgment against prospective borrower). But mutuality is not necessary in a loan commitment; a lender can grant an option to borrow to a borrower or extend a unilateral offer under which the borrower is not obligated to borrow but can accept the offer by fulfilling the conditions precedent for the loan. See California Real Estate Finance Practice: Strategies and Forms §2.1 (Cal CEB 2000). Under an option, the borrower pays a fee to the lender for the option. A contract exists at that point, and the implied covenant of good faith and fair dealing is found in the option agreement for which the fee was paid.

The lender should state clearly the expiration date for the option in the text of the commitment and also specifically provide that the lender has no more responsibilities of any kind after that date. Additionally, the commitment letter should identify all conditions regarding the lender's duty to fund (see §12.38). This practice may provide a base point for the termination of the lender's obligations.

When no commitment fee or other consideration is paid to the lender, an offer to lend on satisfaction of certain conditions precedent can be characterized as an offer to enter into a unilateral contract. Because such an offer can be accepted only by performance, no contract actually comes into existence until the borrower has satisfied all the specified conditions. As a result, a lender may be able to withdraw the offer before acceptance without incurring liability for breach of contract. However, before such a unilateral offer is revoked, the lender must consider the risks involved in withdrawing the offer after a prospective borrower has partially performed, *e.g.,* by submitting appraisals or other documents. Generally, once a prospective borrower has begun to perform, the lender will be precluded from revoking the offer. See Restatement (Second) of Contracts §45 (1981); *Los Angeles Traction Co. v Wilshire* (1902) 135 C 654, 67 P 1086.

PRACTICE TIP: A lender who does not wish to make a loan will sometimes still try to keep the fee. This posture shows motive for a lender to deny the existence of the binding commitment, so the lender must be very careful in evaluating whether all the conditions precedent have been satisfied. The factual context of the motive could easily lead to a determination of a breach of the covenant of good faith and fair dealing or a breach of contract. See §§12.2, 12.18.

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3. Oral Commitments; Collateral Agreements

§12.33 a. Statute of Frauds

The Statute of Frauds applies to commercial (*i.e.,* nonconsumer) agreements to lend money when the loan is to be secured by a lien on real property. Civil Code §1624(a)(7) provides in part that the following contracts are not enforceable unless the contract, or some note or memorandum of the contract, is in writing and signed by the party to be charged or by the party's agent:

> A contract, promise, undertaking, or commitment to loan money or to grant or extend credit, in an amount greater than one hundred thousand dollars ($100,000), not primarily for personal, family, or household purposes, made by a person engaged in the business of lending or arranging for the lending of money or extending credit. For purposes of this section, a contract, promise, undertaking or commitment to loan money secured solely by residential property consisting of one to four dwelling units shall be deemed to be for personal, family, or household purposes.

Subject to the statutory exceptions stated above (and the judicially and legislatively recognized defenses and exceptions, generally, to the Statute of Frauds), the Statute of Frauds applies to any agreement to lend money in excess of $100,000 regardless of whether the borrower has agreed to grant a lien on real property to secure the loan.

Historically in California, the Statute of Frauds was viewed as barring an oral commitment to lend money if the loan were to be secured by a deed of trust because the Statute of Frauds bars the sale of real property or of "an interest therein" unless it is in writing. CC §1624(a)(3). No California court had squarely decided whether the Statute of Frauds is applicable to a promise to lend money to be secured by a deed of trust. However, a federal court applied California law to an oral agreement to make a loan that was to be secured by an interest in real property, holding that the promise to make the loan was separable from the promise to grant a lien on the real property. *Landes Constr. Co. v Royal Bank of Canada* (9th Cir 1987) 833 F2d 1365. The court held that "[a]n oral agreement to lend money with which to purchase real property clearly falls outside California's Statute of Frauds" but that "an oral agreement to grant a lien against real property as security for a debt is within the statute." 833 F2d at 1370. The court permitted the borrower to seek damages for breach of an alleged oral commitment and held that the promise to convey a deed of trust was divisible from the promise to lend money. Notwithstanding this finding that the promises were separable, the court stated that the borrower would not have been able to use the Statute of Frauds to avoid granting the security interest if the bank had lent the money or if the borrower had sought specific performance rather than damages.

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§12.34 b. Parol Evidence Rule

A lender may succeed in raising the California parol evidence rule as a defense to an oral agreement for a loan if the court finds the agreement would normally have been referred to or included in the actual loan documents signed by the parties, but was not. See *Banco do Brasil, S.A. v Latian, Inc.* (1991) 234 CA3d 973, 285 CR 870, in which the borrowers argued that the bank had promised to make a $2 million line of credit available to them but executed loan documents that made no reference to this line of credit. In ruling that the oral agreement was barred by the parol evidence rule, the court stated: "The courts simply cannot permit clear and unambiguous integrated agreements, such as the one before us, to be rendered meaningless by the oral revisionist claims of a party who, at the end of the game, does not care for the result." 234 CA3d at 1011.

The parol evidence rule also provided a defense in *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735, discussed in §12.134.

However, in *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162, the court concluded that the conflicting provisions of the loan agreement and the deed of trust created a triable issue of fact regarding the true intentions of the parties, *i.e.,* whether the parties mutually intended to permit cross-collateralization of the security on two separate, contemporaneous loans. The court ruled that parol evidence was admissible to resolve this ambiguity. The court also ruled that parol evidence was admissible regarding whether the dragnet clause was within the reasonable expectations of the borrowers when they signed the deed of trust. For further discussion of *Fischer,* see §§9.59-9.60, 9.62.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.35 c. D'Oench Doctrine and FIRREA

§12.35 c. *D'Oench* Doctrine and FIRREA

The holding of *D'Oench, Duhme & Co. v FDIC* (1942) 315 US 447, 86 L Ed 956, 62 S Ct 676, is generally known as the *D'Oench* doctrine. This doctrine, partially codified under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) at 12 USC §1823(e), provides that no agreement between a borrower and a federally insured bank is enforceable against the Federal Deposit Insurance Corporation (FDIC) unless that agreement plainly appears in the loan agreements in the bank's official records. It has also been used offensively by the Resolution Trust Corporation (RTC) to attempt to cut off defenses asserted by borrowers when the RTC moves to enforce defaulted obligations. *Resolution Trust Corp. v Midwest Fed. Sav. Bank* (9th Cir 1993) 36 F3d 785 (rejecting RTC's contention that common law *D'Oench* doctrine and its statutory counterpart barred reformation of loan documents to give effect to bank and borrowers' fully documented agreement that loan was nonrecourse). Further, both the offensive and defensive aspects of the *D'Oench* doctrine protect successors in interest to agencies such as the FDIC, RTC, or Federal Savings and Loan Insurance Corporation (FSLIC). *Newton v Uniwest Fin. Corp.* (9th Cir 1992) 967 F2d 340. The doctrine has thus been enforced by California state courts in real property cases. *Webb v Superior Court (New W. Fed. Sav. & Loan Assocs.)* (1990) 225 CA3d 990, 275 CR 581 (*D'Oench* bars assertion of state law claims or defenses against successor in interest of FSLIC loan portfolio).

WARNING: Although FIRREA provides that in FDIC actions against borrowers a copy of a document from the bank's files (including a photocopy or microcopy) must be deemed the same as the original (see 12 USC §1820(f)), this rule was initially interpreted as not overriding foundational rules of evidence. See *Remington Inv., Inc. v Hamedani* (1997) 55 CA4th 1033, 64 CR2d 376. However, in 2006, FIRREA was amended to supersede the *Remington* court's conclusion. Section 1820(f) now expressly provides that such copies shall not only be deemed original records for all purposes but also may be introduced into "evidence in all State and Federal courts or administrative agencies, and shall be admissible to prove any act, transaction, occurrence, or event therein recorded."

The scope of and exceptions to the *D'Oench* doctrine and its FIRREA counterpart have been complex and evolving. A 1994 Supreme Court decision cast doubt on the continuing vitality of the nearly 50 years of federal common law developed under the *D'Oench* case after the 1989 enactment of FIRREA. See *O'Melveny & Myers v FDIC* (1994) 512 US 79, 80, 129 L Ed 2d 67, 114 S Ct 2048, which did not have before it *D'Oench* issues but stated:

> This Court will not adopt a judge-made federal rule to supplement comprehensive and detailed federal statutory regulation; matters left unaddressed in such a scheme are presumably left to state law. Title 12 U.S.C. §1821(d)(2)(A)(i) … places the FDIC in the insolvent S&L's shoes to pursue its claims under state law, except where some provision in the extensive framework of … [FIRREA] specifically creates a special federal rule of decision.

However, the *O'Melveny & Myers* court observed that a special, judicially created federal rule may be warranted when there is significant conflict between state law and some federal policy or interest, such as uniformity of the law. 512 US at 80. Because the court did not have before it any aspect of the *D'Oench* doctrine, the doctrine's continuing viability is the subject of numerous conflicting court of appeals decisions. For example, the D.C., Third, and Eighth Circuit Courts of Appeals held that the *D'Oench* doctrine was indeed preempted by FIRREA. *Murphy v FDIC* (DC Cir 1995) 61 F3d 34; *FDIC v Deglau* (3d Cir 2000) 207 F3d 153 (following *Murphy*); *DiVall Insured Income Fund Ltd. Partnership v Boatmen's First Nat'l Bank* (8th Cir 1995) 69 F3d 1398 (same).

The Eleventh Circuit reached the opposite conclusion, holding that FIRREA did not preempt *D'Oench*, notwithstanding *O'Melveny & Myers v FDIC*. See *Motorcity of Jacksonville v Southeast Bank N.A.* (11th Cir 1996) 83 F3d 1317, vacated and remanded sub nom *Hess v FDIC* (1997) 519 US 1087, 136 L Ed 2d 708, 117 S Ct 760 (for reconsideration in light of *Atherton v FDIC* (1997) 519 US 213, 136 L Ed 2d 656, 117 S Ct 666). In *Atherton*, the Supreme Court held that the standard of conduct for directors set forth in FIRREA was only a starting point; FIRREA does not preempt stricter state law standards. Subsequently, the Eleventh Circuit reinstated its earlier opinion, holding

that FIRREA does not preempt the *D'Oench* doctrine. See *Motorcity of Jacksonville, Ltd. v Southeast Bank N.A.* (11th Cir 1997) 120 F3d 1140.

In a later development in *Murphy*, after the case was transferred from the D.C. District Court to the District Court for the Southern District of Florida, the Eleventh Circuit reaffirmed its holding in *Motorcity of Jacksonville* that FIRREA does not preempt *D'Oench* and that the *D'Oench* doctrine remains good law in the Eleventh Circuit. See *Murphy v FDIC* (11th Cir 2000) 208 F3d 959 (applying *D'Oench* after determining that transferee courts are not required to defer to law of transferor circuit).

The Court of Appeals for the Ninth Circuit has not yet ruled on this issue but generally interprets *D'Oench* and its FIRREA counterpart co-extensively. See *Brookside Assocs. v Rifkin* (9th Cir 1995) 49 F3d 490, 495 n2 (declining to reach preemption issue); *Resolution Trust Corp. v Kennelly* (9th Cir 1995) 57 F3d 819, 822 n3 (same, but suggesting in dictum that FIRREA is preemptive). See also *FDIC v Suna Assocs.* (2d Cir 1996) 80 F3d 681 (applying *D'Oench* and FIRREA interchangeably without discussing preemption).

PRACTICE TIP: A determination that *D'Oench* is statutorily preempted might or might not benefit a party asserting claims or defenses against federal regulatory agencies or their successors in interest. In some respects, the bar to such claims under FIRREA is narrower than the bar raised by the *D'Oench* doctrine. See *Murphy v FDIC* (DC Cir 1995) 61 F3d 34, 37 (unlike *D'Oench,* FIRREA bars only claims that would diminish the FDIC's interest in a specific asset). However, FIRREA is potentially broader than *D'Oench* in that it prohibits reliance on a side agreement not executed by the obligor and the bank contemporaneously with the bank's acquisition of the underlying asset, even if the side agreement appears in the bank's official records. 12 USC §1823(e)(1)(B); *FDIC v Zook Bros. Constr. Co.* (9th Cir 1992) 973 F2d 1448 (under FIRREA, loan consolidation agreement executed in 1982 cannot be invoked to limit FDIC's interests under guaranty executed in 1980). See also *RTC Mortgage Trust 1994-S2 v Shlens* (1998) 62 CA4th 304, 72 CR2d 581 (enforcing personal liability on secured note held by assignee of RTC; unsigned (by lender) and unrecorded exculpation agreement offered in defense did not meet requirements of FIRREA and *D'Oench*).

The Ninth Circuit has held that the *D'Oench* doctrine does not apply when the FDIC acts as a receiver for the failed institution. *Ledo Fin. Corp. v Summers* (9th Cir 1997) 122 F3d 825.

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§12.36 4. Unauthorized Commitments

Lenders have been sued when there has been an unauthorized commitment. Typically, disputes over unauthorized commitments arise when lending officers exceed their authority with a promise to make a loan or say that the loan committee's approval is a "rubber stamp" and the borrower "should not worry about it." In *Kruse v Bank of America* (1988) 202 CA3d 38, 248 CR 217, the court found that the borrower knew the loan he sought was beyond the lending officer's authority to approve. The borrower thus could not claim that the lending officer bound the bank to make the loan without the approval of the loan committee. 202 CA3d at 64. In contrast, in *Pipkin v Thomas & Hill, Inc.* (NC 1979) 258 SE2d 778, a loan officer who issued an unauthorized commitment letter was held to have apparent authority and the lender was bound by its terms. Although a lending officer's unauthorized representations to lend at an interest rate lower than that contained in the signed loan documents may not be enforceable against the bank, the borrower may have a right to rescind the loan because no contract was formed. See *Grimes v New Century Mortgage Corp.* (9th Cir 2003) 340 F3d 1007.

PRACTICE TIP: To avoid creating contrary impressions through conduct or negotiations, lenders should require their agents to disclose their limited authority to borrowers and to follow all internal procedures for loan approvals.

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§12.37 5. Loan Assignment; Holder in Due Course Doctrine

Lenders, particularly lenders that securitize a large percentage of their loans, frequently sell (and thus transfer ownership of) loans secured by real property. See, *e.g.,* discussion of securitized lending in California Real Estate Finance Practice: Strategies and Forms, chap 10 (Cal CEB 2000); 1-2 Nelson & Whitman, Real Estate Finance Law, chaps 5, 11 (5th ed 2007). The securitization of loans and the engagement of loan servicers to act as collection agents for the loans are considered obstacles to achieving workouts (loan modification agreements) on smaller loans (see chap 10), and these activities may also make a rescission or an action for damages more difficult. For a discussion of such barriers to loan modifications, see Eggert, *What Prevents Loan Modifications?,* 18 Hous Policy Debate (No. 2, 2007), available online at http://ssrn.com/abstract=1081479.

The assignee may defend claims arising from the acts or omissions of the originating lender by invoking the holder in due course doctrine, adopted in California under Com C §3302, which provides:

> (a) Subject to subdivision (c) and subdivision (d) of Section 3106, "holder in due course" means the holder of an instrument if both of the following apply:
> (1) The instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity.
> (2) The holder took the instrument (A) for value, (B) in good faith, (C) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (D) without notice that the instrument contains an unauthorized signature or has been altered, (E) without notice of any claim to the instrument described in Section 3306, and (F) without notice that any party has a defense or claim in recoupment described in subdivision (a) of Section 3305.
> (b) Notice of discharge of a party, other than discharge in an insolvency proceeding, is not notice of a defense under subdivision (a), but discharge is effective against a person who became a holder in due course with notice of the discharge. Public filing or recording of a document does not of itself constitute notice of a defense, claim in recoupment, or claim to the instrument.
> (c) Except to the extent a transferor or predecessor in interest has rights as a holder in due course, a person does not acquire rights of a holder in due course of an instrument taken (1) by legal process or by purchase in an execution, bankruptcy, or creditor's sale or similar proceeding, (2) by purchase as part of a bulk transaction not in ordinary course of business of the transferor, or (3) as the successor in interest to an estate or other organization.
> (d) If, under paragraph (1) of subdivision (a) of Section 3303, the promise of performance that is the consideration for an instrument has been partially performed, the holder may assert rights as a holder in due course of the instrument only to the fraction of the amount payable under the instrument equal to the value of the partial performance divided by the value of the promised performance.
> (e) If (1) the person entitled to enforce an instrument has only a security interest in the instrument and (2) the person obliged to pay the instrument has a defense, claim in recoupment, or claim to the instrument that may be asserted against the person who granted the security interest, the person entitled to enforce the instrument may assert rights as a holder in due course only to an amount payable under the instrument which, at the time of enforcement of the instrument, does not exceed the amount of the unpaid obligation secured.
> (f) To be effective, notice shall be received at a time and in a manner that gives a reasonable opportunity to act on it.
> (g) This section is subject to any law limiting status as a holder in due course in particular classes of transactions.

The doctrine allows the assignee to hold the loan contract free of many claims the borrower has against the originator. See, *e.g., Wilson v Toussie* (ED NY 2003) 260 F Supp 2d 530; *Stuckey v Provident Bank* (Miss 2005) 912 So2d 859. The doctrine applies only to negotiable instruments, such as checks or promissory notes, which are promises to pay to order or bearer a fixed sum of money that are unconditional and assignable and under which payment is required either on demand or at some specific time. *Growth Equities Corp. v Freed* (1991) 227 CA3d 506, 509, 277 CR 848 (citing Com C §3104(1)).

The holder in due course doctrine eliminates most but not all defenses that a borrower might have. A borrower

retains the so-called "real defenses" against a holder in due course, which are defined in Com C §3305(a)(1) and include infancy, duress, lack of legal capacity, illegality of the transaction, discharge of the borrower through bankruptcy proceedings, and fraud causing the borrower not to know the nature of the loan documents or their essential terms. However, the "real defenses" are rare and often difficult to prove.

Certain claims or defenses based on the federal Truth in Lending Act (TILA) (15 USC §§1601-1667f; see §12.59) and the amendments to TILA under the Home Ownership and Equity Protection Act of 1994 (HOEPA) (Pub L 103-325, 108 Stat 2160; see §12.70) may be brought against a holder in due course. On assignee liability in the context of TILA, see §12.64.

For some high-interest mortgage loans, the HOEPA provides certain defenses that may be brought even against a holder in due course. See 15 USC §§1639, 1641. If a loan has an interest rate that meets or exceeds HOEPA's interest rate trigger or has fees that meet or exceed HOEPA's fee trigger (defined below), then the loan is considered a high-cost loan under HOEPA. See 15 USC §1602(aa). The HOEPA abrogates the holder in due course rule for high-cost mortgages because a purchaser or assignee of a high-cost mortgage referred to in 15 USC §1602(aa) is "subject to all claims and defenses with respect to that mortgage that the consumer could assert against the creditor of the mortgage." 15 USC §1641(d)(1). See *Reiser v Residential Funding Corp.* (7th Cir 2004) 380 F3d 1027.

Assessing the applicability of this doctrine and its potential exceptions is complex. See §§1.24-1.30, 3.59, 9.119, 12.103. See also 1 Nelson & Whitman, Real Estate Finance Law §§5.27-5.35 (5th ed 2007); Eggert, *Held Up in Due Course (Part 2): Predatory Lending, Securitization, and the Holder in Due Course Doctrine,* 35 Creighton L Rev 503 (Apr. 2002), available online at http://ssrn.com/abstract=904661.

Borrowers have brought actions claiming that lenders who cannot produce the original notes are not holders in due course and therefore not entitled to foreclose. However, federal courts have ruled that because California is a nonjudicial foreclosure state and foreclosures may be brought by trustees under the deed of trust without producing the note, a creditor need not prove that it is a holder in due course in possession of the note in order to foreclose. See, *e.g., Bouyer v Countrywide Bank* (ND Cal, June 25, 2009, No. C 08-5583) 2009 US Dist Lexis 53940 (possession of original note is not prerequisite to trustee sale); *Sicairos v NDEX W., LLC* (SD Cal, Feb. 13, 2009, No. 08cv2014) 2009 US Dist Lexis 11223 (noting that CC §2924(a)(1) does not expressly require party commencing nonjudicial foreclosure to physically possess or produce promissory note).

Borrowers have been more successful in their "produce the note" defenses in bankruptcy court when lenders have sought to obtain relief from the automatic bankruptcy stay to foreclose. See, *e.g., In re Lee* (Bankr CD Cal 2009) 408 BR 893; *In re Kwan Jin Hwang* (Bankr CD Cal 2008) 393 BR 701, rehearing granted and opinion modified at (Bankr CD Cal 2008) 396 BR 757. See also §§7.105-7.106.

PRACTICE TIP: When there is a legitimate question whether the purported creditor holding the mortgage is in fact the holder of the note, borrowers' attorneys should consider whether they can and should litigate the issue of ownership of the note in bankruptcy court.

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§12.38 6. Failure of Conditions Precedent; Waiver of Conditions

Most lenders are careful to include all necessary conditions in a loan commitment in order to avoid having to make a loan they do not want to make and did not agree to make. Almost all commitment letters require that the stated conditions precedent must be satisfied by the borrower before the lender will be obligated to make the committed loan. Borrowers often will assert that the conditions have been satisfied or waived by the lender in order to qualify for the loan under the terms of the commitment.

For example, in *Clardy Mfg. Co. v Marine Midland Bus. Loans Inc.* (5th Cir 1996) 88 F3d 347, the Fifth Circuit reversed an award of damages to a borrower who asserted that because certain creditworthiness conditions in the lender's proposal letter were satisfied, the lender was obligated to make the loan. The court of appeals held that the enumerated conditions were "neither so definite nor so all inclusive" as to establish that a commitment letter would necessarily issue on their satisfaction. 88 F3d at 353.

Similarly, in *Penthouse Int'l v Dominion Fed. Sav. & Loan Ass'n* (2d Cir 1988) 855 F2d 963, the waiver-of-conditions allegation figured prominently in the reversal by the Second Circuit Court of Appeals of the trial judge's decision awarding the borrower $129 million in damages. The borrower had convinced the trial court (sitting without a jury) that all conditions had been met or waived, but the court of appeals held that there was no evidence that the lead lender had had authority to waive conditions on behalf of the defendant, who was a participating lender.

Courts have generally found lenders to be relieved of having to make a loan when a condition precedent has been clearly required in the commitment but has not been satisfied. See *Farm Crop Energy, Inc. v Old Nat'l Bank* (Wash 1988) 750 P2d 231. Nevertheless, the lender should be cautious when deciding that a failure of a condition has occurred if it is a minor or immaterial condition. A court that finds no *material* breach has occurred may well find that the lender had other, self-interested motives for its actions, such as rising interest rates. See *Mortgage Fin., Inc. v Podleski* (Colo 1987) 742 P2d 900. Moreover, the lender should not conclude that a simple failure by the borrower to satisfy a condition relieves it of its loan commitment when it has acted contrary to enforcing the condition or in a way that indicates the condition is not required. Such conduct can constitute a waiver. See *Island Recreational Dev. Corp. v Republic of Texas Sav. Ass'n* (Tex 1986) 710 SW2d 551.

Conditions precedent, however, can and do afford the lender substantial protection against liability for breach of a loan commitment. Consequently, the lender should include in the commitment, in writing, all the preliminary requirements in the form of conditions precedent. Preliminary requirements that can and should be set forth in writing as conditions precedent include adequate appraisals, prior satisfactory inspections, construction of the improvements for a take-out loan in accordance with plans and specifications, adequate property insurance, obtaining permanent financing, obtaining participants for the loan, and obtaining an appropriate lenders' title insurance policy insuring priority for the lender's security. These conditions should also be stated to be subject to waiver only in writing signed by the lender.

EXAMPLE: Lenders should require borrowers to obtain property insurance as a condition for purchase money loans to ensure that the lender can share in the proceeds in the event of an insurable loss. See *Foothill Village Homeowners Ass'n v Bishop* (1999) 68 CA4th 1364, 81 CR2d 195.

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§12.39 7. Checklist: Commitment Letter Procedures

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The following is a list of safeguards for lenders as they implement commitment letters. Taking these steps should reduce their exposure to liability claims. (The actual form and substance of a commitment letter is dependent on the nature of the particular transaction.)

- Ensure adherence to the policy and practice of putting all loan commitments in writing.
- Inform the borrower of the policy requiring a writing and verify its application to this borrower.
- Inform the borrower of the specific lending officer's lending limits.
- Include a provision that the commitment may only be modified or a condition waived by a writing signed by the lender, and that there can be no modification or waiver by conduct.
- Include provisions setting forth each condition precedent in detail.
- Include a provision that sets forth what type of commitment agreement is being made (*e.g.,* bilateral agreement, unilateral agreement, option agreement).
- Include a provision for the commitment fee and state what it is (if there is no fee, state this affirmatively).
- Include a provision that the commitment and its provisions cannot be separated or severed one from another by operation of law, unless agreed to in writing by the lender.
- Include a provision that sets forth when and how the borrower must accept the commitment.
- Include an integration clause.
- Include a "time is of the essence" clause.
- Include an expiration date and a provision that after that date the lender has no further duties.

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§12.40 C. Liability in Loan Documentation and Closing

The careful and proper documentation and closing of a loan is the most important process in which a lender can protect itself against being sued by a borrower. See California Real Estate Finance Practice: Strategies and Forms (Cal CEB 2000) for discussion of loan documentation and closing, including annotated forms.

Sections 12.41-12.45 treat specific points relevant to lender liability. These points and practice tips are made from the point of view of advising the lender on what documentation and care are needed to avoid exposure to liability.

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§12.41 1. Variations From Terms of Commitment Letter; Unwarranted Delays in Closing

Typically, the loan commitment is nothing more than an outline of the material terms of the loan. Once the borrower has accepted the commitment, the parties embark on the process of documenting the loan—*i.e.,* preparing a formal loan agreement and related documents that set forth the loan transaction in great detail. Inevitably, disagreements will arise between the borrower and the lender over the inclusion or wording of certain provisions in the loan documents. Although these disputes are almost always resolved during the loan documentation process, a lender will be at risk if it insists on varying from the terms of the commitment letter or including additional material provisions in the final loan documents. See, *e.g., 999 v C.I.T. Corp.* (9th Cir 1985) 776 F2d 866, in which the court of appeals upheld an award of $925,000 against a lender for failure to honor a loan commitment. In *999*, the Ninth Circuit Court of Appeals found that the prospective borrower had rightfully rejected the transaction by refusing to agree to an additional, material provision ($25,000 per month prepayment penalty) that was not included in the original loan commitment. See also *River Colony Estates Gen. Partnership v Bayview Fin. Trading Group* (SD Cal 2003) 287 F Supp 2d 1213 (loan purchaser's knowledge that borrowers' fiduciary and original lender failed to disclose to borrowers material differences in interest rate (and other loan terms) and substantial assistance given by purchaser in lending process supported cause of action for aiding and abetting breach of fiduciary duty); *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162.

The duty to negotiate in good faith applies equally to the borrower. In *Teachers Ins. & Annuity Ass'n v Butler* (SD NY 1986) 626 F Supp 1229, the court found that the implied covenant of good faith and fair dealing imposed a duty on both parties to negotiate in good faith the terms of the final loan documents. Finding that the borrower's refusal to accept a provision requiring payment of a prepayment fee in the event of a default was simply a pretext for not going forward with the loan, the court awarded damages to the lender. The court stated that "provisions necessary to implement the express terms of the commitment letters, but … not contained in the commitment letters" are historically contained in closing documents for commercial real estate loans.

Under Fin C §22317.5, the California Finance Lenders Law (Fin C §§22000-22780) prohibits a lender from

- failing to disburse funds according to the loan commitment accepted by the borrower; or
- intentionally delaying the closing of a loan for the sole purpose of increasing interest, costs, fees, or charges payable by the borrower.

Thus, although lenders should not vary from the loan commitment or require additional material terms in the loan documents unless the borrower agrees, they can include standard provisions necessary to implement the loan contemplated by the commitment letter.

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§12.42 2. Conduct in Negotiations

The lender's conduct and attitude, and the conduct and attitude of lender's counsel, in the course of negotiations may have a bearing in a later liability suit against the lender. A significant case in which the attitude and conduct of lender's counsel jeopardized the lender's position occurred in *Penthouse Int'l v Dominion Fed. Sav. & Loan Ass'n* (2d Cir 1988) 855 F2d 963. In entering a $129-million judgment (in excess of the lender's net worth) for the borrower and against the lender and the lender's attorney, the trial judge was adversely influenced by the attitude of the lender's attorney, both during loan negotiations (when, among other things, the attorney called the loan documentation prepared by others "idiotic") and when he testified at trial. Describing counsel's testimony at trial, the trial judge said he "continuously shifted uneasily in the chair, sweated like a trapped liar, and the glaze that came over his shifty eyes gave proof to his continuing perjury." 855 F2d at 974. The judgment was reversed on appeal as the appellate court found insufficient evidence to support the trial court's findings of fact. The trial judge's show of extreme dislike for the lender's attorney probably contributed to the appellate reversal.

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§12.43 3. Waiver of Jury Trials

Including in the loan documents a waiver of a right to trial by jury has had mixed results. Early cases arising in a loan context focused on the issue of consent. For a jury trial waiver to be effective, it must at least be knowing, voluntary, and intelligent. *Standard Wire & Cable Co. v Ameritrust Corp.* (CD Cal 1988) 697 F Supp 368 upheld waivers of the right to a jury trial contained in individual guaranties executed contemporaneously with other documents in a financing transaction in which the guarantors were represented by counsel. In *K.M.C. Co. v Irving Trust Co.* (6th Cir 1985) 757 F2d 752, the court held that a contractual waiver was not effective because it was neither knowing nor voluntary. In *K.M.C.,* the loan officer had represented to the borrower that the jury trial waiver would not be enforced; in light of this representation, the court refused to find that the borrower had waived this right.

The California Supreme Court provided a good deal of clarity concerning waivers of the right to jury trial in a commercial (nonconsumer) context. In *Grafton Partners LP v Superior Court* (2005) 36 C4th 944, 32 CR3d 5, the court rejected the notion that California law is neutral on the issue of jury waivers. Holding that ambiguities must be resolved in favor of preserving the right to jury trial, the court repudiated the validity of contractual jury waivers entered into prior to the commencement of litigation and not as part of an arbitration or judicial reference provision. In so ruling, the court overruled, to the extent inconsistent with *Grafton,* the decision of *Trizec Props. Inc. v Superior Court* (1991) 229 CA3d 1616, 280 CR 885. The essential reasoning in the *Grafton* decision—which the court described as principally a matter of statutory interpretation—was that the legislature, by enacting CCP §631, authorized jury waivers in the course of litigation but had not approved such waivers in a prelitigation (*i.e.,* contractual) context. Given this lack of legislative authority and the constitutional mandate to hold the right to jury trial "inviolate" (Cal Const art I, §16), the court held that prelitigation waivers were not enforceable. The court further declined to limit its decision only to prospective cases, reasoning that parties to existing contracts should not be denied the right to a jury trial and that prior decisions had not resulted in a longstanding or widespread uniform body of law that would now be overturned. The court did, however, approve jury trial waivers that are included explicitly or implicitly in arbitration clauses and judicial reference provisions and reconciled this outcome with its holding by noting that (1) the legislature has expressly authorized the use of predispute arbitration clauses under CCP §§1280-1299.9, (2) there is a strong public policy favoring arbitration, and (3) such clauses, unlike jury waiver provisions, conserve rather than consume judicial resources. 36 C4th at 964.

The *Grafton* decision may not be the final word on predispute jury waivers. The decision creates a somewhat anomalous situation in which the two ends of the civil dispute resolution spectrum—full jury trials and private arbitration —are favored and fully permitted, but the resolution of disputes by civil bench trials is disfavored and cannot be secured through the use of predispute contracts. The court appears to have recognized this anomaly and to invite legislative attention to the jury waiver issue. Pending such possible legislative action, however, *Grafton* provides clarity, simplicity, and predictability in the area at the cost of some loss of freedom of contract.

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§12.44 4. Mandatory Arbitration Clauses

Increasingly, lenders are turning to arbitration provisions as a means of avoiding "runaway" jury verdicts and in an attempt to cut the costs of dispute resolution. As the *Grafton* court recognized (see §12.43), California has adopted a strong public policy in favor of arbitration clauses and has expressly recognized the enforceability of such clauses by statute. Code of Civil Procedure §1281 provides:

> A written agreement to submit to arbitration an existing controversy *or a controversy thereafter arising* is valid, enforceable and irrevocable, save upon such grounds as exist for the revocation of any contract. [Emphasis added.]

Moreover, arbitration clauses that do not include an express waiver of the right to a jury trial have nevertheless been upheld. See *Madden v Kaiser Found. Hosps*. (1976) 17 C3d 699, 131 CR 882. The *Grafton* decision adds additional incentive for lenders to include arbitration or judicial reference provisions in their loan documents. See, *e.g.,* California Real Estate Finance Practice: Strategies and Forms, chaps 3-4 (Cal CEB 2000).

The validity of arbitration and judicial reference provisions may be independently challenged on the basis of unconscionability. For example, arbitration provisions contained in consumer loan agreements evidencing certain small consumer loans were found unconscionable, and therefore unenforceable, in *Patterson v ITT Consumer Fin. Corp.* (1993) 14 CA4th 1659, 18 CR2d 563. Arbitration provisions in loan documents are unenforceable if the execution of the loan documents was obtained by fraud. *Jones v Adams Fin. Servs.* (1999) 71 CA4th 831, 84 CR2d 151. Similarly, a court of appeal held that bank customers did not consent to the insertion of an alternative dispute resolution (ADR) clause in their checking account agreements with the bank even though they had given advance consent allowing the bank to change the terms of the agreements. See *Badie v Bank of America* (1998) 67 CA4th 779, 790, 79 CR2d 273. See also *Flores v Transamerica HomeFirst, Inc.* (2001) 93 CA4th 846, 113 CR2d 376 (court declared arbitration clause in reverse mortgage to be unconscionable).

In an unsecured lending (credit card) case, the supreme court addressed the enforceability of arbitration clauses and concluded that under some circumstances, "class action waivers in consumer contracts of adhesion are unenforceable, whether the consumer is being asked to waive the right to class action litigation or the right to classwide arbitration." See *Discover Bank v Superior Court* (2005) 36 C4th 148, 153, 30 CR3d 76.

For nonlender cases refusing to enforce arbitration agreements in whole or in part because of unconscionability or a party's lack of consent, see *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892 (trial court may sever unconscionable provisions from contract and force employee to arbitrate under remainder of contract); *Armendariz v Foundation Health Psychcare Servs.* (2000) 24 C4th 83, 99 CR2d 745 (if agreement to arbitrate is wholly one-sided, trial court may declare entire agreement unconscionable and refuse to enforce it); *Bruni v Didion* (2008) 160 CA4th 1272, 73 CR3d 395 (homebuyers did not knowingly agree to arbitration provisions, which were unconscionable because they were contained in homebuilder's warranty (regarded as contract of adhesion) and they violated buyers' reasonable expectations). See analysis of *Little* in 25 CEB Civ Litigation Rep 58 (Apr. 2003) and of *Armendariz* in Souza & True, *Employment Litigation: Significant 2000 Cases,* 22 CEB Civ Litigation Rep 271 (Dec. 2000). For an appellate decision in a consumer (motor home) case finding no evidence that an arbitration clause was unconscionable, see *Crippen v Central Valley RV Outlet, Inc.* (2004) 124 CA4th 1159, 22 CR3d 189. See also unconscionability analysis applied to judicial reference clauses in *Trend Homes, Inc. v Superior Court* (2005) 131 CA4th 950, 32 CR3d 411; *Greenbriar Homes Communities, Inc. v Superior Court* (2004) 117 CA4th 337, 11 CR3d 371.

Arbitration provisions may be enforceable—even if presented on a "take it or leave it" basis—as long as the allegedly weaker party has the opportunity to negotiate and the opportunity to seek a more favorable contract with some other party instead. *Spinello v Amblin Entertainment* (1994) 29 CA4th 1390, 34 CR2d 695. *Spinello* distinguished cases involving true adhesion contracts, in which the weaker party not only lacked the ability to bargain but also lacked a realistic opportunity to look elsewhere for a more favorable contract.

A bankruptcy petition filed after the invocation of a contract arbitration provision will not prevent determination of the matters by arbitration as long as the contract is enforceable. *MCI Telecommunications Corp. v Gurga* (*In re Gurga)*

(BAP 9th Cir 1994) 176 BR 196.

California courts will enforce equitable arbitration awards in business cases even though a court could not have made such an award. See *Advanced Micro Devices, Inc. v Intel Corp.* (1994) 9 C4th 362, 36 CR2d 581. See also *Michigan Mut. Ins. Co. v Unigard Sec. Ins. Co.* (9th Cir 1995) 44 F3d 826.

For extensive discussion of mediation and arbitration clauses and their enforceability in real property litigation, see California Real Property Remedies and Damages, chap 14 (2d ed Cal CEB 2002).

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§12.45 5. Checklist: Loan Documentation Procedures

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The following are suggestions for documenting a loan that may assist the lender in avoiding liability.

- Use experienced counsel.
- Insist that borrower has truly independent counsel.
- Include an integration clause.
- Set forth all terms and conditions in writing in the loan documents.
- Compare all terms and conditions in the proposed loan documents with the commitment agreement, loan underwriting and written approval form of lender guidelines for loan administration, and the lender's standard loan provisions and policies.
- Include representatives from the lender's loan administration team in documenting the loan.
- Include a clause saying that the loan agreement overrides all other agreements that are in conflict with its terms (including the commitment letter and the construction contract).
- Add a "no waiver by conduct" clause.
- Consider an arbitration clause and jury trial waiver clause.

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§12.46 D. Disclosure of Material Adverse Information

Lenders in many instances obtain adverse information about a property or project as they collect underwriting data. For example, an in-house appraisal could show that the loan is in excess of the lender's loan-to-value guidelines or that pro forma rent projections show the project revenues insufficient to cover debt service. Whether a lender should disclose this information to its borrower or other interested parties is a close call, posing a large dilemma and possible risk for the lender. See §§12.47-12.49. If adverse information is not material in the context of the size of the loan and the sophistication of the borrower, the underwriting information need not be disclosed. If the information is significantly adverse and material, the loan should not be made. If the loan is not made and, therefore, the borrower's project is never attempted, the adverse information will probably never have an impact. On the other hand, if the borrower is unsophisticated and the information is of modest materiality, the question is very difficult. The usually safer and preferred route would be to disclose the information.

For discussion of disclosure obligations regarding particular parties in loan transactions, see §§12.47-12.49. On California common law and statutory nondisclosure liability in real property transactions, see California Real Property Remedies and Damages, chap 3 (2d ed Cal CEB 2002).

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§12.47 1. To Borrower

California case law does not squarely address the issue of when adverse information must be disclosed to the borrower. For example, in *Kruse v Bank of America* (1988) 202 CA3d 38, 52, 248 CR 217, the court simply reiterated part of the definition of "actionable fraud" in CC §1710, which states that, ordinarily, "failure to disclose material facts known only to one party is not actionable fraud unless there is a fiduciary or confidential relationship imposing a duty to disclose."

However, certain cases have outlined some of the principles by which lenders should be guided. In *Warner Constr. Co. v City of Los Angeles* (1970) 2 C3d 285, 294, 85 CR 444, an action by a contractor against the real property owner, the California Supreme Court said:

> In transactions which do not involve fiduciary or confidential relations, a cause of action for non-disclosure of material facts may arise in at least three instances: (1) the defendant makes representations but does not disclose facts which materially qualify the facts disclosed, or which render his disclosure likely to mislead; (2) the facts are known or accessible only to defendant, and defendant knows they are not known to or reasonably discoverable by the plaintiff; (3) the defendant actively conceals discovery from the plaintiff.

The court in *Goodman v Kennedy* (1976) 18 C3d 335, 347, 134 CR 375, cited the *Warner* case for the principle that when one party to a transaction has sole knowledge of or access to material facts and knows that such facts are not known to or reasonably discoverable by the other party, a duty of disclosure may arise. However, the party having knowledge of the facts must also know that omitted matters are material and that the other party does not know these facts and cannot reasonably discover them. 18 C3d at 348.

Some California cases cite Restatement (Second) of Torts §551 (1977) for the rule on the duty of disclosure in a business transaction. See *Wells v John Hancock Mut. Life Ins.* (1978) 85 CA3d 66, 149 CR 171. The rule is stated as follows:

> (1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question; (2) one party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated … facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

In *Nibbi Bros., Inc. v Brannan St. Investors* (1988) 205 CA3d 1415, 1425, 253 CR 289, which involved a business transaction, the court confirmed that if a person "who is under no duty to speak nevertheless does so … he is bound to speak honestly, and not to suppress facts which materially qualify those stated." That principle must be considered in light of the related principle that ordinarily the misrepresentation must be of *fact*. Civil Code §1710 defines "deceit" in part as "suppression of a fact, by one who … gives information of other facts which are likely to mislead for want of communication of that fact." See §12.5. Hence, if a lender communicates any facts to its borrower, it should communicate *all* material facts on the issue or liability may well ensue. In most cases, the prudent course will be to disclose any adverse information, because by entering into, administering, or working out a commercial real property loan, the lender's communicating some facts is unavoidable.

Under general principles of agency and statutory duties created by California real estate law, a real estate loan broker has clear disclosure obligations. See, *e.g., Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392 (when loan documents did not coincide with oral representations made by broker earlier in the transaction, broker's failure to orally disclose actual interest rate, late payment penalty, or amount of balloon payment was breach of fiduciary duty).

The obligation of lenders to borrowers to ensure the quality of appraisals on real property securing federally insured mortgages (24 CFR §§25.6(ee), 203.5(e)) may ultimately create new disclosure duties for lenders.

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§12.48 2. To Third Parties

A lender was held liable to its customer's supplier when the bank negligently responded to a credit inquiry by giving the impression that the customer had sufficient funds to honor a large check when in fact the customer had insufficient cash and a history of overdrafts. *MSA Tubular Prods., Inc. v First Bank & Trust Co.* (10th Cir 1989) 869 F2d 1422.

In *Karoutas v HomeFed Bank* (1991) 232 CA3d 767, 283 CR 809, the court allowed purchasers who bid on and bought a home at a nonjudicial foreclosure sale to go forward with their action against the foreclosing lender for rescission and damages based on the lender's failure to disclose a prior internal inspection report documenting severe subsidence problems on the property. See *Alexander v McKnight* (1992) 7 CA4th 973, 9 CR2d 453 (seller liable for failure to disclose prior offensive and noxious activities of neighbor); *Little v Community Bank* (1991) 234 CA3d 355, 286 CR 4 (judgment creditor selling homestead liable under CCP §704.760(c) for negligent failure to disclose existence of senior liens at foreclosure sale). However, a lender need not disclose information that is unrelated to the particular transaction. *Schoepe v Zions First Nat'l Bank* (D Utah 1990) 750 F Supp 1084, aff'd (1992) 952 F2d 1401 (unpublished opinion) (bank acting as escrow agent need not disclose loan relationship with one of parties to escrow).

In an attempt to provide foreclosure trustees and, perhaps, secured creditors with a measure of comfort in the wake of the *Karoutas* case, the legislature amended CC §2924h(g) to provide that "it shall not be unlawful for any person, including a trustee, to state that a property subject to a recorded notice of default or subject to a sale conducted pursuant to this chapter is being sold in an 'as is' condition." The foregoing amendment appears of little consequence in light of California law imposing a duty on sellers of real property to disclose material defects known to them, regardless of "as is" provisions in the sale contract.

The duties to disclose are further discussed in California Real Property Sales Transactions, chaps 2, 6 (4th ed Cal CEB 2007). Remedies for nondisclosure are discussed in California Real Property Remedies and Damages, chaps 1-3, 6 (2d ed Cal CEB 2002).

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§12.49 3. To Guarantors and Insurers

Although the circumstances under which the principles mentioned in §12.47 should be applicable to the relationship between the lender and the borrower are uncertain, adverse material facts must be disclosed to a guarantor upon whose guaranty the lender relies. *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564. In this case, the court stated that the lender has a duty to the guarantor to disclose facts known to the lender if the lender has reason to believe that those facts materially increase the risk beyond that which the guarantor intended to assume and that those facts are unknown to the guarantor. 70 C2d at 84. Another condition that must be shown to establish liability for the nondisclosure is that the lender had a reasonable opportunity to communicate the facts to the guarantor. 70 C2d at 93. The guaranty agreement and the relationship between the lender and the guarantor should determine the lender's conduct in this regard. See 70 C2d at 86.

A lender owes this same duty of disclosure to a guarantor during the life of the guaranty as it does at the loan's inception. The lender, according to *Sumitomo*, owes to the guarantor a duty of continuous good faith and fair dealing. 70 C2d at 85. See also *Barrett v Bank of America* (1986) 183 CA3d 1362, 229 CR 16, discussed in §§12.16, 12.119, in which the court found the guarantor's "special relationship" with the lender imposed a quasi-fiduciary duty on the lender, and as a result, the lender's failure to disclose certain matters carried liability for the lender sounding in constructive fraud.

Disclosure by the lender to the guarantor of adverse information is a difficult problem, but *Sumitomo* and *Barrett* seem to suggest that a lender follows a preferred and better practice by disclosing material, adverse information—especially if it is very material and adverse and could increase the guarantor's risk.

For the protection of both the federal government (as insurer) and the borrower, lenders are accountable for the quality of appraisals on real property securing mortgages insured by the Federal Housing Administration (FHA). 24 CFR §§25.6(ee), 203.5(e). Arguably, if a lender knows or has reason to know that an appraisal in an FHA-insured mortgage is deficient or substandard, the lender has a duty to disclose that fact to the government and the borrower.

Loan guaranties issued by the Rural Housing Service (RHS) are incontestable "except for fraud or misrepresentation," including negligent misrepresentation, of which the lender "has actual knowledge" at the time of becoming a lender or which the lender "participates in or condones." 7 CFR §1980.308.

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III. PREDATORY LENDING

§12.50 A. Historical Background

Ever since use of the term "predatory lending" began in the early 1990s, users of the term have argued over its exact meaning. It has been used to describe a large number of different problems arising in the residential home lending industry. Some have sought to define "predatory lending" by referring to a set of abusive practices often committed by high-cost lenders. Others have focused on whether lenders have used sharp practices to obtain above-market interest rates or other costs or fees or have encouraged borrowers to enter into loans likely to lead to foreclosure. In earlier editions of this book, the term was perceived to apply most strictly to situations involving "reverse redlining" or unscrupulous lenders and loan brokers who targeted certain geographic areas or vulnerable groups of people.

However "predatory lending" is defined, the practice often targets specific types of victims. These groups generally include those who have difficulty protecting themselves from sharp business practices and those who, because they have been previously shut out of the mortgage or financial industry, might be less experienced in negotiating a loan, less able to shop around for the best loan product, or most desperate to obtain a loan despite unfair terms. The elderly, the unsophisticated or poorly educated, and other vulnerable segments of the population have been targeted for abusive loans, especially if they have owned their homes for some time and have accumulated significant equity in those homes. "Predatory lenders" have convinced such borrowers to refinance their homes despite the high price of interest or closing costs or other unfair terms in the loan. See, *e.g., American Fin. Servs. Ass'n v City of Oakland* (2005) 34 C4th 1239, 1244, 23 CR3d 453. See also *Griffin v Felton (In re Felton)* (Bankr ND Cal 1996) 197 BR 881. The goals of predatory lending are to obtain loans with higher than market rate interests or other costs, to strip out the equity in borrowers' houses through high fees and frequent refinancing, and often to quickly sell the loans, typically on the secondary market or by securitizing them. Often, a borrower is left with a loan it cannot repay and a mortgage servicer collecting on behalf of a trust that claims to be a bona fide holder of the loan and so immune to defenses to foreclosure that the borrower may have against the originator of the loan. See §§12.37, 12.103.

The most recent manifestation of predatory lending is the subprime lending crisis that began in late 2006. During part of 2005, all of 2006, and the first half of 2007, lenders made a large number of loans without adequately underwriting the loans. Because they failed to underwrite the loans, the lenders made many loans to borrowers who could not repay the loans—some were unable to pay when the loan reset to a higher amount, and others were unable to pay even before then. The subprime industry has been swamped with increasing default and foreclosure rates as borrowers are unable to pay off their loans.

The subprime crisis has completely altered the subprime lending industry. Many of the largest subprime lenders have gone bankrupt, been seized by regulators, or otherwise exited the subprime market. Investors have dramatically reduced their purchases of securities backed by subprime loans, so that much of the remaining subprime lending is done by institutions holding their own loans rather than selling them. Investment banks that securitized loans have gone bankrupt or have changed their status.

Borrowers have not been the only victims of predatory lending, especially with the advent of the subprime crisis. The increasingly common practices of bundling large numbers of generic real estate secured loans for resale in secondary markets (often on a securitized basis in which the status of "beneficiary" was spread over a large number of passive investors) and the repackaging of subprime-backed securities into even more complex financial instruments played a major role in the turbulent mortgage markets and mortgage "crisis" of 2006 and beyond. As a result, many investors and investment funds have unwittingly purchased high-risk securities that ultimately are backed by loans with much higher than expected default rates, and the investors have little chance of recovering their losses from the originating lenders and brokers.

The expectation of immediate bundling and resale seems to have led to a major relaxation of loan underwriting standards that, in many instances, led some mortgage brokers and mortgage bankers to focus less on the long-term

strength of the borrowers and the real property security and more on simply generating the largest possible face value of mortgage paper. In some cases, courts have found it difficult even to identify the legal owners of the creditor's interest under the mortgage or deed of trust. See, *e.g.*, *In re Kwan Jin Hwang* (Bankr CD Cal 2008) 393 BR 701, rehearing granted and opinion modified at (Bankr CD Cal 2008) 396 BR 757; *In re Parrish* (Bankr ND Ohio 2005) 326 BR 708.

When Wall Street brokerage houses and other participants more familiar with stock markets and securities than with land entered the mortgage markets, a good deal of real estate savvy and prudential wisdom was displaced by abstract and financial models that disregarded historic and predictable real property market cycles. This led to an unusually long-sustained real estate boom, but it also meant that the eventual market corrections were concomitantly more severe. When this happened, market effects swamped the benefits of streamlined and standardized instruments. See, *e.g.,* Loubier & del Castillo, *The New Age of Real Estate Loan Defaults,* 31 CEB Real Prop L Rep 6 (Jan. 2008).

NOTE: Lending abuses are not confined to consumer loans made by noninstitutional or conduit lenders. Institutional lenders with respectable reputations in the banking industry can also be liable for lending abuses, and plaintiffs may be sophisticated commercial borrowers. See, *e.g., Auerbach v Great W. Bank* (1999) 74 CA4th 1172, 88 CR2d 718, discussed in §§12.129, 12.133; *State Nat'l Bank v Farah Mfg. Co.* (Tex App 1984) 678 SW2d 661, discussed in §§12.6, 12.26.

Over time, regulators and legislators on both the state and federal levels, as well as attorneys, legal aid organizations, consumer advocacy groups, and the lending industry, became more aware of the high rate of default and foreclosure occurring in the subprime industry and the borrowers' difficulty in understanding the increasingly complex loans offered to homeowners or the puzzling, dense, and impenetrable documentation that accompanies home loans. As a result, there have been efforts at the federal, state, and even local levels to address abusive lending and to provide remedies to its victims.

At this writing, in addition to California (see §§12.56-12.58), numerous states, counties, and municipalities throughout the United States have passed some form of law in an attempt to protect homeowners and home purchasers from predatory lending practices. A sampling of statutes includes the Florida Fair Lending Act (Fla. Stat. §§494.0078-494.00797); the Predatory Home Loan Practices Act (Mass. Gen. Laws ch. 183C); the Consumer Mortgage Protection Act (Mich. Comp. Laws §§445.1631-1645); N.Y. Banking Law §6-L; the Consumer Protection Predatory Lending Act (Ohio Rev. Code Ann. §§1349.25-1349.37); the Mortgage Bankers and Brokers and Consumer Equity Protection Act (63 Pa. Cons. Stat. §§456.101-456.3101); and Tex. Fin. Code Ann. §§343.001-343.206.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.51 B. Summary of Predatory Lending Practices

§12.51 B. Summary of Predatory Lending Practices

At its heart, "predatory lending" is the use of sharp practices to obtain a loan that is priced above the market rate, that has other abusive terms, or that significantly increases the likelihood that a borrower will go into default or foreclosure. See Huelsman, *A Brief Primer on Fighting Predatory Lending Practices*, http://www.abanet.org/genpractice/newsletter/lawtrends/0509/business/predatorylending.html. The following are the most prevalent and pernicious loan practices that significantly damage the borrower:

- "Steering" and the "yield spread premium," in which a supposedly independent broker is paid a commission premium by the lender for brokering a loan with increased interest rates despite the borrower's ability to qualify for more favorable loan terms. For discussion of yield spread premiums, see §§12.11, 12.56.
- Putting a borrower into a loan with little or no regard to the borrower's ability to repay the loan. This practice is prohibited in high-fee/high-cost residential loans. See, *e.g.,* 15 USC §1639(h); 12 CFR §226.34(a)(4); Fin C §4973(f)(1). This is especially common with adjustable rate mortgages, in which the rate adjusts after 3 to 5 years (so-called 3/1 and 5/1 ARMs), and Option ARMs, in which borrowers are given the choice to pay (1) the fully amortized payment (30-year and 15-year amortization schedule), (2) the interest-only payment, or (3) a negative amortizing payment of less than the full interest rate. These loans are many times packaged as "stated income loans" or "no docs" loans and underwritten by the lender for the negative amortized payment amount.
- Excessive impounding of interest payments. This practice can have several effects, including (1) reducing the amount of money a refinancing borrower actually realizes from the loan, (2) supporting such sales-pitch techniques as "no payment for 6 months," (3) reducing a lender's out-of-pocket exposure when the unaffordable loan inevitably defaults, and (4) "seeding" a credit file for eventual flipping by artificially creating the appearance of a borrower who always pays on time. This practice is prohibited in high-fee/high-cost loans. See, *e.g.,* 15 USC §1639(g); 12 CFR §226.32(d); Fin C §4973(d), discussed further in §12.56.
- Falsifying loan applications. A loan broker or lender may state on a loan application that a prospective borrower's income is greater than it really is in order to facilitate approval of the loan. This practice is likely to be found in loans made on so-called "stated income" bases.
- Adding false cosigners or guarantors in order to obtain additional security for the loan. See *e.g., Griffin v Felton (In re Felton)* (Bankr ND Cal 1996) 197 BR 881.
- Making unfavorable loans to disabled, mentally incapacitated, elderly, or uneducated homeowners. See, *e.g., Warren v Merrill* (2006) 143 CA4th 96, 49 CR3d 122, discussed in §12.13.
- Forging signatures on loan documents.
- Using a refinance loan with a higher interest rate to pay off lower income or lower interest mortgages.
- Making loans in excess of 100-percent loan to value (LTV).
- Bait and switch tactics, such as substantially changing loan terms at closing. See *Grimes v New Century Mortgage Corp.* (9th Cir 2003) 340 F3d 1007.
- Charging more than 1 day of interest on funds that have not yet been disbursed. See CC §2948.5; Fin C §50204(o); *Quicken Loans, Inc. v Wood* (9th Cir 2006) 449 F3d 944, cited in §§8.14, 8.45, 8.54.
- High annual interest rates or "default" interest rates that escalate the rate on an event of default (monetary or nonmonetary). Such rates are prohibited in high-fee/high-cost loans. See, *e.g.,* 15 USC §1639(d); 12 CFR §226.32(d)(4); Fin C §4973(e), discussed further in §§12.56, 12.72. See also *Beal Bank v Crystal Props., Ltd. (In re Crystal Props., Ltd.)* (9th Cir 2001) 268 F3d 743.
- High points, high broker or lender fees, and padded closing costs. See, *e.g.,* 15 USC §1602(aa)(1)(B); 12 CFR §226.32(a)(1)(ii); Fin C §4979.6.
- Interest-only loans with short terms and balloon payments due at maturity, which virtually guarantee default and the "flipping" opportunity. This is prohibited in high-fee/high-cost loans. See, *e.g.,* 15 USC §1639(e); 12 CFR §226.32(d)(1), discussed further in §§12.70-12.73; Fin C §4973(b)(1).
- Negative amortization (monthly interest payments are less than actual interest incurred, thereby forcing an

increase in the balance rather than a decrease). This is prohibited in high-fee/high-cost loans. See, *e.g.,* 15 USC §1639(f); 12 CFR §226.32(d)(2); Fin C §4973(c), discussed further in §§12.56, 12.72.

- Undisclosed or inadequately disclosed ARM adjustments. These have been particularly prevalent in recent years, and it is these borrowers, who didn't fully grasp the impact the adjustment would have, who are causing the greatest increase in default and foreclosure rates.
- Padded appraisal costs. See, *e.g.,* 24 CFR §§203.37a, 203.255.
- Fraudulently inflated home values in collusive appraisal scams.
- Padded recording fees.
- Bogus fees (*e.g.,* the closing statement (HUD-1) may state that the broker charges an underwriting fee when in fact brokers have no underwriting fee because, by definition, brokers do not "underwrite" loans).
- Itemizing duplicate services and charging separately for them.
- Misinforming the prospective homebuyer that credit insurance is required, or failing to disclose to the buyer that the lender or broker is earning a commission on the insurance. This is prohibited in high-fee/high-cost loans. See Fin C §4979.7.
- Mandatory arbitration clauses. To the extent that these clauses are more prevalent in subprime and securitized loans, they create not only a dual lending system but also a dual justice system for borrowers, eliminating rights to discovery, class action litigation, a court trial based on applicable state law, and appeal. See §§12.43-12.44.
- Falsely identifying loans as "lines of credit" or "open-ended mortgages" so as to avoid certain lending statutes and regulations applicable only to closed-end or fully amortized loans. This is prohibited in high-fee/high-cost loans. See, *e.g.,* 12 CFR §226.34(b); Fin C §4973(m)(1), discussed further in §12.56.
- Forced placed insurance. This consists of forcing a borrower to pay for insurance obtained by the lender or loan servicer at exorbitant cost under the claim that the homeowner does not have insurance, thus paving the way for the lender or servicer to get an undisclosed commission for selling it to the borrower. Such insurance generally costs two to three times the normal rate for homeowners insurance and does not cover the borrower at all.
- Repeated refinancing, widely known as "flipping." Oppressive loan terms force borrowers to pay high points, fees, or prepayment penalties. When an ARM interest rate resets or a balloon payment becomes due and borrowers are unable to pay their loans, they must repeatedly refinance. Dealing with borrowers caught in cycles of flipping, lenders strip equity on each closing by charging excessive loan fees and closing costs. These practices are prohibited in high-fee/high-cost loans. See, *e.g.,* 12 CFR §226.32(d)(1); Fin C §4973(j), discussed further in §§12.56, 12.72.
- Increased per diem interest when payments are late (so-called "default interest rates").
- Excessive prepayment penalties. See, *e.g.,* Fin C §4973(a). Prepayment penalties lock borrowers into high-interest loans or strip equity from their homes as they refinance to escape bad loans. Prepayment penalties are severely limited in high-fee/high-cost loans. See, *e.g.,* 15 USC §1639(c); 12 CFR §226.32(d)(6)-(7), discussed further in §12.72; Fin C §4973(a), discussed further in §12.56. See also *Weiss v Washington Mut. Bank* (2007) 147 CA4th 72, 53 CR3d 782. In some loans, prepayment penalties are completely prohibited. See §§8.42, 8.45.
- Foreclosure abuses. See CC §§1695-1695.17, discussed in §§2.9, 12.55, 12.58.
- Home-improvement scams.

See also statutory protections discussed in §§12.55-12.85. For further study, see United States Department of Housing and Urban Development/United States Department of Treasury Joint Task Force Study on Predatory Lending, available on HUD website at http://www.hud.gov/library/bookshelf12/pressrel/treasrpt.pdf. See also HUD website cautioning consumers about predatory lending at http://www.hud.gov/offices/hsg/sfh/buying/loanfraud.cfm.

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C. Preliminary Considerations

§12.52 1. Tort Versus Contract Damages

Whether the claim sounds in tort or contract will affect the measure and availability of damages. See full discussion in §§12.19-12.22. See also §§12.97-12.101. A plaintiff who prevails under a contract theory will be entitled to "the amount which will compensate the party aggrieved for all the detriment proximately caused [by the breach], or which, in the ordinary course of things, would be likely to result therefrom." CC §3300. A successful tort plaintiff is entitled to recover all damages proximately caused "whether it could have been anticipated or not." CC §3333.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.53 2. Checklist: Predatory Lending Facts

§12.53 2. Checklist: Predatory Lending Facts

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In addition to this checklist, an attorney evaluating a loan for predatory characteristics should review all marketing materials and correspondence relied on by the borrower; all loan documents, such as commitment letter, note, deed of trust, and written disclosures (including disclosures of lending terms and anticipated loan and settlement costs and fees under Truth in Lending Act (TILA) (15 USC §§1601-1667f), Regulation Z (12 CFR pt 226), Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617), and Regulation X (24 CFR pt 3500)); prohibited practices for secured residential lending in statutes and federal regulations listed in §§12.55-12.85 and 12.90-12.92; and all representations and advice given orally by the lender's agent or its broker to the borrower before or at the loan closing. The attorney should also review the prior loans obtained by this borrower on the property. The following list of questions is generally in the order of importance.

- Is the borrower facing a foreclosure on his or her home?
- Has a foreclosure date been set?
- If no foreclosure is pending, is the borrower behind in mortgage payments or in danger of defaulting on payments?
- Has the borrower signed a loan agreement, and does he or she now question whether it is a fair contract?
- Is the borrower considering signing a contract for a loan secured by his or her home?
- Is a family member, friend, or another person asking the borrower to sign papers related to the ownership of the client's home?
- Is the borrower a senior citizen, a minority or disabled person, or someone otherwise vulnerable to predatory tactics?
- Does or did the property have any amount of equity; how much?
- What was the original purchase price of the property?
- If this loan paid off a prior loan, how much was owed on the prior loan?
- How much is still owed on the current loan(s)?
- Who was the lender or mortgage company?
- Who is the lender now?
- Was the loan a second mortgage secured by the property?
- Where and how did the marketing or sale of the loan to the borrower take place?
- Did the borrower contact the lender, or did the lender solicit the borrower?
- What was the borrower's understanding of the loan terms?
- Who was present when the broker described the loan terms?
- Did the borrower receive any written explanations of the loan terms?
- Where and when was the closing conducted? Who was present?
- Were any of the terms left blank when documents for the loan were signed?
- Were any signatures forged or invalid?
- Were the loan documents notarized? Was the notary present at the time the loan documents were signed?
- Does the date the deed of trust was notarized accurately reflect the date of signing?

- Did the transaction go through escrow?
- Did the borrower get a copy of all the loan documents? If so, when did the borrower receive a copy of all the loan documents?
- How were loan proceeds disbursed (including broker, closing, and escrow fees)?
- Were the lender and the broker or servicing company the same?
- Did the broker or salesperson use scare tactics, such as environmental or energy costs, or taxes or liens?
- How much was the loan compared to the amount of money needed by the borrower?
- Was there a balloon payment for a lump sum at the end of the term of the loan?
- Are there prepayment penalties if the loan is paid off early?
- What is the interest rate for the loan?
- What are/were the costs and fees of obtaining the loan?
- Were the cost and fees of obtaining the loan paid out-of-pocket by the borrower or financed into the loan?
- How much are/were the points or closing costs for the loan transaction?
- Is there negative amortization on the loan principal owed?
- Was the loan made for a contractor to do home-improvement work?
- If so, was the work completed, and was the work performed done professionally?
- Was the loan used to pay off a prior loan with a lower interest rate?
- Was the loan used to pay off unsecured debts?
- How much was the loan compared to the value of the home (loan-to-value ratio)?
- Did the loan broker or lender falsify information (such as amount of income or values of assets) to qualify the borrower?
- Were there any cosigners?
- If this was a purchase money loan, did the buyer and seller use the same real estate broker?

See also factors listed in §12.54.

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§12.54 D. Parties; Sources and Theories of Liability

With the evolution of statutory liability, defendant parties may be found liable for predatory lending violations based on contract, negligence, civil or criminal fraud, or strict liability theories. Many of these theories are discussed in §§12.55-12.92. Liability for predatory lending can also be based on one or more of the forms of liability discussed in §§12.2-12.26.

Depending on the parties involved (borrowers, brokers, lenders, secondary market purchasers for value), an attorney analyzing a possible predatory lending problem should be prepared to consider numerous and quite disparate theories of liability.

WARNING: Some lenders are state-chartered (generally governed by laws of the state where chartered); others are federally chartered (*e.g.,* national banks are protected by preemption rules in 12 CFR §§34.1-34.4; federal savings entities are regulated under 12 CFR §560.2; see, *e.g., Weiss v Washington Mut. Bank* (2007) 147 CA4th 72, 53 CR3d 782). On some liability claims, state-chartered lenders may be regulated by both state and federal law. On other claims, state-chartered lenders are regulated by federal law because of the application of the preemption doctrine. See, *e.g.,* §§8.14, 8.31, 8.45-8.46. Assessing liability, therefore, requires (1) preliminary investigation of the lender's chartered status and the facts underlying the borrower's claim and (2) a thorough grasp of the interplay between state and federal law.

There are almost as many different legal theories as there are fact patterns and casts of characters within the predatory lending context. The tools at the plaintiff attorney's disposal will depend on many different factors—objective as well as subjective or strategic—that the attorney may encounter. These factors might include the following:

- Whether the loan involved the services of a mortgage broker;
- Whether the disclosures were appropriate;
- The borrower's preloan financial condition (*e.g.,* whether the borrower was in trouble with another loan);
- Whether the suspect loan was a purchase money loan or a refinance, construction, or other form of non-purchase money financing vehicle;
- Whether the loan is a closed-end or open-end loan;
- Whether the loan has been sold on the secondary market or whether it is still owned and being serviced by the original lender;
- Whether there is a real or perceived advantage to either obtaining or avoiding federal subject matter jurisdiction;
- Whether any party (borrower, lender, broker) is in bankruptcy; and
- Whether a Notice of Default or Notice of Trustee Sale has been recorded and properly served.

See also checklist in §12.53.

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§12.55 1. Statutory Sources

Statutory remedies available include federal, state, local, and municipal laws and ordinances. Local regulation of lending practices in California, however, is preempted by state statutes. See *American Fin. Servs. Ass'n v City of Oakland* (2005) 34 C4th 1239, 1259, 23 CR3d 453, discussed in §12.56.

The statutes generally fall into four broad categories:

(1) Substantive schemes that regulate actual lending practices, such as Fin C §§4970-4979.8, the Home Equity Sales Contract Act (CC §§1695-1695.17), CC §§2945-2945.11 (regulating mortgage foreclosure consultants, discussed in §§2.9, 12.58), and the Home Ownership and Equity Protection Act of 1994 (HOEPA) (Pub L 103-325, 108 Stat 2160);

(2) Disclosure schemes that do not regulate loan terms per se but prescribe the nature, extent, and timing of written disclosures about a particular loan if it falls under the statute's coverage (Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617) and the Truth in Lending Act (TILA) (15 USC §§1601-1667f));

(3) Statutes that regulate the actual loan documentation and closing process (RESPA); and

(4) Miscellaneous schemes that do not prima facie address home mortgage lending but may find application under certain factual settings and assist the practitioner (Fair Housing Act (FHA) (42 USC §§3601-3631); Bus & P C §17200).

NOTE: Also consider the state and federal statutes applied in lender liability situations, listed in §12.11.

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a. State Lending Statutes

§12.56 (1) Fin C §§4970-4979.8

Since June 30, 2002, California's anti-predatory loan statutes (Fin C §§4970-4979.8) have, with certain specified exceptions, applied to "covered loans," which are certain "consumer loans."

A "consumer loan" is "a consumer credit transaction that is secured by real property located in this state used, or intended to be used or occupied, as the principal dwelling of the consumer that is improved by a one-to-four residential unit." Fin C §4970(d). "Consumer loan" does not include a reverse mortgage, an open line of credit, or a bridge loan. Fin C §4970(d).

To be a "covered loan," a "consumer loan" must have either (1) an annual percentage rate (APR) that exceeds by more than 8 points the yield on Treasury securities having a similar term or (2) total points and fees, as defined, payable by the consumer at or before closing that exceed 6 percent of the total loan amount. Fin C §4970(b).

A covered loan is also one in which the original principal balance does not exceed the most current conforming loan limit for a single-family first mortgage loan established by the Federal National Mortgage Association (Fannie Mae). Fin C §4970(b). See http://www.fanniemae.com/aboutfm/loanlimits.jhtml for conforming loan limits. Between January 1, 2006, and January 1, 2009, the national conforming loan limit was $417,000. Loan limits for mortgages originated in 2009 are set under the provisions of the American Recovery and Reinvestment Act of 2009. Under that legislation, loan limits for 2009-originated loans are the higher of the 2008 limits and those that were originally announced for 2009 under the Housing and Economic Recovery Act of 2008. For example, in counties where 2009 limits actually increased (most counties in California), the new limits will remain at the higher level. See http://www.fhfa.gov/webfiles/1279/CLLarra022309_final.pdf.

This law governs loans made by a real estate broker licensed under the Real Estate Law (Bus & P C §§10000-10580), a finance lender or broker licensed under the California Finance Lenders Law (Fin C §§22000-22780), a residential mortgage lender licensed under the California Residential Mortgage Lending Act (Fin C §§50000-50706), a commercial or industrial bank organized under the Banking Law (Fin C §§99-3904), a savings association organized under the Savings Association Law (Fin C §§5000-10010), and a credit union organized under the California Credit Union Law (Fin C §§14000-16906). See Fin C §4970(g).

Holders in due course are not liable for violations, and persons chartered by Congress to engage in secondary mortgage market transactions are exempt from compliance. Fin C §4979.8. For discussion of holders in due course, see §§1.30, 12.37, 12.103. Also exempt are national banks, which are federally regulated. See 12 CFR §§34.3-34.4.

Covered loans under the California anti-predatory lending statutes are subject to the following limitations:

- Prepayment charges are prohibited after the first 36 months after the loan closes. Fin C §4973(a)(1).
- Prepayment charges may be applied within the first 36 months if the lender or broker offered the borrower another product without a prepayment charge with appropriate disclosures. Fin C §4973(a)(2). The prepayment charge must be limited to 6 months' interest, and the prepayment charge may not be collected if the loan accelerates because of a default. Fin C §4973(a)(2)(C)-(D).
- Negative amortization is restricted to first mortgages and must be disclosed. Fin C §4973(c).
- Advance payment of consolidated periodic payments (impounding) from the loan proceeds is prohibited. Fin C §4973(d).
- Default interest (see §§8.1, 8.34) is prohibited. Fin C §4973(e).
- The person who originates the loan must reasonably believe the consumer has the ability to repay the loan, taking into consideration, among other things, the consumer's income, obligations, employment status, and other financial resources. Fin C §4973(f)(1). However, a lender may rely on the income merely stated by the borrower for purposes of this reasonable belief. Fin C §4973(f)(3).
- Payment of loan proceeds to home-improvement contractors is restricted. Fin C §4973(g).
- The person who originates the loan may not recommend or encourage a consumer to default on an existing

consumer loan. Fin C §4973(h).

- Discretionary loan balance acceleration is prohibited unless it arises from a default. Fin C §4973(i).
- Any new loan that consists of the refinancing of a consumer loan, debt consolidation, or a cash-out must "result in an identifiable benefit to the consumer." Fin C §4973(j).
- Specific disclosures must be made on all affected loans no later than 3 business days before the signing of the loan documents. Fin C §4973(k).
- The person who originates the loan may not steer, counsel, or direct any prospective borrower to accept a loan product that has a specified risk grade less favorable than another risk grade for which the borrower would otherwise be qualified. Fin C §4973(*l*)(1).
- If the loan is a brokered mortgage, the above anti-steering provision also applies to the broker. Fin C §4973(*l*)(2).
- The person who originates the loan may not evade this law by structuring the loan as an open-end credit plan or splitting the loan. Fin C §4973(m).
- The person who originates the loan may not engage in fraudulent acts concerning the loan. Fin C §4973(n).
- The person who originates the loan may not make a covered loan that finances points and fees in excess of $1000 or 6 percent of the original principal balance, whichever is greater. Fin C §4979.6.

Administrative actions are available to licensing authorities, and civil actions are available to licensing authorities and aggrieved consumers. See Fin C §§4974-4978. Loan terms that violate this law are unenforceable, and the court may enter a judgment that reforms the loan agreement. Fin C §4978(b)(1). Plaintiffs may recover their actual damages or $15,000, whichever is greater, along with attorney fees and costs. Fin C §4978(a).

Unintentional violations or compliance failures that result from a bona fide error that occurs despite procedures reasonably adopted to avoid the error must be corrected within 45 days of receipt of the complaint or discovery of the error. Fin C §4974.

The issue of "yield spread premiums" was addressed in *Wolski v Fremont Inv. & Loan* (2005) 127 CA4th 347, 25 CR3d 500. A yield spread premium (YSP) is a commission premium that the lender pays to a mortgage loan broker for inducing a borrower to accept a higher interest rate loan than another loan package for which the borrower would otherwise qualify. 127 CA4th at 351. In *Wolski* the plaintiff contended that the YSP should count in the calculation of "points and fees" payable by the borrower "at or before closing" so as to include these points and fees in the calculation in Fin C §4970(b)(2) and bring the loan under the definition of "covered loan" for applicability of the statute.

Focusing on the transactional nuance that it is the lender who pays the broker and not the borrower directly, the *Wolski* court held that the YSP, which is a kickback to a broker for steering the borrower into a high-interest loan, does not bring the loan within the scope of the statute's coverage, because the payment is paid by the lender after close of escrow and not by the borrower at or before close of escrow. 127 CA4th at 352.

PRACTICE TIP: Counsel need not consider local regulation of predatory lending practices. The supreme court held that Fin C §§4970-4979.8 preempts a City of Oakland ordinance, despite evidence of Oakland's higher instance of subprime lending and predatory practices. Even though these are important local concerns, the court held that they do not give a city the "license to regulate a highly complex financial area comprehensively addressed by state law." *American Fin. Servs. Ass'n v City of Oakland* (2005) 34 C4th 1239, 1259, 23 CR3d 453.

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§12.57 (2) Finance Lenders Law

The California Finance Lenders Law (Fin C §§22000-22780) prohibits a lender from failing to disburse funds according to the loan commitment accepted by the borrower or intentionally delaying the closing of a loan for the sole purpose of increasing interest, costs, fees, or charges payable by the borrower. Fin C §22317.5.

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§12.58 (3) Foreclosure Rescue and Foreclosure Consultation Statutes

A foreclosure rescue scam occurs when a homeowner who is in foreclosure transfers the property to a lender or third party (straw buyer) for the purposes of obtaining a new loan on the property. Some victims understand that they are transferring ownership of the property but are under the belief that they will be able to continue to live in the property while making payments on the new loan. Other victims believe they are obtaining new financing and have no idea they have transferred title to their home. It was quite common during the mortgage boom that the new take-out loan would be for an amount much greater than what was owed, with the equity going into the pocket of the violator of the statute.

Civil Code §§1695-1695.17 and 2945-2945.11 set forth protections for a homeowner that has had a notice of default recorded against its property. These statutes include criminal penalties for committing certain acts against the homeowner's property interests. CC §§1695.8, 2945.7. For further discussion, see §§2.8-2.9.

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b. Federal Lending Statutes and Regulations

§12.59 (1) TILA and Regulation Z: Truth in Lending

The federal Truth in Lending Act (TILA) (15 USC §§1601-1667f), together with Regulation Z (12 CFR pt 226; Supp I of Regulation Z) and the Official Staff Interpretations of Regulation Z (known as "the Commentary"), requires lenders to make detailed disclosures to borrowers in consumer credit transactions. See §§12.60-12.69D, 12.96. For discussion of TILA in the context of debtor strategies to enjoin foreclosure, see §7.36; for discussion of TILA in the context of debtor strategies in bankruptcy, see §7.115. See also Simmons, *The Federal Truth in Lending Act: What You Don't Know Can Hurt You,* 27 CEB Real Prop L Rep 149 (Nov. 2004).

Remedies for violation of TILA include the right of rescission, actual damages, statutory damages, attorney fees, and costs. 15 USC §§1635, 1640(a). On rescission, see §§12.63-12.69B. On requirements for proving actual damages, see *Gold Country Lenders v Smith (In re Smith)* (9th Cir 2002) 289 F3d 1155 (borrower must establish detrimental reliance, such as showing that borrower would have either obtained more favorable interest rate elsewhere or not consummated loan). For discussion of attorney fees, see §12.69D.

WARNING: The Truth in Lending Act is a complex set of statutes, regulations, and commentaries and is fraught with land mines beyond the scope of this chapter's summary. Attorneys unfamiliar with this area of law who wish to allege or defend a TILA claim must thoroughly review all the law and cases before filing a complaint or other pleading. Attorneys wishing to bring an action on behalf of a homeowner should consider obtaining the National Consumer Law Center's book on truth in lending, available at https://shop.consumerlaw.org/. Attorneys wishing to defend such an action should consider obtaining the handbook available from the U.S. Comptroller of the Currency at http://www.occ.treas.gov/handbook/til.pdf.

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§12.60 (a) History of TILA

Congress enacted the Truth in Lending Act (TILA) (15 USC §§1601-1667f) in 1968. Section 105 of TILA (15 USC §1604) requires the Federal Reserve Board to promulgate implementing regulations, which are collectively known as Regulation Z (12 CFR pt 226). Regulation Z provides for Official Staff Interpretations (known as "the Commentary"), which give guidance to the attorney, effectively putting meat on the bones that are TILA. For the Commentary, see Supp I of Regulation Z (Supp I). Reliance on the Commentary protects the creditor from any civil or criminal liability under TILA. See 15 USC §1640(f); 12 CFR pt 226, Supp I, Intro, 1.

Initially, TILA was only a disclosure statute; by requiring that consumers be informed of the true cost of their borrowing, it was hoped that consumers could not only make informed decisions but also make comparisons between similar lending products. In 1980, however, TILA was substantially changed to provide greater simplicity and new consumer protections. In 1994, TILA was again amended to add the Home Ownership and Equity Protection Act of 1994 (HOEPA) (Pub L 103-325, 108 Stat 2160), which was implemented through Regulation Z paragraph 32 (12 CFR §226.32). See §12.70.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.61 (b) Sources of TILA Law

§12.61 (b) Sources of TILA Law

Truth in Lending Act (TILA) law is composed of three parts:

(1) TILA itself, found at 15 USC §§1601-1667f;

(2) Regulation Z (the implementing regulations), found at 12 CFR pt 226; and

(3) Official Staff Interpretations (Commentary) (interpreting the regulations and written by the staff of the Federal Reserve Board), found at 12 CFR pt 226 (Regulation Z), Supp I.

In many areas, Regulation Z fleshes out the meaning of TILA, and the Commentary fleshes out the meaning of Regulation Z. In researching this area of law, it is necessary to look to all three components.

NOTE: At the time of publication, HR 1106, 111th Cong, 1st Sess (2009) and S 61, 111th Cong, 1st Sess (2009) are pending before the United States Congress to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence. Proposed language may provide additional remedies for violations of TILA or other consumer statutes. See http://www.govtrack.us/congress/bill.xpd?bill=h111-1106 and http://www.govtrack.us/congress/bill.xpd?bill=s111-61.

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§12.62 (c) Lenders and Loans Governed by TILA

A lender is governed by TILA if the lender has made more than five loans secured by residential property in the preceding year or more than five loans in the current year. 15 USC §1602(f); 12 CFR §226.2(17) n3. Under HOEPA, a lender is a lender for TILA purposes on the very first HOEPA loan made, if the loan is made through a mortgage broker, and is a lender for TILA purposes on the second HOEPA loan made within a 12-month period, if the loan is not made through a broker. See 15 USC §1602(f); 12 CFR §226.2(17) n3. See also §12.70.

The general rule is that a loan secured by the borrower's principal dwelling is governed by TILA unless the loan is not intended primarily for personal, family, or household purposes. See 15 USC §1602(h); 12 CFR §226.1. Although most residential mortgage transactions, such as real property purchase money loans and refinancing loans, are subject to the disclosure requirements of TILA (see *Williams v Countrywide Home Loans, Inc.* (SD Tex 2007) 504 F Supp 2d 176), the rescission remedy under TILA does not apply to a purchase money loan, defined as a "residential mortgage transaction" (see 15 USC §§1602(w), 1635(e)(1); 12 CFR §226.2(a)(24); *Perkins v Central Mortgage Co.* (ED Pa 2006) 422 F Supp 2d 487). In contrast, the damage remedies under TILA apply to all residential mortgage loans generally governed by TILA. See 15 USC §1640.

PRACTICE TIP: TILA provides for different remedies depending on the violation. Actual damages (minimum of $400, maximum of $4000, effective for conduct occurring after July 30, 2008; $200 to $2000 for loans closed before that date), statutory damages, rescission, and attorney fees are available. See 15 USC §1640(a). Rescission is the strongest remedy available to the consumer under TILA.

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§12.63 (d) Extended Right to Rescind

The right to rescind the loan for a material TILA violation exists if three criteria are met (see 15 USC §1635; 12 CFR §226.15 (open-ended credit); §226.23 (closed-end credit)):

(1) The transaction involves consumer credit;

(2) The credit is not for the initial purchase or construction of the consumer's property; and

(3) The credit is secured by the principal dwelling of the consumer.

Under TILA, the extended right to rescind is created when the borrower is not properly notified of the 3-day right to cancel (see §12.65) or when the required disclosures are not accurate within certain statutorily defined tolerances. 15 USC §1635(a), (f); 12 CFR §§226.15(a)(3), 226.23(a)(3). The TILA right to rescind procedures are detailed in §12.69. Additional rights to rescind are also afforded under HOEPA. See §12.70.

TILA's right to rescind is quite powerful. If a governed loan violates TILA and rescission is a remedy, then the lender loses the right to charge interest on the loan. 15 USC §1635(b); 12 CFR §§226.15(d)(1)-(2), 226.23(d)(1)-(2). The lender also loses the right to charge all the costs and fees charged to obtain the loan, even if those fees and costs were paid to third parties. 15 USC §1635(b); 12 CFR §§226.15(d)(2), 226.23(d)(2); 12 CFR pt 226, Supp I (Commentary) §§226.15(d)(2), 226.23(d)(2).

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§12.63A (i) Statute of Limitations

The statute of limitations for rescinding a loan under TILA is 3 years from the loan consummation or longer if a TILA enforcement agency brings an administrative action involving the borrower's rights and that action extends beyond the 3-year period. 15 USC §1635(f). See 12 CFR §226.23(a)(3). See also *Grimes v New Century Mortgage Corp.* (9th Cir 2003) 340 F3d 1007.

The language of the statute has caused some courts to refer to it as "a statute of repose." See, *e.g., In re Community Bank Litig.* (WD Pa 2006) 467 F Supp 2d 466. The 3-year period is jurisdictional in nature and cannot be tolled. *Beach v Ocwen Fed. Bank* (1998) 523 US 410, 140 L Ed 2d 566, 118 S Ct 1408.

But if a lender wrongfully fails to accept a demand for rescission made within the 3-year period, the borrower has an additional 1 year under 15 USC §1640(e) to bring an action to enforce the rescission. *Miguel v Country Funding Corp.* (9th Cir 2002) 309 F3d 1161 (dicta); *Santos v Countrywide Home Loans* (ED Cal, Aug. 14, 2009, No. 1:09-cv-00912) 2009 US Dist Lexis 71736. The 1-year period may be subject to equitable tolling. See, *e.g., Plascencia v Lending 1st Mortgage* (ND Cal 2008) 583 F Supp 2d 1090 (applied equitable tolling doctrine in action for money damages under TILA). This may give a borrower nearly 4 years to bring an action, depending on when the notice of rescission was sent to the lender.

PRACTICE TIP: If more than technical violations of TILA are involved and the 3-year period under TILA has expired, consider the possibility of a state law fraud action. See Practice Tip in §12.5. On asserting extended right to rescind defensively after expiration of statute of limitations, see §12.65.

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§12.63B (ii) Scope of Remedy; Effect of Sale, Foreclosure, Transfer, or Refinancing

A borrower's right to rescind terminates on the sale or transfer of the property, including a foreclosure sale. 15 USC §1635(f); 12 CFR pt 226, Supp I (Commentary) §226.23(a)(3)-3. See *Hallas v Ameriquest Mortgage Co.* (D Ore 2005) 406 F Supp 2d 1176. The Ninth Circuit ruled that a borrower's entering into a sales contract is tantamount to selling the property and terminates the borrower's right to rescind. *Hefferman v Bitton* (9th Cir 1989) 882 F2d 379.

When property is transferred to a trust, there also may be rescission rights. The result depends on whether the beneficiaries are natural persons and the purpose of the trust. A beneficiary of a revocable living trust who is a natural person will have rescission rights. *Amonette v Indymac Bank* (D Haw 2007) 515 FS2d 1176. However, the regulations define a consumer, for rescission purposes, as only a natural person. 12 CFR §226.2(a)(11). Thus a trust naming an LLC as the beneficiary, even when the LLC is controlled by a natural person, may lack these rights. *Caminero v Wells Fargo Bank* (ED Va, Mar. 5, 2008, No. 1:07cv800) 2008 US Dist Lexis 17111.

California courts and the federal courts of the Ninth Circuit disagree about whether TILA violations are actionable after the loan has been paid off by a subsequent refinancing. See *Pacific Shore Funding v Lozo* (2006) 138 CA4th 1342, 42 CR3d 283 (citing numerous federal cases allowing borrowers to rescind loans after refinancing as long as rights are exercised within 3-year period for rescission under TILA). In the Ninth Circuit, such actions are barred. *King v California* (9th Cir 1986) 784 F2d 910; *Plascencia v Lending 1st Mortgage* (ND Cal 2008) 583 F Supp 2d 1090.

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§12.64 (iii) Assignee Liability

Inherent in the business of making loans secured by residential property is the continuing need for capital to lend. Therefore, many home loans are sold to other banks or investors to raise additional capital. See §§12.17, 12.37, 12.50. Liability for violating TILA runs to the lender. Once the loan is sold, the liability, as related to rescission, extends to the assignee as well. 15 USC §1641(c). On giving notice of rescission to assignee, see Practice Tip in §12.69.

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§12.65 (iv) Rights to Rescind

There are, effectively, two separate rights to rescind. The first is the 3-day right to cancel, which can be exercised by the borrower during the 3 business days after the loan documents are signed. 15 USC §1635(a). The 3-day right to cancel the transaction is unconditional. During this 3-day period, the lender should not release loan proceeds or record the security interest. This 3-day right to cancel ends at midnight on the third business day after the loan documents were signed. 15 USC §1635(a). A business day is Monday through Saturday, with certain holidays excluded.

The second right to rescind is the extended right to cancel, which only arises if the lender fails to comply with certain TILA disclosures. See §12.66. The period to exercise this extended right is 3 years under 15 USC §1635(f). See §12.63A.

The extended right to rescind or cancel may be raised defensively. For example, a borrower may rescind if the loan is rescindable (see §12.62) after the lender starts foreclosure proceedings or brings an action on the note, but only if the borrower exercises the rescission right during the 3-year period prescribed by §1635(f). See *Beach v Ocwen Fed. Bank* (1998) 523 US 410, 140 L Ed 2d 566, 118 S Ct 1408. In contrast, a borrower may assert a TILA violation defensively as a recoupment or setoff in a lender action "to collect the debt," even if the lender files its action after the expiration of the 1-year period for filing borrower actions for damages. See 15 USC §1640(e). The 1-year period, but not the 3-year period, is subject to equitable tolling. *Beach v Ocwen Fed. Bank, supra; Ramadan v Chase Manhattan Corp.* (3rd Cir 1998) 156 F3d 499; *Velazquez v GMAC Mortgage Corp.* (CD Cal 2008) 605 F Supp2d 1049; *Plascencia v Lending 1st Mortgage* (ND Cal 2008) 583 F Supp 2d 1090.

Another twist on this point was provided by *Fidler v Central Coop. Bank (In re Fiddler)* (Bankr D Mass 1998) 226 BR 734, in which the court held that Massachusetts state law, which roughly parallels the TILA, expressly permitted the borrower to assert a claim for recoupment against the lender attempting to enforce the debt more than 3 years after the completion of the loan.

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§12.66 (e) Inaccurate Disclosures Trigger Rescission Right

Under TILA, the extended right to rescind is created when the TILA disclosures are not accurate within certain statutorily defined tolerances. See §12.63. Additional rights to rescind are also afforded under HOEPA. See §12.70.

The TILA Disclosure is a form required for closed-end loan transactions. Four boxes at the top of the page disclose the annual percentage rate, the finance charge, the amount financed, and the total payments. Some of the other necessary disclosures in the body of the form include the number of payments to be made over the term of the loan and the regular payment amount. See 15 USC §1638(a); 12 CFR §226.18; 12 CFR pt 226, App H-2.

Regulation Z establishes uniform standards for the electronic delivery of disclosures required by TILA. See 12 CFR §§226.5, 226.15(b), 226.16(c), 226.23(b)(1), 226.24, 226.36.

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§12.67 (i) Annual Percentage Rate

The annual percentage rate (APR) is considered the true interest rate that will be paid by the borrower over the life of the loan. 12 CFR §226.22(a)(1).

TILA allows several methods of determining the APR. 12 CFR §226.22(a)(1)-(b); 12 CFR pt 226, App J. One APR calculator program is offered by the Office of the Comptroller of the Currency. The calculator is located at http://www.occ.treas.gov/aprwin.htm.

In general, the tolerance for the accuracy of the APR disclosed in the TILA Disclosure is one-eighth of 1 percent (.00125). 12 CFR §226.22(a)(2); 12 CFR pt 226, Supp I (Commentary) §226.22(a)(2)-1. The tolerance for the APR in an irregular transaction is one-fourth of 1 percent (.0025). 12 CFR §226.22(a)(3); 12 CFR pt 226, Supp I (Commentary) §226.22(a)(3)-1. An "irregular" transaction is one that has either multiple advances, irregular payment periods, or irregular payment amounts (other than an irregular first period or an irregular first or final payment). 12 CFR §226.22(a)(2) n46; see 12 CFR pt 226, Supp I (Commentary) §226.22(a)(3)-1.

TILA states that the APR is inaccurate if it exceeds or is lower than the accurate APR by.00125. However, if the APR disclosed is higher than the true APR, a safe harbor may be available for the lender. See *Ramsey v Vista Mortgage Corp. (In re Ramsey)* (BAP 9th Cir 1994) 176 BR 183 (borrower who brings action due to overstatement of APR must demonstrate detrimental reliance on overstatement to be entitled to 3-year rescissionary period); *Barber v Knox County Sch. Employees Credit Union (In re Cox)* (Bankr CD Ill 1990) 114 BR 165 (overstatement of APR violates TILA unless it is result of good faith use of faulty calculation tool and creditor, promptly on discovery of error, discontinues use of tool and notifies Federal Reserve Board of error, as provided in regulations). See also 15 USC §1602(z); 12 CFR §226.22(a)(1) n45d; 12 CFR pt 226, Supp I (Commentary) §226.22(a)(1)-5.

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§12.68 (ii) Finance Charge; Amount Financed; Total Payments

The "finance charge" is broadly defined as the sum of all charges, payable directly or indirectly by the borrower, that are imposed directly or indirectly by the lender as an incident to or a condition of the extension of credit. 15 USC §1605(a); 12 CFR §226.4(a). Even for those familiar with the myriad charges incurred by borrowers for loans secured by their homes, determining which charges are or are not finance charges can be daunting.

The amount disclosed as the finance charge in the TILA Disclosure must be accurate up to a certain tolerance. The tolerance depends on what action or right the borrower is enforcing. 15 USC §1605(f). If the borrower is seeking to rescind the loan transaction and the lender has not started foreclosure proceedings, the tolerance is one-half of 1 percent (.005). 15 USC §1605(f)(2)(A). If the lender overstates the finance charge, there is no extended right to rescind. 15 USC §1605(f)(1)(B). However, if the lender has started foreclosure proceedings, either judicial or nonjudicial, the tolerance is $35. 15 USC §1635(i)(2). Again, if the APR is overstated, there may be a safe harbor for lenders.

The amount financed is generally the amount of credit provided to the borrower. Essentially, it is the remainder after the finance charge has been subtracted from the total payments.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.69 (f) Rescission Procedure

§12.69 (f) Rescission Procedure

The TILA rescission process can be completed without going to court; it was designed to operate extra-judicially. By statute, a TILA rescission is immediately and automatically effective on the mailing of a timely rescission demand. See 15 USC §1635(a); 12 CFR §226.23(a)(2) (right to rescind transaction effected by notifying creditor); 15 USC §1635(b) (transaction is "void upon such a rescission"). In other words, a TILA rescission, as long as it is timely, takes full effect before any court order enforcing the rescission.

This interpretation was endorsed by the Eleventh Circuit in *Williams v Homestake Mortgage Co.* (11th Cir 1992) 968 F2d 1137. According to *Williams*, a timely TILA rescission demand has, on mailing, the immediate and automatic effect of voiding the subject transaction. 968 F2d at 1140. The automatic nature of a TILA rescission distinguishes it from common law rescission. The court in *Williams* noted that a TILA rescission is a streamlined statutory procedure that discards common law rules to place the consumer in a better bargaining position. See analysis in Murken, *Can't Get No Satisfaction? Revising How Courts Rescind Home Equity Loans Under the Truth in Lending Act,* 77 Temp L R 457 (2004).

WARNING: Section 1635(b) is a rare statutory remedy that clearly specifies what is required of the consumer. A trustee foreclosing under CC §2924 (see chap 2) should halt the trustee sale and notify the lender on receiving a copy of a notice of rescission and ascertaining that it was properly served. On potential trustee and lender liability for conducting wrongful trustee sale, see §§2.26, 12.139. See also chap 7.

If the homeowner does not sell the home or lose it in a foreclosure, the extended right of rescission can be exercised up to 3 years after the loan consummation. 15 USC §1635(f); 12 CFR §§226.15(a)(3), 226.23(a)(3). The regulations set up a three-step process to rescind a loan.

(1) The borrower must notify the lender, in writing, of the cancellation of the loan. While the notice must be in writing, it can be transmitted by mail, telegram, or other means. 12 CFR §§226.15(a)(2), 226.23(a)(2). It should be sent to the lender's designated place of business. 12 CFR §§226.15(a)(2), 226.23(a)(2). A rescission notice sent by the borrower's attorney is also effective. 12 CFR pt 226, Supp I (Commentary) §226.2(a)(22)-2. While signing the right to cancel form, if there is such a form, and sending it to the lender is effective, it is considered a better practice to draft a letter notifying the lender of the rescission and the reasons for it. Send the letter to the address provided on the right to cancel form as well as to any other address the borrower may have for the lender.

Currently, rescission letters sent to loan servicers are not effective notice to the lender or its assignee. *Miguel v Country Funding Corp.* (9th Cir 2002) 309 F3d 1161. Many borrowers do not understand the difference between the owner of the loan and a loan servicer. Even savvy attorneys have trouble determining who owns the loan because assignments are no longer routinely recorded.

PRACTICE TIP: It is important to review the loan file to determine who was the lender at the time the loan was consummated. Additionally, the attorney should always check the chain of title to see if the loan has been assigned. If so, the attorney should send a copy of the rescission letter to the new lender as well. A call to the servicer can reveal who the owner is, although servicers generally do not like to give that information. Additional strategies include the following:

- To determine who is the current holder of the note, send a separate, formal written request that the loan servicer provide the name, address, and telephone number of the owner of the loan as required by 15 USC §1641(f)(2). TILA provides a private right of action for actual and statutory damages and attorney fees for a violation of §1641. See 15 USC §1640(a). State on the request that it is a Qualified Written Request under the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617). Failure to respond within 60 days may give the borrower a private right of action under 12 USC §2605(f).
- Another way to avoid the outcome in *Miguel v Country Funding Corp., supra,* would be to prepare a rescission letter addressed to the "Holder of Loan #_____" and mail it in care of the servicer to its physical address.

The Commentary states that if the creditor fails to provide an address for a designated agent to whom a rescission notice may be sent, delivery to the entity to which the borrower makes the payments will be effective notice to the lender or its assignee. 12 CFR pt 226, Supp I (Commentary) §226.23(a)(2)-1.

- To determine if the loan has been securitized, go to the website of the Securities and Exchange Commission at http://www.sec.gov/edgar/searchedgar/webusers.htm.

Under the statute, once the loan is rescinded, the security interest or lien becomes automatically void by operation of law. 15 USC §1635(b); 12 CFR §§226.15(d)(1), 226.23(d)(1). See also 69 Fed Reg 16769, 16771-16772 (Mar. 31, 2004), reiterating that security interest becomes void when consumer rescinds. The note also is voided. The lender's interest in the property is "automatically negated, regardless of its status and whether or not it was recorded or perfected." 12 CFR pt 226, Supp I (Commentary) §§226.15(d)(1)-1, 226.23(d)(1)-1. See *Stone v Mehlberg* (WD Mich 1989) 728 F Supp 1341, 1347. But see *Merriman v Beneficial Mortgage Co. (In re Merriman)* (D Kan 2005) 329 BR 710, 729.

(2) Within 20 days of receipt of the notice of cancellation, the lender must return to the borrower any money or property that has been given to anyone in connection with the loan. See, *e.g.,* authorities cited in *Lynch v GMAC Mortgage Corp. (In re Lynch)* (Bankr D NH 1994) 170 BR 26. The lender must also take steps to reflect that the security interest has terminated. 15 USC §1635(b); 12 CFR §§226.15(d)(2), 226.23(d)(2).

(3) Once the lender has terminated the security interest and returned any money or property it received, the borrower is then required to tender any property or money received from the lender. 15 USC §1635(b); 12 CFR §§226.15(d)(3), 226.23(d)(3); 12 CFR pt 226, Supp I (Commentary) §§226.15(d)(3)-1, 226.23(d)(3)-1. This step is the reverse of most states' rescission laws. See, *e.g.,* CC §1691(b); *Smith v Rickards* (1957) 149 CA2d 648, 308 P2d 758. The statute does not prescribe a time period in which tender must be accomplished.

As a result of the rescission, the lender retroactively loses the right to charge interest, fees, and costs on the loan, even costs paid to outside third parties such as the title insurer. 15 USC §1635(b); 12 CFR §§226.15(d)(2), 226.23(d)(2); 12 CFR pt 226, Supp I (Commentary) §§226.15(d)(2)-(1), 226.23(d)(2)-(1). Therefore, the amount of tender is calculated by first determining what funds the borrower actually received for its direct benefit. (Cash-out to the borrower and funds released to pay the borrower's debts are examples of uses for the borrower's direct benefit.) Once that amount is determined, it is reduced by the total payments the borrower has made on the loan. 12 CFR pt 226, Supp I (Commentary) §§226.15(d)(3)-1, 226.23(d)(3)-1. Attorney fees are available against a violating lender, as well as actual and statutory damages. 15 USC §1640(a). The remaining balance is the amount due on tender. Once tender is delivered (see, *e.g., Yamamoto v Bank of N.Y.* (9th Cir 2003) 329 F3d 1167), the rescission process is complete. 15 USC §1635(b).

For an example of how a bankruptcy court may equitably apply the TILA rescission remedy in a borrower's Chapter 13 case, see *Lynch v GMAC Mortgage Corp., supra*.

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§12.69A (g) Tender Issues

When a borrower exercises its right to cancel under TILA, any security interest given by the borrower for the loan "becomes void upon such a rescission." 15 USC §1635(b). The statute also states that the borrower is no longer liable for any finance or other charge. The statute describes the procedure of how and when the lender must return the money or property paid by the borrower and how the parties must take any action necessary to reflect the termination of the security interest. It further sets forth the procedure of when and how the consumer must tender. Specifically, the second step described in §12.69 indicates that after the lender terminates the security interest and returns any money or property it received, the borrower is then required to tender any money received from the lender. The final sentence of §1635(b) states: "The procedure prescribed by this subsection shall apply except when otherwise ordered by a court."

The legislative history of §1635(b) states that "the court, at anytime during the rescission process, may impose equitable conditions to insure that the consumer meets his obligations after the creditor has performed his obligations as required under the act." S Rep No. 368, 96th Cong, 2d Sess at 29 (1980), reprinted in 1980 US Code Cong & Ad News 236, 265. On tendering money received as a condition of obtaining a preliminary injunction to stop a foreclosure, see §12.69B.

Equitable modification of the TILA rescission process is controversial, and there is yet to be a consensus in the federal courts. One question is under what circumstances is an equitable modification of the rescission process proper. Another is what steps in the rescission process are modifiable. The statute speaks of modification of the process, but only steps two and three are processes, and step one is a conclusion of law. See three-step process in §12.69.

The Ninth Circuit analyzed the tender issue in *Yamamoto v Bank of N.Y.* (9th Cir 2003) 329 F3d 1167. In *Yamamoto*, the lender brought a motion for summary judgment on the basis that the borrowers admitted they could not tender the loan proceeds. The trial court gave the borrowers 60 days to tender and, when they could not tender, granted the lender's motion. The trial court never got to the issue of whether or not the lender had violated TILA. The court of appeal decided that under the specific facts in the case, it was proper to dismiss the action before deciding whether the statute had been violated. It noted that it was permissible for a court to equitably modify all three steps of rescission and, in fact, could make the borrower's ability to tender a condition of granting rescission, at least under the facts of that case. The court further noted that in some cases, the lender not only contests the borrower's right to rescind but produces "evidence sufficient to create a triable issue of fact about compliance with TILA's disclosure requirements." The court noted that in those circumstances, "it cannot be that the security interest vanishes immediately upon the giving of the notice." 329 F3d at 1172.

In 2004, the TILA Commentary (see §12.59) was amended. That version states that the modification of the second step "does not affect a consumer's substantive right to rescind and to have the loan amount adjusted accordingly." It further states that when the consumer's right to rescind is contested, "a court would normally determine whether the consumer has a right to rescind and determine the amounts owed before establishing the procedures for the parties to tender any money or property." 12 CFR pt 226, Supp I (Commentary) §226.15(d)(4)-1.

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§12.69B (h) Injunctive Relief

In connection with rescission under TILA, a court may issue an injunction to stop a nonjudicial foreclosure. See *Nichols v Deutsche Bank Nat'l Trust Co.* (SD Cal, Nov. 21, 2007, No. 07cv2039-L) 2007 US Dist Lexis 86223, 2007 WL 4181111; *Wrobel v SL Pope & Assocs.* (SD Cal, Aug. 15, 2007, No. 07CV1591 IEG) 2007 US Dist Lexis 59779, 2007 WL 4538661 (reinstated preliminary injunction preventing trustee sale on finding that plaintiffs had probability of success on merits of TILA claim); *Phleger v Countrywide Home Loans, Inc.* (ND Cal, Mar. 3, 2009, No. C 07-01686) 2009 US Dist Lexis 17419 (upheld TRO to enjoin sale because creditor did not establish on summary judgment motion that it provided 3 days' notice to rescind required under TILA).

WARNING: Before granting a preliminary injunction, some courts require the borrower to demonstrate the ability to tender back the loan proceeds in the event the borrower proves entitlement to rescission. See §§12.69-12.69A. Compare, *e.g., Wrobel v SL Pope & Assocs., supra* (citing 12 CFR §226.23(d)(3); *Yamamoto v Bank of N.Y.* (9th Cir 2003) 329 F3d 1167, 1173; *LaGrone v Johnson* (9th Cir 1976) 534 F2d 1360; *Palmer v Wilson* (9th Cir 1974) 502 F2d 860), with *Phleger v Countrywide Home Loans, supra* (declined to apply *Yamamoto* rule on review of preliminary injunction).

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§12.69C (i) Damages Under TILA

A consumer may be entitled to damages even when rescission is unavailable. However, damage claims are subject to a 1-year statute of limitations. 15 USC §1640(e). This period may be tolled on equitable grounds. *Reiser v Residential Funding Corp.* (7th Cir 2004) 380 F3d 1027; *Ramadan v Chase Manhattan Corp.* (3rd Cir 1998) 156 F3d 499; *King v California* (9th Cir 1986) 784 F2d 910. Among the equitable grounds to toll the statute of limitations are failure to provide each borrower copies of TILA statements or the other closing documents and fraudulent concealing of TILA violations.

Actual damages include consequential damages and emotional distress arising from the TILA violations. Examples of these damages are the following:

- Lost profits resulting from creditor's failure to cancel security interest on receiving notice of rescission, thus preventing debtor from selling the property and requiring quiet title suit (12 CFR §§226.15(a)(2), 226.15(d)(2), 226.23(a)(2), 226.23(d)(2));
- The cost of securing a higher-priced loan or second mortgage financing (*Fisher v American Gen. Fin. Co.* (4th Cir 2002) 52 Fed Appx 601 (unpublished));
- The time and effort spent sorting out billing errors (*Kurz v Chase Manhattan Bank* (SD NY 2003) 273 FS2d 474); and
- Emotional distress damages (*Butler v Sterling, Inc.* (6th Cir 2000) 2000 US App Lexis 6419.

In addition to these consequential damages, the consumer may also be entitled to "benefit-of-the-bargain" damages. Dunn, Recovery of Damages for Fraud §2.1 (2d ed 1995). Benefit-of-the-bargain damages set the damages as the difference between the value of what was promised and the value of what was actually delivered. This rewards the consumer's expectations and does not require that the consumer actually would have sought the more favorable terms if the consumer knew the truth. Restatement (Second) of Torts §549(2) comments g-i; §549 comment i.

The Ninth Circuit requires the consumer to show reliance to recover actual damages from inadequate disclosures. This means the consumer must establish that the consumer either would have secured a better loan or would not have taken the proffered loan at all. *Smith v Gold Country Lenders* (In re Smith) (9th Cir 2002) 289 F3d 1155.

The consumer may have an additional cause of action against the lender for failing to comply with its implied duty of good faith and fair dealing. This rule has been applied in other consumer protection and securities law cases. See, *e.g., Basic Inc. v Levinson* (1988) 485 US 224, 99 L Ed 2d 194, 108 S Ct 978; *State ex rel Webster v Areaco Inv. Co.* (Mo Ct App 1988) 756 SW2d 633. See also §§12.11, 12.18-12.23.

In addition to actual damages, the consumer will be entitled to statutory damages, which range from a minimum of $400 to a maximum of $4000 per violation. 15 USC §1640(a)(2)A(ii), effective July 30, 2008.

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§12.69D (j) Attorney Fees

A borrower who succeeds in a TILA action for either damages or rescission is entitled to an award of attorney fees and costs of suit as an element of damages. 15 USC §1640(a)(3). On applying the attorney fee rule, see *Lawrence v Creditthrift of Am., Inc.* (5th Cir 1980) 622 F2d 1207, opinion reinstated on rehearing at 644 F2d 506; *Pedro v Pacific Plan* (ND Cal 1975) 393 F Supp 315; Anno, 140 ALR Fed 557 (1997).

PRACTICE TIP: Because attorney fees are available to a prevailing borrower in a TILA action, one use of the TILA statute is as an add-on to a common law fiduciary breach claim to make attorney fees available when they might not otherwise be recoverable.

No provision under TILA grants attorney fees to prevailing lenders. See *Semar v Platte Valley Fed. Sav. & Loan Ass'n* (9th Cir 1986) 791 F2d 699, 703 n10. However, a prevailing defendant may be awarded its attorney fees as sanctions under Fed R Civ P 11 if the court finds that the allegations in the complaint and other factual contentions did not have or were not likely to have evidentiary support at the inception of the lawsuit. See, *e.g., Moazed v First Union Mortgage Corp.* (D Conn 2004) 221 FRD 28.

For general discussion of attorney fees in lender liability actions, see §12.102.

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§12.70 (2) HOEPA: Home Ownership and Equity Protection Act of 1994

The Home Ownership and Equity Protection Act of 1994 (HOEPA) (Pub L 103-325, 108 Stat 2160) (see 15 USC §1639) was passed as part of a 1994 effort to limit the harm of certain high-cost loans to certain borrowers. It and its accompanying regulations are the primary federal law that actively seeks to prohibit or curb predatory lending practices.

HOEPA essentially enhances the disclosures required under the existing Truth in Lending Act (TILA) (15 USC §§1601-1667f), prohibits certain predatory loan practices, and provides for some assignee liability. It is similar in some respects to the California statutes discussed in §§12.56-12.58, but its triggers, disclosures, and prohibitions are somewhat different. HOEPA was enhanced, effective October 1, 2002 (66 Fed Reg 65604 (2001)), to further tighten up disclosure requirements and to also prohibit certain practices classified by regulators as "predatory." See 12 CFR §226.32. It was again significantly enhanced with further changes in regulations effective October 1, 2009. See §12.73.

One court, *Fluehmann v Associates Fin. Servs.* (D Mass, Mar. 29, 2002, No. 01-40076-NMG) 2002 U.S. Dist. Lexis 5755, described the legislative purpose of HOEPA as

> a congressional response to the substantive abuses of creditors offering alternative, typically high interest rate, home loans to residents in certain geographic areas. The statute was enacted to ensure that consumers most vulnerable to abuse would be afforded a safety net without impeding the flow of credit altogether. H.R. Rep. No. 103 652, at 159 (1994).

HOEPA does not apply to purchase money loans, true open-ended (revolving) credit arrangements, or reverse mortgages but only to closed-end financings that meet either the interest rate trigger or the fee trigger, which are described below.

HOEPA's restrictions apply to any lender that originates two or more covered loans, or one or more such loans through a mortgage broker, in any 12-month period. 15 USC §1602(f), (aa).

The remedies for violation of HOEPA are the same as those for violation of TILA, including rescission, actual damages, statutory penalties up to twice the amount of the fees charged (not to exceed $4000), and attorney fees and costs. See 15 USC §§1635, 1640. However, for certain violations of HOEPA, enhanced statutory damages are provided. See 15 USC §1640(a)(4). Though only available in the first year, these enhanced damages can be very significant.

HOEPA provides specified assignee liability for loans that trigger its provisions unless the assignee can demonstrate that a reasonable person employing ordinary due diligence could not have determined at the time of the transaction that the transaction fell within the statute's purview. 15 USC §1641(a), (d)-(e). This safe harbor should be rare because of the requirement that the originating lender provide written notice to any assignee that the loan is a HOEPA loan and that it remains subject to the borrower's claims and defenses. 15 USC §1641(d)(4); 12 CFR §226.34(a)(2). This provision is similar to the Federal Trade Commission's holder in due course rule. On holder in due course doctrine, see §§12.37, 12.103.

If a loan is a HOEPA loan, the disclosure requirements and other prohibitions apply. Because HOEPA is a section of TILA (see 15 USC §1639), a loan must be governed by TILA to be governed by HOEPA. Loans governed by TILA must meet one of the following interest or fee triggers to be considered HOEPA loans:

- Loans in first position with interest rates in excess of 8 percent of the yield of treasury instruments of similar maturity. 15 USC §1602(aa)(2); 12 CFR §226.32(a)(1)(i). The interest rate is measured as of the 15th of the month preceding the month in which the loan application is first submitted. 15 USC §1602(aa)(1)(A). In calculating the HOEPA trigger threshold, certain charges considered finance charges must be added into the total loan cost. See 15 USC §1602(aa)(4). See also 12 CFR pt 226, Supp I (Commentary) §226.32(a)(1)-3. The applicable treasury yield can be found in the Federal Reserve Board's statistical release H.15 table, which can be found at http://www.federalreserve.gov/releases/h15/update/.
- Subordinate loans that exceed 10 percent of the treasury yield of treasury instruments of similar maturity. This is measured as of the 15th of the month preceding the month in which the loan application is first submitted. 12 CFR §226.32(a)(1)(i).

- Any residential property secured loan that charges the consumer fees and points that exceed the greater of 8 percent of the loan amount, or a set dollar amount adjusted annually according to the Consumer Price Index by the Federal Reserve Board ($547 for 2007). 15 USC §1602(aa)(1)(B); 12 CFR §226.32(a)(1)(ii). This fee trigger also includes amounts paid at closing for optional credit life, accident, health, or loss-of-income insurance and for other debt-protection products written in connection with the credit transition. 12 CFR §226.32(b)(1)(iv).
- Effective October 1, 2009, a new category was created called "higher-priced mortgage loans," defined as first mortgages that are 1.5 or more percentage points above the average prime offer rate or second mortgages that are 3.5 or more percentage points above the average prime offer rate. See 12 CFR §226.35(a)(1), cited in §12.73. The rules (12 CFR §§226.32(d)(7), 226.34(a)(4), 226.35(b)(2)) prohibit the following:
- Making a loan without regard to the borrower's ability to repay the loan from income and assets other than the value of the borrower's home;
- Failure to verify income and assets relied on for the repayments; and
- Charging prepayment penalties except under specified circumstances.

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§12.70A (a) "Open-Ended Credit Loan" Defined

The TILA disclosure is not required in an open-ended loan situation. In an open-ended loan, there is a line of credit, and the lender believes that the borrower will be borrowing from the line rather than paying down the line. In this way it is similar to a credit card, which is also a form of open-ended credit, but this provides tax advantages and expands the borrower's total credit available. A home equity line of credit (HELOC) is generally an open-ended credit transaction but subject to its maximum borrowing limits.

Under 15 USC §1602(aa)(1), a mortgage covered by that subdivision "means a consumer credit transaction that is secured by the consumer's principal dwelling, other than … a transaction under an open end credit plan." In relevant part, 15 USC §1602(i) states that the term "open end credit plan" means "a plan under which the creditor reasonably contemplates repeated transactions, which prescribes the terms of such transactions, and which provides for a finance charge which may be computed from time to time on the outstanding unpaid balance."

While open-ended forms of loan transactions are exempt from HOEPA, Regulation Z prohibits lenders from structuring a loan as open-ended to evade HOEPA. 12 CFR §226.34(b).

In one of the few reported cases on this point, a bankruptcy court determined that the HELOC loan was not open-ended, because the lender had disbursed the entire line of credit at the closing, the payments due covered interest only, and the lender knew that the borrower could not hope to pay down the line of credit because the borrower's income was insufficient. See *Merriam v Chase Manhattan Mortgage Corp.* (*In re Merriam)* (WD NY 2005) 333 BR 22.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.71 (b) Required Disclosures

§12.71 (b) Required Disclosures

HOEPA loans require that the following disclosures be given to the borrower at least 3 days before the loan documents are signed (15 USC §1639(a), (b)(1)):

- The consumer is not required to complete the agreement even though an application has been signed (15 USC §1639(a)(1)(A));
- The transaction creates a mortgage on the consumer's home, which could result in loss of the home and any equity therein should the borrower fail to pay according to the loan terms (15 USC §1639(a)(1)(B));
- The specific and accurately reported annual percentage rate and the amount of the monthly payment (15 USC §1639(a)(2)(A));
- Whether there is any balloon payment required (however, balloon payments within 5 years are prohibited) (12 CFR §§226.32(c)(3), 226.32(d)(1)); and
- On variable rate loans, the possibility that the monthly payment may increase, and the maximum monthly payment is based on the maximum allowed interest rate under the loan agreement (15 USC §1639(a)(2)(B)).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.72 (c) Limited or Prohibited Loan Practices

§12.72 (c) Limited or Prohibited Loan Practices

The following loan practices are either strictly prohibited or severely limited in HOEPA loans:

- Loan flipping, defined by the statute as certain refinancings within the first 12 months of the loan. This prohibition may not apply if the lender can show that the refinancing was in the consumer's best interest. 12 CFR §226.34(a)(3). The loan flipping prohibition applies to affiliates and assignees of the originating lender. 12 CFR §226.34(a)(3).
- Loans that result in any form of negative amortization. 15 USC §1639(f).
- Increases in interest rates on default. 15 USC §1639(d).
- Prepayment penalties. 15 USC §1639(c)(2).
- Impounding from loan proceeds more than 2 months of periodic payments required under the loan. 15 USC §1639(g).
- Demand clauses, generally described as any provisions that allow the lender to call the loan prior to maturity, except in certain limited circumstances. 12 CFR §226.32(d)(8).
- Any loan that results in the borrower's monthly payment obligations, including the loan payment, exceeding 50 percent of its monthly income. 15 USC §1639(h); 12 CFR §226.32(d)(7)(iii).
- Balloon payments on any loan with a maturity of 5 years or less. This includes limitations on interest-only loans and requires that any HOEPA loan require regular payments to pay down principal. 15 USC §1639(e).

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§12.73 (d) HOEPA Changes Effective October 1, 2009

Changes to Regulation Z (12 CFR pt 226), effective October 1, 2009, added four key protections for a newly defined category of "higher-priced mortgage loans" secured by a consumer's principal dwelling. See 73 Fed Reg 44522, 44531 (2008). See generally 12 CFR §§226.32-226.36. The new rule's definition of "higher-priced mortgage loans" (see 12 CFR §226.35(a)) captures virtually all loans in the subprime market but generally excludes loans in the prime market. To provide an index, the Federal Reserve Board publishes the "average prime offer rate" based on a survey currently published by the Federal Home Loan Mortgage Corporation (Freddie Mac). A loan is higher-priced if it is a first-lien mortgage and has an annual percentage rate 1.5 percentage points or more above this index, or 3.5 percentage points above if it is a subordinate-lien mortgage. 12 CFR §226.35(a)(1). This definition overcomes certain technical problems with the original proposal, but the expected market coverage is similar.

For loans in this new category, the protections accomplish the following:

(1) Prohibit lenders from making a loan without regard to a borrower's ability to repay the loan from income and assets other than the home's value. 12 CFR §226.34(a)(4). A lender complies, in part, by assessing repayment ability on the basis of the highest scheduled payment in the first 7 years of the loan. 12 CFR §226.34(a)(4)(iii)(B). To show that a lender violated this prohibition, a borrower does not need to demonstrate that it is part of a "pattern or practice." See 73 Fed Reg 44522, 44539; 12 CFR §226.35(b)(1).

(2) Require creditors to verify the income and assets they rely on to determine repayment ability. 12 CFR §§226.34(a)(4)(ii), 226.35(b)(1).

(3) Ban any prepayment penalty if the payment can change in the initial 4 years; for other higher-priced loans, a prepayment penalty period may not last for more than 2 years. 12 CFR §§226.32(d)(7), 226.35(b)(2). This rule is substantially more restrictive than originally proposed.

(4) Require creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans. 12 CFR §226.35(b)(3) (effective April 1, 2010).

In addition to governing higher-priced loans, the rules provide the following protections for loans secured by a consumer's principal dwelling (12 CFR §226.36), regardless of whether the loan is higher-priced:

- Creditors and mortgage brokers are prohibited from coercing a real estate appraiser to misstate a home's value. 12 CFR §226.36(b)(1).
- Companies that service mortgage loans are prohibited from engaging in certain practices such as pyramiding late fees. In addition, servicers are required to credit consumers' loan payments as of the date of receipt and provide a payoff statement within a reasonable time of request. 12 CFR §226.36(c).
- Creditors must provide a good faith estimate of the loan costs, including a schedule of payments, within 3 days after a consumer applies for any mortgage loan secured by a consumer's principal dwelling, such as a home-improvement loan or a loan to refinance an existing loan. 12 CFR §226.19(a). Currently, early cost estimates are only required for home-purchase loans.
- Consumers cannot be charged any fee until after they receive the early disclosures, except a reasonable fee for obtaining the consumer's credit history. 12 CFR §226.19(a)(1)-(2).
- For all mortgages, the rule also sets additional advertising standards, requiring additional information about rates, monthly payments, and other loan features. See 12 CFR §§226.16(d)-(e), 226.24.
- The rule bans seven deceptive or misleading advertising practices, including representing that a rate or payment is "fixed" when it can change. 12 CFR §226.24(i).

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§12.74 (3) Real Estate Settlement Procedures Act of 1974

The Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617) was passed in 1974 with the dual objectives of (1) helping consumers make better-informed decisions in their choices of settlement providers and (2) prohibiting providers of those settlement services from engaging in certain loan settlement practices, mostly relating to kickbacks and improper fee collection.

RESPA applies to any "federally related mortgage loan," defined as any loan secured by residential real property of one to four units and (1) made by any federally insured lender, (2) made by any lender regulated in any manner by any agency of the federal government, (3) made by the Secretary of the Treasury or assisted in any way by any agency of the federal government (*e.g.,* loan programs under the VA, HUD, or Department of Agriculture), (4) eligible for purchase by Fannie Mae, Ginnie Mae, or Freddie Mac, or (5) made by any "'creditor', as defined in section 103(f) of the Consumer Credit Protection Act (15 USC §1602(f)), who makes or invests in residential real estate loans aggregating more than $1,000,000 per year." 12 USC §2602(1).

The most important requirements of RESPA affecting consumer mortgage loans and applicable remedies are discussed in §§12.75-12.83.

NOTE: Regulations effective January 1, 2010, significantly revise disclosure requirements and forms lenders must use under RESPA. For analysis, see http://www.docutechcorp.com/compliance/mortgage-compliance-updates/prepare-now-for-january-2010-respa-changes.html.

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§12.75 (a) RESPA Disclosures; Settlement Statement

The primary disclosure vehicles by which RESPA effectuates its purpose are the uniform settlement statement under 12 USC §2603 (often referred to as the "HUD-1") and the special information booklets and good faith estimate of settlement costs (GFE) required by 12 USC §2604.

Lenders are required to give mortgage loan applicants the following at the time of their loan applications:

- A special information booklet, which contains consumer information regarding various real estate settlement services. The special information booklet is required for purchase transactions only. 12 USC §2604(a), (d). If the borrower does not get the booklet at the time of application, the lender must mail it within 3 business days of receiving the loan application. 12 USC §2604(d). The special information booklets are developed and provided by the Secretary of Housing and Urban Development. 12 USC §2604(a). Lenders may print and distribute their own booklets as long as their form and content are approved by the Secretary of Housing and Urban Development. 12 USC §2604(e). The special information booklets must include the following in clear and concise language (12 USC §2604(b)):
  - A description and explanation of the nature and purpose of each settlement cost (12 USC §2604(b)(1));
  - An explanation and sample of the standard real estate settlement form (12 USC §2604(b)(2));
  - A description and explanation of the nature and purpose of escrow accounts (12 USC §2604(b)(3));
  - An explanation of the choices available in selecting persons to provide real estate settlement services (12 USC §2604(b)(4)); and
  - An explanation of the unfair practices and unreasonable or unnecessary charges to be avoided (12 USC §2604(b)(5)).
- A good faith estimate of settlement costs (GFE), which lists the charges the buyer is likely to pay at settlement. 12 USC §2604(c). This is only an estimate, and the actual charges may differ. If a lender requires the borrower to use a particular settlement provider, then the lender must disclose this requirement on the GFE. This document must be given to the loan applicant along with the special information booklet. 12 USC §2604(c).
- A mortgage servicing disclosure statement, which discloses to the borrower whether the lender intends to service the loan or transfer it to another lender. 12 USC §2605(a). It also provides information about complaint resolution. 12 USC §2605(b)(3), (e)(1).

PRACTICE TIP: The RESPA statute does not provide an explicit penalty for the failure to provide the special information booklet, good faith estimate, or mortgage servicing statement, and there is no private right of action for failing to provide or accurately disclose these items. However, the failure to comply may be relevant evidence in a California common law action for fraud or negligent misrepresentation regarding the terms of the loan; for example, the borrower may have relied on oral representations made earlier in the transaction and not have understood the final documentation of the transaction at closing.

The uniform settlement statement required under RESPA must (12 USC §2603(a))

> conspicuously and clearly itemize all charges imposed upon the borrower and all charges imposed upon the seller in connection with the settlement and shall indicate whether any title insurance premium included in such charges covers or insures the lender's interest in the property, the borrower's interest, or both.

No private right of action exists for violations of 12 USC §2603(a); federal agency enforcement is exclusive. See 12 USC §2614; 24 CFR §3500.19; *Allison v Liberty Savs.* (7th Cir 1982) 695 F2d 1086.

NOTE: Effective January 1, 2010, lenders must use newly revised GFE and settlement statement forms. For an analysis, see http://www.docutechcorp.com/compliance/mortgage-compliance-updates/prepare-now-for-january-2010-respa-changes.html.

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§12.76 (b) Private Right of Action for Violations

While RESPA is broad in its coverage, borrowers have a private right of action only in §§6 (12 USC §2605), 8 (12 USC §2607), and 9 (12 USC §2608). See §§12.77-12.83.

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§12.77 (i) Section 6: Disclosure of Loan Servicing Transfer

Each person who makes a federally related mortgage loan must disclose to the borrower at the time of the loan application whether the servicing of the loan may be assigned, sold, or transferred to any other person during the period that the loan is outstanding. 12 USC §2605(a).

Each servicer of any federally related mortgage loan must notify the borrower in writing of any assignment, sale, or transfer of the servicing of the loan to any other person not less than 15 days before the effective date of transfer. 12 USC §2605(b)(1), (2)(A).

The notice must contain the effective date of transfer, the name, address, and telephone number of the transferee, and a phone number for the transferor that can be contacted by the borrower to answer inquiries relating to the transfer of servicing. 12 USC §2605(b)(3)(A)-(D). The notice must also contain the date on which the transferor servicer who is servicing the mortgage loan before the assignment, sale, or transfer will cease to accept payments relating to the loan and the date on which the transferee servicer will begin to accept payments. 12 USC §2605(b)(3)(E). In addition, the notice must contain a statement that the assignment, sale, or transfer of the servicing of the mortgage loan does not affect any term or condition of the security instruments other than terms directly related to the servicing of such loan. 12 USC §2605(b)(3)(G).

During the 60-day period beginning on the effective date of the loan servicing transfer, a late fee may not be imposed on the borrower with respect to any payment on the loan, and no payment may be treated as late for any other purposes if the payment is received by the transferor servicer (rather than the transferee servicer who should properly receive payment) before the due date applicable to the payment. 12 USC §2605(d).

On remedies for violations of 12 USC §2605, see §§12.79-12.83.

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§12.78 (ii) Section 6: Qualified Written Requests

If any servicer or lender of a RESPA-covered loan receives a qualified written request (QWR) from the borrower for information relating to the servicing of the loan, the servicer must provide a written response acknowledging receipt of the QWR within 20 days. 12 USC §2605(e)(1)(A).

The servicer must respond within 60 days from receipt of the QWR by making appropriate corrections or providing an explanation of why the information is not available. See 12 USC §2605(e)(2).

A QWR must be written correspondence, other than notice on a payment coupon, that includes, or provides a manner by which the servicer can identify, the name and account of the borrower and a statement of the reasons for the borrower's belief that the account is in error or sufficient detail regarding other information sought by the borrower. 12 USC §2605(e)(1)(B).

During the 60-day period beginning on the date of the servicer's receipt of a QWR from any borrower relating to a dispute about the borrower's payments, a servicer may not provide information regarding any overdue payment owed by such borrower and relating to such period or QWR to any consumer reporting agency. 12 USC §2605(e)(3).

On remedies for violations of 12 USC §2605, see §§12.79-12.83.

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§12.79 (iii) Section 6: Private Right of Action; Class Actions

Under 12 USC §2614, a borrower may bring a private lawsuit, or a group of borrowers may bring a class action suit, within 3 years against a servicer who fails to comply with any provision of 12 USC §2605. Borrowers may obtain "actual damages" (which are not defined in the statute) and, in the case of a pattern or practice of noncompliance, statutory damages not to exceed $1000. In a class action, if there is a pattern of noncompliance, the statutory damages are up to $500,000 or 1 percent of the net worth of the servicer. 12 USC §2605(f).

For a case applying strict liability principles to RESPA violations under 12 USC §2605, see *Rawlings v Dovenmuehle Mortgage, Inc.* (MD Ala 1999) 64 F Supp 2d 1156 (unintentional violations actionable). On types of damages recoverable, compare *Rawlings v Dovenmuehle Mortgage, Inc., supra* (mental anguish damages allowed), and *Cortez v Keystone Bank* (ED Pa 2000) 2000 US Dist Lexis 5705 (emotional distress, loss of access to credit, interest, and related expenses) with *Katz v Dime Savs. Bank, FSB* (WD NY 1997) 992 F Supp 250 (proof of actual monetary loss required; emotional distress and personal injury damages not allowed).

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§12.80 (iv) Section 8: Kickbacks, Fee-Splitting, Unearned Fees

RESPA §8 (12 USC §2607) prohibits any person from giving or accepting any fee, kickback, or thing of value for a settlement business referral. 12 USC §2607(a). It also prohibits giving or accepting any portion, split, or percentage of any charge made or received for a real estate settlement service in a covered transaction other than for services actually performed. 12 USC §2607(b). For evaluating the problems in proving a violation of RESPA's antikickback provisions in the context of claims against a California mortgage broker, see *Stetler v Greenpoint Mortgage Funding, Inc.* (ED Cal, Mar. 7, 2008, No. 1:07cv0123 DLB) 2008 US Dist Lexis 20129.

Violations of the antikickback, referral fees, and unearned fees provisions of RESPA are subject to criminal and civil penalties. 12 USC §2607(d). In a criminal case, a person who violates the provisions of §2607 may be fined up to $10,000 and imprisoned up to 1 year. 12 USC §2607(d)(1). In a private lawsuit, a person who violates the provisions of §2607 may be liable to the person charged for the settlement service for an amount equal to three times the amount of the charge paid for the service. 12 USC §2607(d)(2).

Attorney fees are available to the prevailing party in an action for violation of RESPA §8 provisions. 12 USC §2607(d)(5).

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§12.81 (v) Section 9: Title Companies

Under RESPA §9 (12 USC §2608), a seller may not require as a condition of selling the property that the buyer purchase title insurance from a particular provider. 12 USC §2608(a). A seller who violates this provision will be liable to the buyer for an amount three times the amount charged for the insurance. 12 USC §2608(b).

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§12.82 (c) Section 10: Impound Accounts

A lender may not require the borrower to deposit into an impound account an amount in excess of one-sixth of the total annual expenses for taxes plus the amount remaining in the month the loan closes for "taxes, insurance premiums, or other charges with respect to the property." 12 USC §2609(a).

A loan servicer that has established an impound account must prepare and deliver an initial statement and annual statements described in 12 USC §2609(c).

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§12.83 (d) Statute of Limitations

The statute of limitations for RESPA violations is 3 years from the date of the occurrence of a violation of RESPA §6 (12 USC §2605) and 1 year from the date of the occurrence of a violation of §8 (12 USC §2607) and §9 (12 USC §2608). See 12 USC §2614. (In contrast, claims for rescission under California contract law do not accrue until the plaintiff discovers the facts constituting the fraud or mistake. CCP §§337(3), 339(3).) There is a division among federal courts about whether the statute is jurisdictional and thus not subject to equitable tolling. Compare *Hardin v City Title & Escrow Co*. (DC Cir 1986) 797 F2d 1037, 1041 (did not apply tolling) with *Moll v United States Life Title Ins. Co.* (SD NY 1988) 700 F Supp 1284, 1293 (applying equitable tolling to RESPA). See also *Lawyers Title Ins. Corp. v Dearborn Title Corp.* (7th Cir 1997) 118 F3d 1157, 1166 (applying 1-year statute of limitations). Some District Courts of the Ninth Circuit have avoided deciding the issue by resolving the cases on other grounds. See *Bloom v Martin* (ND Cal 1994) 865 F Supp 1377, 1387; *Kay v Wells Fargo & Co*. (ND Cal July 24, 2007) 2007 U.S. Dist. Lexis 55519. See also *King v State of Cal.* (9th Cir 1986) 784 F2d 910, 914 (statute of limitations under TILA is not jurisdictional and is subject to equitable tolling).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.84 c. Fair Housing Laws

§12.84 c. Fair Housing Laws

The federal Fair Housing Act (FHA) (42 USC §§3601-3631) is designed to prohibit discriminatory conduct in residential real estate transactions.

It is clear from 42 USC §3605 and cases that interpret it that the FHA prohibits discriminatory lending and related finance practices. Section 3605(a) states:

> It shall be unlawful for any person or other entity whose business includes engaging in residential real estate-related transactions to discriminate against any person in making available such a transaction, or in the terms or conditions of such a transaction, because of race, color, religion, sex, handicap, familial status, or national origin.

The FHA defines a "residential real estate-related transaction" as (1) making or buying a loan or providing other financial assistance for the purchase, construction, or improvement of a dwelling or a loan secured by residential real estate or (2) selling, brokering, or appraising residential real property. 42 USC §3605(b); 24 CFR §100.115. A wide range of credit actors engaged in real estate and lending-related activities are covered under the FHA. These include mortgage lenders as well as their officers, fiduciaries, employees, appraisers, brokers, authorized representatives, and agents. See 42 USC §3605(a); 24 CFR §§100.110-100.135. See also *Singleton v Gendason* (9th Cir 1976) 545 F2d 1224.

The FHA prohibits not only the practice of "redlining" but also that of "reverse redlining" particular communities or groups of protected persons. Redlining is the discriminatory "practice of *denying* the extension of credit to specific geographic areas due to the income, race, or ethnicity of its residents." *Hargraves v Capital City Mortgage Corp.* (D DC 2000) 140 F Supp 2d 7, 20, vacated in part on other grounds 147 F Supp 2d 1 (emphasis added) (citing *United Cos. Lending Corp. v Sargeant* (D Mass 1998) 20 F Supp 2d 192, 203 n5); *Nationwide Mut. Ins. Co. v Cisneros* (6th Cir 1995) 52 F3d 1351. Conversely, reverse redlining is the "practice of *extending* credit on unfair terms to those same communities." *Hargraves,* 140 F Supp 2d at 20 (emphasis added) (citing *Sargeant,* 20 F Supp 2d at 203 n5).

When lenders engage in reverse redlining, homeowners and borrowers in particular census tracts and neighborhoods with a high percentage of protected class members are issued a disproportionately higher percentage of expensive loans. This type of lending practice has been found to be discriminatory under the FHA. *Honorable v Easy Life Real Estate Sys.* (ND Ill 2000) 100 F Supp 2d 885, 892; *Johnson v Equicredit Corp.* (ND Ill 2002) 2002 US Dist Lexis 4817 (minority borrower's allegation that terms and conditions of mortgage loan from one lender were less favorable than those of *similarly situated* Caucasian borrowers contracting with other lender was sufficient to state cause of action under 42 USC §3605).

Under a "disparate impact theory," such fair lending discrimination occurs when there is a showing of discriminatory effects. *Hargraves v Capital City Mortgage Corp., supra* (citing *Jackson v Okaloosa County* (11th Cir 1994) 21 F3d 1531, 1543 (FHA violation can be demonstrated by showing either direct discrimination or discriminatory effects)). See also *Matthews v New Century Mortgage Corp.* (SD Ohio 2002) 185 F Supp 2d 874.

In *Matthews*, the court addressed the issue of whether "reverse redlining" claims are cognizable under the FHA, stating that (185 F Supp 2d at 886)

> the plaintiff need not show that the lender refused to transact business, but only that the lender refused to transact business on *fair terms*. Specifically, to establish a *prima facie* case of discrimination in violation of §3605 based on reverse redlining, the plaintiff must show: (1) that she is a member of a protected class; (2) that she applied for and was qualified for loans; (3) that the loans were given on grossly unfavorable terms; and (4) that the lender continues to provide loans to other applicants with similar qualifications, but on significantly more favorable terms. [Citations.] In the alternative, if the plaintiff presents direct evidence that the lender intentionally targeted her for unfair loans on the basis of sex and marital status, the plaintiff need not also show that the lender makes loans on more favorable terms to others. [Citations.]

Additionally, courts have found violations of the FHA in reverse redlining cases under an "exploitation" theory. In *Hargraves v Capital City Mortgage Corp., supra,* the court held that because plaintiffs had sufficiently alleged that the

terms of defendants' loans were unfair and predatory, it was not necessary for plaintiffs to show that defendants made loans on more favorable terms to individuals outside the targeted protected class. See also *Honorable v Easy Life Real Estate Sys.* (ND Ill 2000) 100 F Supp 2d 885, 887 ("To establish 'exploitation' liability, the plaintiffs must show that (1) as a result of racial segregation, dual housing markets exist, and (2) defendant sellers took advantage of this situation by demanding prices and terms unreasonably in excess of prices and terms available to white citizens for comparable housing."); *Contract Buyers League v F & F Inv.* (ND Ill 1969) 300 F Supp 210, 216 (denying motion to dismiss in civil rights action because plaintiff homebuyers' allegations that defendants sold homes to them "on discriminatory prices and terms" stated claim under Civil Rights Act, and rejecting defendant's argument that comparative evidence was required).

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§12.85 d. Racketeer Influenced and Corrupt Organizations Act (RICO)

Claims characterized as predatory lending have been found to fall within the statutory applicability of the Racketeer Influenced and Corrupt Organizations Act (RICO) (18 USC §§1961-1968). See *Hargraves v Capital City Mortgage Corp.* (D DC 2000) 140 F Supp 2d 7, vacated in part on other grounds 147 F Supp 2d 1.

To state a claim for relief under 18 USC §1962(c), a plaintiff must allege facts showing "(1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity." *Sedima, S.P.R.L. v Imrex Co.* (1985) 473 US 479, 496, 87 L Ed 2d 346, 358, 105 S Ct 3275. A RICO conspiracy claim requires additional averments showing a plausible conspiracy to conduct the affairs of an enterprise through a pattern of racketeering activity. See, *e.g., Shearin v E.F. Hutton Group, Inc.* (3d Cir 1989) 885 F2d 1162, 1166, overruled on other grounds in *Beck v Prupis* (2000) 529 US 494, 505, 146 L Ed 2d 561, 571, 120 S Ct 1608.

An essential requirement of a RICO claim is the existence of an enterprise. See 18 USC §1962(b)-(c). An enterprise "includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity." 18 USC §1961(4).

There are three elements to an association-in-fact enterprise: (1) "an ongoing organization, formal or informal"; (2) "the various associations function as a continuing unit"; and (3) the enterprise exists "separate and apart from the pattern of activity in which it engages." *U.S. v Turkette* (1981) 452 US 576, 583, 69 L Ed 2d 246, 254, 101 S Ct 2524.

Another essential element of a RICO claim is a pattern of racketeering activity. See, *e.g., Sedima, S.P.R.L. v Imrex Co., supra*. See also *Biggs v Eaglewood Mortgage, LLC* (D Md 2008) 582 F Supp 2d 707. A pattern of racketeering activity is defined as "at least two acts of racketeering activity, … the last of which occurred within ten years … after the commission of a prior act of racketeering activity." 18 USC §1961(5). Racketeering activity includes a number of indictable acts under the federal criminal code, including mail and wire fraud under 18 USC §§1341, 1343, and 1961(1). "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake." Fed R Civ P 9(b). The principal purpose of this requirement at the pleading stage is "to ensure that the defendant receives fair notice of the alleged misconduct or fraudulent acts of which the plaintiff complains in order to prepare a responsive pleading." *Beard v Worldwide Mortgage Corp.* (WD Tenn 2005) 354 F Supp 2d 789, 799. The requirement "has been interpreted to mean that a plaintiff must allege at a minimum 'the time, place, and content of the alleged misrepresentation…; the fraudulent scheme; the fraudulent intent of the defendants; and the injury resulting from the fraud.'" 354 F Supp 2d at 799 (quoting *Coffey v Foamex L.P.* (6th Cir 1993) 2 F3d 157, 161).

To plead a conspiracy under 18 USC §1962(d), a "plaintiff must set forth allegations that address the period of the conspiracy, the object of the conspiracy, and the certain actions of the alleged conspirators taken to achieve that purpose." *Shearin v E.F. Hutton Group, Inc.* (3d Cir 1989) 885 F2d 1162, 1166, overruled on other grounds in *Beck v Prupis* (2000) 529 US 494, 505, 146 L Ed 2d 561, 571, 120 S Ct 1608. "[A]greement to commit predicate acts and knowledge that the acts were part of a pattern of racketeering activity" must also be pled. 885 F2d at 1166. Finally, although the complaint need not allege that each defendant in the conspiracy claim violated the underlying substantive provision (*Smith v Berg* (3d Cir 2001) 247 F3d 532, 537), it must be shown that at least one of the co-conspirators violated the relevant predicate subsection, in this case 18 USC §1962(c). See, *e.g., Lum v Bank of America* (3d Cir 2004) 361 F3d 217, 227 n5 (upholding dismissal of §1962(d) claim because plaintiff failed to adequately plead any substantive RICO violation).

The primary benefit to the practitioner of being able to bring a predatory lending claim under a RICO theory is the availability of treble damages (18 USC §1964(c)) as well as the availability of a 4-year statute of limitations for violations. See *Agency Holding Corp. v Malley-Duff & Assocs. Inc.* (1987) 483 US 143, 97 L Ed 2d 121, 107 S Ct 2759 (applying Clayton Act (15 USC §§12-27) statute of limitations to RICO claims). See also 15 USC §15b (limitations of actions under Clayton Act).

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§12.85A e. False Claims Act

Federal insurance and other forms of credit support have an important role in the housing market. Promoters, anxious to make sales that depend on the availability of insurance and other federally sponsored mortgage support, have been known to provide false information about home sales transactions so that sales to otherwise unqualified buyers can be made with the support of federal programs. Such conduct has led to civil actions under the False Claims Act (31 USC §§3729-3733) against those who provided false information that induced federal agencies and programs to guarantee or insure otherwise uninsurable transactions. In *U.S. v Eghbal* (9th Cir 2008) 548 F3d 1281, a district court granted and the Ninth Circuit affirmed summary judgment in favor of the government for almost $6 million in damages and civil penalties against speculators who bought foreclosed properties and then provided unqualified buyers with false information that permitted the buyers to illegally obtain federally insured mortgages.

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2. Common Law

§12.86 a. Fraud

Common law fraud has been successfully used in "predatory lending" cases. See *Henry v Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)* (9th Cir 2006) 471 F3d 977 (lender's fraudulent lending scheme subject to class action fraud liability). See also *Gonzalez v Ameriquest Mortgage Co.* (2004) 2004 US Dist Lexis 22705 (plaintiff's allegations of misrepresentation of loan terms sufficient to withstand demurrer). For discussion of fraud actions against lenders, see §§7.78-7.84, 12.5.

The statute of limitations for California statutory fraud and related theories begins to run on the date of discovery of the injury rather than the transaction closing date. For example, the 3-year statute for tort-based actions for fraud or mistake provides that the cause of action does not accrue until the plaintiff discovers the facts constituting the fraud or mistake. CCP §338(d). Similar rules apply for contract rescission. See CCP §§337(3) (4-year statute applicable to written contracts), 339(3) (2-year statute applicable to oral contracts).

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§12.87 b. Breach of Fiduciary Duty

A fiduciary relationship may exist between a real estate loan broker and the borrower. *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392. Mortgage loan brokers have "an obligation to make a full and accurate disclosure of the terms of a loan to borrowers and to act always in the utmost good faith toward their principals." 24 C3d at 782. Under the reasoning in *Wyatt*, a lender could become liable along with the loan broker if the lender or its authorized agents "directly ordered, authorized or participated in" the broker's tortious conduct. 24 C3d at 785. Even if a lender is not a fiduciary at the inception of the loan, the lender may become a fiduciary of the borrower after the loan closes. See §12.119. For further discussion of breach of fiduciary duties in mortgage transactions and available damages, see §§12.13-12.17, 12.99 and California Real Property Remedies and Damages §§3.21-3.28 (2d ed Cal CEB 2002).

PRACTICE TIP: A major challenge to claiming fiduciary breach is that most mortgage loans are sold or assigned in the secondary market or securitized, and few if any originating lenders end up owning the loan. The practical effect is that the holder of the loan is often able to obtain holder in due course status, which severely limits the defenses to loan enforcement available to the borrower in default on a predatory loan. See §§12.37, 12.103. While this doesn't preclude pursuing a broker for monetary damages, the overarching goal of most homeowners facing default and foreclosure is to stop the foreclosure process and save the family residence. A loan assignee that is able to demonstrate holder in due course status may be able to defeat an application seeking injunctive relief and still proceed to a trustee sale. A borrower can defeat a claim of holder in due course status, however, by showing that the current holder of the note had knowledge of or participated in the broker's tortious conduct. See Com C §3302(a)(2), cited in §12.37.

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§12.88 c. Negligence

A lender may be negligent in the manner in which it handles loan applications. However, conduct amounting to a breach of contract is tortious only when it also constitutes promissory fraud or violates an independent duty arising under tort law. See *Lazar v Superior Court* (1996) 12 C4th 631, 49 CR2d 377; *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 515, 28 CR2d 475. For discussion of negligence theories and lender liability, see §12.7.

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§12.89 d. Breach of Covenant of Good Faith and Fair Dealing

A covenant of good faith and fair dealing is implied in every contract. *Egan v Mutual of Omaha Ins. Co.* (1979) 24 C3d 809, 169 CR 691. Ordinarily a breach of the covenant will give rise only to contract damages. *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 684, 254 CR 211. Accordingly, the California Supreme Court will not likely extend tort remedies for a breach of the implied covenant of good faith and fair dealing to the commercial context, such as the lender-borrower context, unless the evidence shows that a special relationship (see §12.19) exists between the borrower and the lender. For further discussion of covenant of good faith and fair dealing, see §§12.18-12.22.

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3. Elder Abuse Laws

§12.90 a. Financial Elder Abuse

The California Elder Abuse and Dependent Adult Civil Protection Act (Elder Abuse Act) (Welf & I C §§15600-15660) seeks to protect *all* persons 65 years of age or older and "dependent adults" between the ages of 18 and 64 who have "physical or mental limitations" that restrict their ability "to carry out normal activities" or to protect their rights, including but not limited to "persons who have physical or developmental disabilities, or whose physical or mental abilities have diminished because of age." Welf & I C §§15610.23, 15610.27.

The Elder Abuse Act creates a cause of action for financial elder abuse, defined at Welf & I C §15610.30 as follows:

> (a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:
> (1) Takes, secretes, appropriates, obtains, or retains real or personal property of an elder or dependent adult for a wrongful use or with intent to defraud, or both.
> (2) Assists in taking, secreting, appropriating, obtaining, or retaining real or personal property of an elder or dependent adult for a wrongful use or with intent to defraud, or both.
> (3) Takes, secretes, appropriates, obtains, or retains, or assists in taking, secreting, appropriating, obtaining, or retaining, real or personal property of an elder or dependent adult by undue influence, as defined in section 1575 of the Civil Code.
> (b) A person or entity shall be deemed to have taken, secreted, appropriated, obtained, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates, obtains, or retains the property and the person or entity knew or should have known that this conduct is likely to be harmful to the elder or dependent adult.
> (c) For purposes of this section, a person or entity takes, secretes, appropriates, obtains, or retains real or personal property when an elder or dependent adult is deprived of any property right, including by means of an agreement, donative transfer, or testamentary bequest, regardless of whether the property is held directly or by a representative of an elder or dependent adult.

A reported case applying the Act to a predatory lending situation is *Wood v Jamison* (2008) 167 CA4th 156, 83 CR3d 877. The Elder Abuse Act was also found applicable to an insurer who solicited and sold to elders annuity life insurance products that matured after the actuarial life expectancy of the annuitants. See *Negrete v Fidelity & Guar. Life Ins. Co.* (CD Cal 2006) 444 F Supp 2d 998.

Instances of financial abuse brought and proven under the Elder Abuse Act subject the defendant to civil damages, attorney fees, and costs. The term "costs" specifically includes reasonable fees for the services of a conservator who is retained to prosecute the financial abuse claim. Welf & I C §15657.5(a). In addition, if the plaintiff can show by clear and convincing evidence that the defendant was guilty of recklessness, oppression, fraud, or malice, then the limitations imposed by CCP §377.34 (limiting damages to those sustained before death) are inapplicable. Welf & I C §15657.5(b)(1).

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.91 b. Regulation of Reverse Mortgages

§12.91 b. Regulation of Reverse Mortgages

A reverse mortgage is a loan to a person aged 62 or older that is designed and marketed to allow the borrower to extract the "locked up" equity out of his or her home to meet day-to-day cash needs. The borrower is not obligated to make any payments on the loan for as long as he or she resides in the home being used as security for the loan. Reverse mortgages are regulated by a patchwork of federal and state statutes. See, *e.g.,* 12 USC §1715z-20; CC §§1923-1923.10. For a definitional discussion of reverse mortgages, see *Labrador v Seattle Mortgage Co.* (ND Cal, Oct. 29, 2008, No. 08-2270 SC) 2008 US Dist Lexis 90698. For an overall review of the regulatory landscape, see *California Provides Further Protection for Seniors Contemplating Reverse Mortgage Loans,* 38 McGeorge L Rev 45 (2007). See also California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 14 (Cal CEB 2003).

The National Reverse Mortgage Lenders Association (NRMLA) estimated that as of July 2007 there was $4.3 trillion of equity held in private homes throughout the United States. The newly created Reverse Mortgage Market Index estimates that figure will increase nearly nine-fold by the year 2030, at which time the figure is estimated to be $37 trillion. See NRMLA press release available at http://www.nrmlaonline.org/rms/press.aspx?article_id=557.

In addition to the protections of the Elder Abuse Act discussed in §12.90, California regulates reverse mortgages as follows:

- Prepayment penalties are prohibited. CC §1923.2(a).
- Interest may be either fixed or adjustable and may fluctuate with changes in the value of the real property security. CC §1923.2(b).
- The loan may include fees and costs charged by the lender or its designee. CC §1923.2(c). There are no limits on what these fees and costs may include or total.
- If the loan calls for periodic payments to the borrower, those payments may not be reduced as a result of any changes in the interest rate. CC §1923.2(d).
- A lender who wrongfully withholds periodic payments due under the lending agreement may be liable for treble the amount due in the periodic payment, plus interest. CC §1923.2(e).
- The loan becomes due and payable on the occurrence of one of the following events: (1) the sale of the real property security, (2) all borrowers cease to occupy the home as a principal residence, (3) a fixed maturity date, or (4) a loan-document-specified event that jeopardizes the security. CC §1923.2(f).
- Temporary absence from the home not exceeding 60 days cannot trigger a payment obligation, and absences of longer than 60 days may not trigger the loan if the borrower has taken steps to protect and safeguard the security. CC §1923.2(g)(1)-(2).
- The lender's right to collect payment is subject to a 4-year limitations period commencing on the date the obligation is originally due. CC §1923.2(g)(3). See CCP §337(1).
- The first page of the deed of trust must state, in 10-point boldface type: "This deed of trust secures a reverse mortgage loan." CC §1923.2(h).
- If the real property security is held in trust, the property will be deemed "owner occupied" if the occupant is a beneficiary of the trust. CC §1923.4.
- Every reverse mortgage lender must provide the borrower with a disclosure statement, specified in the statute in conspicuous 16-point type or larger, of the existence of credit counseling services. CC §1923.5.

Federal regulation of reverse mortgages restricts federal insurability of the loans. To be eligible for insurance, the loan must have these characteristics:

- Be made by an approved lender (12 USC §1715z-20(d)(1)).
- Be made to an elderly homeowner (defined in 12 USC §1715z-20(b)(1) as at least 62 years of age) (12 USC §1715z-20(d)(2)(A)).
- Be made to a borrower who received "adequate counseling" by a third party (12 USC §1715z-20(d)(2)(B)).

- Be made to a borrower who received "full disclosure" of all associated costs and fees (12 USC §1715z-20(d)(2)(C)).
- Be secured by a one-to-four-unit dwelling of which the principal borrower occupies at least one unit (12 USC §1715z-20(d)(3)).
- Provide that prepayment may be made at any time without penalties (12 USC §1715z-20(d)(4)).
- Have either a fixed or variable interest rate or provision allowing for sharing of future equity appreciation (12 USC §1715z-20(d)(5)).
- Provide for antideficiency protection under certain conditions (12 USC §1715z-20(d)(7)).
- Provide for future payments to the mortgagor-borrower based on approved methods of calculation (12 USC §1715z-20(d)(9)).
- Prohibit certain cost-shifting to the borrower (12 USC §1715z-20(d)(11)).

The Secretary of Housing and Urban Development may change or add to the loan requirements in order to preserve insurability. See 12 USC §1715z-20(d)(6), (8)-(9), (11). Particular disclosures must be made to the homeowner, many of which are similar or identical to those required under TILA and others of which are unique to the peculiar provisions and characteristics of the reverse mortgage vehicle. See 12 USC §1715z-20(e)-(f). The number of loans that may be insured may not exceed 275,000. 12 USC §1715z-20(g).

WARNING: There is some concern that the taking of a reverse mortgage may cause the borrower to lose or jeopardize benefits available under government benefit programs such as SSI or Medicaid, which may consider reverse mortgage proceeds to count as "liquid assets" if they are maintained in an account. For more information, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 14 (Cal CEB 2003).

Congress passed legislation entitled the Expanding American Home Ownership Act of 2007 (HR 1852, 110th Cong, 2d Sess (2007)), which significantly loosened regulation of reverse mortgages to allow higher loan limits, lifted the cap on the number of reverse mortgage loans the FHA is authorized to insure, permitted reverse mortgages on co-ops and condominiums, allowed the use of reverse mortgage loan proceeds to purchase another home, and made other significant changes. For further discussion, see Elder Law Resources §14.21.

For more information on reverse mortgages, see http://www.reverse.org/faqs.htm. For comparison of reverse mortgage programs, see AARP website at http://www.aarp.org/money/revmort.

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§12.92 4. Federally Insured and National Bank Loans

Borrowers obtaining federally insured mortgages are protected from predatory lending practices under 24 CFR §§203.37a and 203.255. See also 24 CFR §§25.6(ee), 203.5(e) (requiring lenders to ensure quality of appraisals on property securing federally insured loans).

Loans made by national banks are also regulated. Specifically, the Office of the Comptroller of the Currency issued regulations in early 2004 that preempt state and local laws addressing predatory lending and prohibit national banks from engaging in certain predatory lending practices (see, *e.g.,* 12 CFR §34.3(b)-(c)); these regulations are much less stringent than California law and generally have no private right of action. See generally 12 CFR pts 7, 34; 69 Fed Reg 1904, 1917 (2004).

Federally insured banks and national banks are not exempt from federal lending statutes such as the Truth in Lending Act (TILA) (15 USC §§1601-1667f), the Home Ownership and Equity Protection Act of 1994 (HOEPA) (Pub L 103-325, 108 Stat 2160), and the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617).

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E. Procedural Issues

§12.93 1. Foreclosure Issues

If a victim of predatory lending is in danger of losing the property under a pending foreclosure sale, two options are available for preventing the sale. One is bankruptcy (see §§11.5-11.6, 12.112); the other is enjoining the trustee sale (see §§7.25-7.55).

Two issues that deserve special consideration in the predatory lending context because they insulate the borrower from personal liability in foreclosure are the one-action rule and the prohibition of deficiency judgments in cases involving purchase money defaults. See chaps 4-5. See also §12.104.

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§12.94 2. Postforeclosure Issues

If a victim of predatory lending has lost the property due to a foreclosure sale, several options are available for setting aside the sale. For discussion on setting aside trustee sale, see §§7.23-7.24, 7.56-7.77.

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§12.95 3. Preemption

To properly assess lender liability, the plaintiff's attorney must confirm the lender's chartered status, investigate in detail the facts underlying the borrower's claim, and thoroughly grasp the interplay of state and federal law. Some lenders are state-chartered (generally governed by law of the state where chartered); others are federally chartered (national banks, *e.g.,* are protected by preemption rules in 12 CFR §§34.1-34.4; federal savings entities are regulated under 12 CFR §560.2; see, *e.g., Weiss v Washington Mut. Bank* (2007) 147 CA4th 72, 53 CR3d 782). On some liability claims, state-chartered lenders may be regulated by both state and federal law. On other claims, state-chartered lenders are regulated by federal law under various preemption doctrines. See, *e.g.,* §§8.14, 8.31, 8.45-8.46.

In *American Fin. Servs. Ass'n v City of Oakland* (2005) 34 C4th 1239, 23 CR3d 453, a municipal ordinance purported to regulate predatory lending practices in the city's home mortgage market. In finding that the state had comprehensively regulated predatory lending practices through the enactment of Fin C §§4970-4979.8, the court held that the municipal ordinance was preempted. 34 C4th at 1256.

For further discussion of federal preemption issues, see §12.29. See also §§12.11, 12.54.

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F. Remedies

§12.96 1. Rescission; Restitution; Modification

If a lender fails to comply with the Truth in Lending Act (TILA) (15 USC §§1601-1667f), the borrower may rescind the loan. 15 USC §1635. On rescission under TILA, see §§12.59-12.69D. The borrower may also rescind for violations of Fin C §§4970-4979.8. See §12.56. For further discussion of available rescission remedies, see chaps 7-8; see also §§12.5, 12.11, 12.70. On restitution remedies, see §12.23.

It is possible that some lenders will be required to modify certain residential loans by receiving financial assistance or by federal regulation. The Federal Emergency Economic Stabilization Act of 2008 and the Troubled Assets Relief Program (together, Pub L 110-343, 122 Stat 3765) authorize federal agencies to, among other things, pay banks a fee to reduce foreclosure rates by reducing the principal amount owing or the interest rate or by modifying other terms of troubled loans. On voluntary loan workouts, including blueprint for residential workouts and commercial forms, see chap 10. On lender liability in workout process, see chap 10; §§12.128-12.137.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ 2. Damages/ a. General Measure of Damages/§12.97 (1) Breach of Contract

2. Damages

a. General Measure of Damages

§12.97 (1) Breach of Contract

A borrower who prevails under contract theory will be entitled to "the amount which will compensate the party aggrieved for all the detriment proximately caused [by the breach], or which, in the ordinary course of things, would be likely to result therefrom." CC §3300.

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§12.98 (2) Tort

A successful tort plaintiff is generally entitled to recover all damages proximately caused "whether it could have been anticipated or not." CC §3333. However, in fraud cases involving the "purchase, sale or exchange of property," CC §3343 provides the exclusive measure of damages and allows the plaintiff "to recover the difference between the actual value of that with which the [plaintiff] parted and the actual value of that which he received." CC §3343(a). This is known as the out-of-pocket rule. Arguably, this measure of damages applies to actions principally between buyers and sellers and nonfiduciary real estate brokers and agents, but a federal decision applied it in a class action by borrowers against their lender. See *Henry v Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)* (9th Cir 2006) 471 F3d 977 (reversed jury verdict on damages calculation issue and remanded for calculation under out-of-pocket rule).

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§12.99 (3) "Benefit of the Bargain" Rule in Fiduciary Breach Cases

If the borrower succeeds under a theory of fraud in a fiduciary breach action (see §§12.13-12.17, 12.87, 12.119), the tort measure will be measured by the "benefit of the bargain" rule under CC §§1709, 3333. See full discussion in California Real Property Remedies and Damages §3.57 (2d ed Cal CEB 2002). It is not clear how this enhanced damage concept might benefit a party victimized as a borrower under a predatory lending scheme, but if the plaintiff has purchased a loan in the secondary market that was not properly originated and incurs damage as a result of a default of the borrower, the originating lender could be responsible for significant damages. The specific problem of fraud in the secondary mortgage market—particularly in the field of private purchases of second deeds of trust—has been largely ignored by regulators and legislators.

EXAMPLE: If an assignee purchases a 10-percent, 15-year note and deed of trust from a loan originator for the original face value of $100,000 and the loan defaults in the first year, under a normal contract theory the plaintiff's recovery against the broker damages is limited to the amount of the original investment ($100,000) plus any unpaid but accrued interest. However, if the plaintiff is successful in proving fiduciary breach, the total damages are the amount of the original investment ($100,000) plus all interest to which the assignee-plaintiff would have been paid from inception to full loan maturity ($150,000), for total damages of $250,000.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.100 b. Treble Damages in Actions Involving Senior Citizens or Disabled Persons

§12.100 b. Treble Damages in Actions Involving Senior Citizens or Disabled Persons

When the plaintiff is a senior citizen or disabled person (see CC §1761(f)-(g)) and fines or penalties are authorized by statute, those fines or penalties may be trebled under CC §3345. In determining whether to impose treble damages, the trier of fact must consider the following:

- Whether the defendant knew the conduct was directed at senior citizens or disabled persons (CC §3345(b)(1));
- Whether the plaintiff suffered (1) loss or encumbrance of a residence, employment, or source of income, (2) loss of property set aside for retirement or for personal or family care and maintenance, or (3) loss of pension, retirement plan, or government benefits program or assets essential to the plaintiff's health or welfare (CC §3345(b)(2)); and
- Whether senior citizens or disabled persons are substantially more vulnerable than other members of the public to the defendant's conduct and actually suffered substantial physical, emotional, or economic damage (CC §3345(b)(3)).

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§12.101 c. Punitive Damages; CC §3294

Because of the higher burden of proof required to obtain punitive damages under California statutory law, this remedy will be rare in predatory lending situations unless the evidence clearly establishes fraudulent intent. Compare, *e.g., Henry v Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)* (9th Cir 2006) 471 F3d 977 (rejecting punitive damages) with *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 157 CR 392, and *Auerbach v Great W. Bank* (1999) 74 CA4th 1172, 88 CR2d 718.

Furthermore, most mortgage lending is done by business entities. In California, punitive damages can be imposed on a corporation only in limited circumstances. See CC §3294(b); *White v Ultramar, Inc.* (1999) 21 C4th 563, 88 CR2d 19; *College Hosp., Inc. v Superior Court (Crowell)* (1994) 8 C4th 704, 34 CR2d 898. See CACI 3945 for jury instructions that apply to entity defendant.

Some lender liability may be based on promissory fraud. See, *e.g., Warren v Merrill* (2006) 143 CA4th 96, 49 CR3d 122, discussed in §12.15. The supreme court reaffirmed that a judgment for promissory fraud will support damages in tort, including emotional distress and punitive damages. See *Lazar v Superior Court* (1996) 12 C4th 631, 49 CR2d 377.

To obtain punitive damages, the plaintiff must prove by clear and convincing evidence that the defendant is guilty of oppression, fraud, or malice. CC §3294(a). However, the plaintiff must first establish entitlement to compensatory damages for tortious activity. *Contractor's Safety Ass'n v California Compensation Ins. Co.* (1957) 48 C2d 71, 307 P2d 626. The rule cannot be satisfied if a jury makes an express verdict not to award compensatory damages. *Cheung v Daley* (1995) 35 CA4th 1673, 42 CR2d 164. See also Comment to BAJI 14.72.1. The economic loss rule will not bar a claim for punitive damages in a fraud action if the claim for fraud exists independently of the claim for breach of contract. See *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352. See also Imre, *Is* Seaman's *Rising From the Ashes? The Ever-Changing Line Between Contract and Tort Remedies,* 27 CEB Civ LR 96 (June 2005); Comment, 28 CEB Real Prop L Rep 24 (Jan. 2005).

"Malice" is defined as conduct "intended by the defendant to cause injury to the plaintiff or despicable conduct which is carried on by the defendant with a willful and conscious disregard of the rights or safety of others." CC §3294(c)(1). Similarly, "oppression" means "despicable conduct that subjects a person to cruel and unjust hardship in conscious disregard of that person's rights." CC §3294(c)(2). Like "malice" and "oppression," "despicable" is subject to court interpretation, but it is even more difficult to apply because it is undefined in the statute. See, *e.g., Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc.* (2000) 78 CA4th 847, 891, 93 CR2d 364; *Mock v Michigan Millers Mut. Ins. Co.* (1992) 4 CA4th 306, 331, 5 CR2d 594 (cited with approval definition of "despicable" in BAJI 14.72.1). Official jury instructions state that "'despicable conduct' is conduct that is so vile, base, or contemptible that it would be looked down on and despised by reasonable people." CACI 3940.

In cases of nondeliberate injury, there must be a "conscious disregard of safety," not just reckless conduct, to justify punitive damages. *G.D. Searle & Co. v Superior Court* (1975) 49 CA3d 22, 122 CR 218.

For comprehensive discussion of punitive damages, see California Tort Damages, chap 14 (2d ed Cal CEB 2002).

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§12.102 3. Attorney Fees

The potential for recovering significant damages arising from either contract or tort claims will often motivate the plaintiff's attorney to develop one theory over the other in preparing for discovery, trial, and settlement discussions. See §§12.97-12.101. The potential for recovering attorney fees, however, is an enormous incentive for disputing parties to settle rather than protract litigation. Although tort damages generally are more inclusive and compensate a party more fully for actual losses (see §12.98) and may in appropriate cases provide additional emotional distress or punitive damages, tort claims usually are more difficult to prove at trial. However, loan documents may contain attorney fee clauses favoring the prevailing party. Also, consumer protection laws often award attorney fees to a prevailing plaintiff, as seen in the following examples:

- Section 1640(a)(3) of the federal Truth in Lending Act (TILA) (15 USC §§1601-1667f), which requires lenders to disclose specific terms in consumer loans, discussed in §§7.36, 12.59-12.69D.
- Section 2607(d) of the federal Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617), which governs loan closings, discussed in §§12.74-12.83.
- Section 4978(a) of the California predatory lending law (Fin C §§4970-4979.8), discussed in §12.56.
- Section 15657.5 of the Elder Abuse Act (Welf & I C §15600-15660), which protects elder or dependent adults from "financial abuse," discussed in §§12.13, 12.90.
- Section 1780(e) of the Consumers Legal Remedies Act (CLRA) (CC §§1750-1784), which may apply to real property secured loans. See *Ansley v Ameriquest Mortgage Co.* (9th Cir 2003) 340 F3d 858, cited in §§8.14, 8.45.
- Section 1785.31 of the Consumer Credit Reporting Agencies Act (CC §§1785.1-1785.36), which protects consumers against inaccurate reports to credit reporting agencies and applies to real property secured loans. See *Hussey-Head v World Sav. & Loan Ass'n* (2003) 111 CA4th 773, 4 CR3d 171.
- Unfair competition, as defined in §17200 of the Unfair Competition Law (UCL) (Bus & P C §§17200-17210), for which attorney fees are available through CCP §1021.5, discussed in §12.23.
- Section 1695.7 of the Home Equity Sales Contract Act (CC §§1695-1695.17), which protects homeowners currently in foreclosure from scams in which the "rescuer" obtains title to the property. See further discussion in §2.8; see also §§12.55, 12.58.
- Civil Code §2945.6, applicable to CC §§2945-2945.11 (regulating mortgage foreclosure consultants), which protect homeowners currently in foreclosure from predators offering to "assist" the homeowner in foreclosure. For further discussion, see §2.9.

Both TILA and RESPA provide for attorney fees to a prevailing plaintiff but not to a prevailing defendant. See, *e.g., Postow v OBA Fed. Savs. & Loan Ass'n* (DC Cir 1980) 627 F2d 1370. See also §12.69D. However, a prevailing defendant may be awarded its attorney fees as sanctions under Fed R Civ P 11 if the court finds that the allegations in the complaint and other factual contentions did not have or were not likely to have evidentiary support at the inception of the lawsuit. See, *e.g., Moazed v First Union Mortgage Corp.* (D Conn 2004) 221 FRD 28. On recovery of attorney fees in state court contract-related actions, see §§7.23, 7.43, 8.83-8.90.

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G. Special Problems

§12.103 1. Holder in Due Course Sanitization

Many loan originators, especially those of subprime loans, have declared bankruptcy or otherwise exited the loan market in recent years after securitizing or otherwise transferring their loans. Consequently, borrowers may face the prospect that even fraudulent loans have been "sanitized" by being transferred to a holder in due course under Com C §3302, which defines the holder in due course issue for loan (and other negotiable) instruments executed under California law. For further discussion, see §§1.28-1.30, 12.37.

Borrowers seeking to stop a foreclosure or otherwise bring claims against an assignee must be prepared for a claim of holder in due course status. One method of attacking holder in due course status is to demonstrate that the creditor is not a holder of the note by showing that the creditor does not have possession of the original note and cannot claim holder in due course status in any other way. See §§1.28-1.30, 12.37. Attorneys representing borrowers in judicial foreclosure states and in bankruptcy have achieved success defending against the foreclosure by alleging that the lender or its transferee lacks standing to bring the suit. See §§3.23, 3.39, 3.45, 3.65, 7.15, 7.105-7.106. However, claims that the foreclosure was improper are difficult to bring after foreclosure has occurred. See §12.37. If the purported creditor cannot demonstrate that it has an interest in the note, the creditor will also not have holder in due course protections. For more on this issue, see Eggert, *Held Up in Due Course (Part 2): Predatory Lending, Securitization, and the Holder in Due Course Doctrine,* 35 Creighton L Rev 503 (Apr. 2002), available on the website of the Social Science Research Network (SSRN) at http://ssrn.com/abstract=904661.

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§12.104 2. Antideficiency Rules

Homeowners are protected from deficiency under several scenarios. To accurately determine which antideficiency rules may apply, it is important to find out when the current loans were obtained and when the property was purchased. See §§12.105-12.107. See also chap 5.

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§12.105 a. Purchase Money Loans

Generally, if the loans were obtained as "purchase money loans" to purchase the borrower's residence, the borrower will be protected by the antideficiency rules. See chaps 4-5.

WARNING: Even a loan secured by a second or third deed of trust may be a purchase money loan. The only relevant question is if the funds obtained from this loan were used to purchase the property. If so, the loan is a purchase money loan.

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§12.106 b. Nonjudicial Foreclosures

The general rule is that if the lender chooses to foreclose on the property through the trustee sale process (see chap 2), then the lender loses its right to obtain a deficiency judgment. See chaps 4-5.

In California it is very unusual for a lender to foreclosure judicially because a judicial foreclosure is far more expensive in legal fees and takes far more time to conduct than does a nonjudicial foreclosure (trustee sale). See chap 3. Therefore, most foreclosures are conducted extra-judicially (nonjudicially), and the lender will be prohibited from obtaining a deficiency judgment.

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§12.107 c. Sold-Out Junior Issues

A lender in second position may choose not to foreclose depending on the situation. In a falling market there may be little or no equity in the property. In fact, it is quite common for the junior lienholder to be completely "under water" with virtually no equity to attach the lien to. Junior lienholders are having to make the hard decision of either advancing funds to bring the loan current and then foreclosing, only to find themselves the new owner of a property with a first deed of trust that exceeds the value of the property, or letting the first deed of trust holder foreclose and then finding themselves holding a note but no security interest, *i.e.,* becoming a "sold-out junior."

Most of these junior lenders will eventually sell these notes to debt collectors for pennies on the dollar. The debt collector will take various steps to attempt to collect on the unsecured note. If the borrowers obtained the loan to purchase the property, they are protected by the antideficiency statutes in most cases. See §§5.39-5.44. This is not likely to stop the debt collector from aggressively attempting to collect the debt, but it should stop the debt collector from obtaining a judgment as long as the homeowner defends on that basis.

PRACTICE TIP: Counsel should also look to the Fair Debt Collection Practices Act (FDCPA) (15 USC §§1692-1692p) as there are likely to be violations. See 15 USC §§1692-1692f. A copy of the FDCPA is available at http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre27.pdf.

For discussion of remedies available to sold-out juniors, see §§5.10-5.12, 5.39-5.44.

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§12.108 3. Workout Strategies on Residential Loans

Lender liability claims are expensive to prosecute and will be defended vigorously. If strong evidence of lender or loan broker liability exists, and if the facts support a remedy for rescission or damages, it might be in the borrower's best interest to attempt a loan workout. On workouts generally, including mid-construction workouts, see chap 10. On lender liability in workouts, see §§12.128-12.137. If the lender is given persuasive evidence of a meritorious claim, it may be willing to negotiate a workout rather suffer rescission, pay damages, or take the property back in a foreclosure.

Workouts are and historically have been more common in large commercial loans, especially if the lender has already foreclosed on other like properties and cannot afford to carry the inventory. Workouts on residential loans have rarely succeeded in the past. However, most residential lenders now have large inventories of properties that have been taken back in foreclosure. Many of these homes are worth far less than the amount due on the loan. Thus, some lenders are more willing to do workouts.

One common issue with workouts is finding a person with authority to make the workout. Lenders and loan servicers have customer service or loss mitigation personnel who are limited in what they can accomplish. However, if the borrower asserts actionable claims, generally an attorney with some authority to resolve the matter for the lender will be assigned to the case.

Another strategy that may induce the lender to negotiate a workout is to request proof of ownership of the note and deed of trust. The complex structure and disparate ownership of mortgage-backed securities makes it harder for borrowers as well as trustees overseeing home loan pools to identify who holds the note. See §7.15. Because the securities may not be mapped to the underlying loans, and because there is no industry repository for mortgage loans sold into investment pools, many loans owned by investment trusts lack the necessary documentation to prove ownership of the note and deed of trust. This may provide fertile ground to enjoin or set aside a trustee sale and ultimately induce the foreclosing party to work out the loan instead.

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§12.109 a. Hope Now Program

Another development that supports workouts for home loans is a policy agreement adopted in the spring of 2007 by the Mortgage Bankers Association, large mortgage lenders, consumer organizations, and civil rights groups. They endorsed a set of principles drafted by the United States Senate Committee on Banking, Housing, and Urban Affairs to address the subprime loan meltdown. See http://dodd.senate.gov/index.php?q=node/3867. The advantage of proceeding under these principles is that lender liability is irrelevant; the principles are the result of a change in policy to preserve homeownership and prevent defaults and foreclosures. Not all lenders have endorsed the principles, and participation is voluntary. The focus is on making early contact with borrowers with adjustable rate mortgages who face interest rate resets and working with them to modify their loans. See http://dodd.senate.gov/multimedia/2007/050207_Principles.pdf.

Modifications under the adopted principles may include switching the loan from an adjustable to a fixed rate loan; reducing the interest rate (factoring in debt-to-income ratio, taxes, and insurance); reducing principal; reamortizing the loan to make payments more affordable; and creating escrows to make tax and insurance payments. Loan servicers will adopt policies that allow large numbers of loan modifications to be done quickly by specially dedicated teams. Although it is unclear whether these workout principles will be applied to a loan already in default, they provide the atmosphere for negotiating workouts on residential loans, especially in the face of strong evidence of lender liability in the formation of the loan.

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§12.110 b. FHASecure Program

In August 2007, the Department of Housing and Urban Development introduced its FHASecure program, designed to help delinquent borrowers with adjustable interest rate loans refinance into Federal Housing Administration (FHA) insured loans. See http://www.fhaloanpros.com/2007/08/will-the-fhasecure-program-really-help-those-facing-foreclosure/. However, the FHA terminated the FHASecure program on December 31, 2008.

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§12.111 4. Negligent Appraisals

Lenders in many instances obtain adverse information about a property as they collect underwriting data. For example, an in-house appraisal could show the loan to be in excess of the lender's loan-to-value guidelines. Whether a lender should disclose this information to its borrower or other interested parties is uncertain. See §§12.47-12.49. If the lender by itself or in collusion with an outside appraiser deliberately exaggerates the property value to increase the loan amount, it may be guilty of fraud. See §§12.5, 12.86. See also Eggert, *Ameriquest Settles Predatory Lending Claims for $325 Million,* 29 CEB Real Prop L Rep 158 (March 2006).

Although older cases held that lenders owe no duty of care to borrowers in preparing appraisals (see, *e.g.*, *Nymark v Heart Fed. Sav. & Loan Ass'n* (1991) 231 CA3d 1089, 283 CR 53), a recent unpublished case (*Lowes v Hill & Co. Real Estate* (ND Cal, Feb. 23, 2006, No. 04-4854 SC) 2006 US Dist Lexis 10152) acknowledged a duty but concluded that the lender had not intended to induce the borrower's reliance on the appraisal.

For the protection of both the borrower and the federal government, a lender must ensure the quality of appraisals on real property securing federally insured mortgages. See 24 CFR §§25.6(ee), 203.5(e).

Civil Code §1090.5, added in 2007, provides that

> [n]o person with an interest in a real estate transaction involving an appraisal shall improperly influence or attempt to improperly influence, through coercion, extortion, or bribery, the development, reporting, result, or review of a real estate appraisal sought in connection with a mortgage loan.

Appraisers are prohibited from engaging in appraisal activity in connection with the purchase, sale, transfer, or financing of real property if the appraiser's compensation is affected by the sales commission generated by the transaction for which the appraisal was made. See Bus & P C §11323.

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§12.112 5. Bankruptcy

The current result of the subprime lending crisis is that some borrowers as well as lenders will apply for bankruptcy relief. This chapter focuses on only some of the issues that arise from that process. For further discussion, see chaps 7, 9.

NOTE: At the time of publication, HR 1106, 111th Cong, 1st Sess (2009) and S 61, 111th Cong, 1st Sess (2009) are pending before the United States Congress to amend the Bankruptcy Code to empower bankruptcy judges to modify the principal amount and terms of loans and loan documents secured only by a debtor's principal residence. Proposed language also may provide additional remedies for violations of TILA or other consumer statutes. Counsel for all parties in interest—debtors, lenders, bankruptcy trustees, trustors, beneficiaries, trustees, and foreclosure trustees, as well as such entities as MERS—must be aware of the impact that the passage of such legislation may have on their clients' rights and remedies. For further information, go to http://www.govtrack.us/congress/bill.xpd?bill=h111-1106 and http://www.govtrack.us/congress/bill.xpd?bill=s111-61.

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§12.113 a. Of Borrower

Because a bankruptcy filing will instantly stay a nonjudicial foreclosure (trustee sale) or a state court judicial foreclosure action against the debtor or property of the estate (see §11.5-11.6), counsel for the borrower may consider bankruptcy relief as a legitimate way to preserve the status quo pending the adjudication of lender liability. If qualified for bankruptcy relief in the form of a plan for reorganization (see §11.96), the borrower may readily avoid the expense and uncertainty of obtaining a temporary restraining order and preliminary injunction against a pending trustee sale. Bankruptcy should be considered if the borrower is marginally solvent, because the expense of a state court lender liability action may undermine the borrower's ability to successfully reorganize in a bankruptcy. See *In re DCNC N.C. I, LLC* (Bankr ED Pa 2009) 407 BR 651.

However, qualifying for bankruptcy relief as an individual was substantially limited by the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23). See §11.2. The BAPCPA also expanded the reasons for which many bankruptcy cases may be converted or dismissed. See §11.3.

PRACTICE TIP: Many consumer attorneys believe that a bankruptcy forum is more debtor-friendly than a state court to adjudicate lender liability claims. Another advantage is that junior lienholder actions (see §12.107) against the borrower are stayed, and the junior's interests are protected along with the borrower's. On the other hand, if a bankruptcy trustee is appointed, there is a degree of loss of borrower control.

For further discussion, see chap 11.

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§12.114 b. Of Lender or Its Officers

Lender bankruptcy will be avoided by those lenders who kept their subprime loan portfolios smaller than other loan types. For others, bankruptcy may be inevitable. Two important areas of bankruptcy law that could arise if a lender in bankruptcy is sued for liability for predatory lending are the trustee's avoidance powers and the nondischargeability provisions of the bankruptcy code. These are costly proceedings and may make sense only if the claims against the lender are in the form of a borrowers' class action.

The trustee may attempt to use its avoidance powers to recover money paid to a third party (*e.g.,* as a fraudulent transfer). See, *e.g., Henry v Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)* (9th Cir 2006) 471 F3d 977. If successful, the money is available in the bankruptcy estate to pay off claims by borrowers against the lender.

The bankruptcy trustee also supervises sales of the bankrupt debtor's assets. Some bankruptcy courts adopted the rule that a creditor selling assets belonging to the bankruptcy estate has a fiduciary duty to conduct the sale in a commercially reasonable manner and is liable to the estate for breaching that duty. Accordingly, in those courts, the trustee will scrutinize the sale of assets for the benefit of other creditors and those holding claims against the estate. See, *e.g., Miller v Greenwich Capital Fin. Prods. (In re American Bus. Fin. Servs.)* (Bankr D Del 2007) 375 BR 112 (lender of debtor (subprime lender in bankruptcy) and its advisor failed to obtain dismissal of action against them by trustee for breach of fiduciary duty in disposing of assets belonging to bankruptcy estate that were collateral for loan to debtor).

The second powerful tool is the nondischargeability adversary proceeding, which may be used by a borrower to determine that the lender's liability is not dischargeable in bankruptcy if the lender has committed fraud. See *Nondischargeability of Debt Based on False Pretenses or Representations, Actual Fraud, or False Financial Statement Under Bankruptcy Code §523(a)(2)* 43 Am Jur POF 3d 1. A nondischargeability action may also be used against the corporate officers of an institutional lender. See *Griffin v Felton (In re Felton)* (Bankr ND Cal 1996) 197 BR 881 (defendant was 90-percent shareholder and president of lending corporation and responsible for approving loans).

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H. Other Resources

§12.115 1. Government Websites

- United States Department of Housing and Urban Development (HUD): http://www.hud.gov/offices/hsg/sfh/pred/predlend.cfm
- HUD Web page on RESPA: http://www.hud.gov/offices/hsg/sfh/res/respa_hm.cfm

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§12.116 2. Legal Aid Providers and Consumer Resources

- National Consumer Law Center (NCLC) (http://www.consumerlaw.org) has published several books, some geared to attorneys and others to consumers. Subjects covered by the NCLC's print and electronic publications are the Truth in Lending Act, consumer bankruptcy, credit reporting practices, credit discrimination, and foreclosure.
- National Association of Consumer Advocates (http://www.naca.net).
- California Reinvestment Coalition (CRC) (474 Valencia St., Suite 230, San Francisco, CA 94103; phone: 415-864-3980; fax: 415-864-3981; e-mail: crc@calreinvest.org; Web address: http://www.calreinvest.org) is a nonprofit research group that conducted a multi-city study of predatory lending in California.

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§12.117 IV. LIABILITY IN LOAN ADMINISTRATION

During the period after the loan has been documented and the basic legal work has been completed—*i.e.,* during the period of loan administration—the lender's actions often give rise to future liability if the loan develops problems or goes into default. After the loan has been documented and funding has commenced but before serious defaults may have occurred, the lender should counsel its employees and agents to act in a way that will not increase its exposure to liability. The most common error of lenders during the loan administration period is to become too involved with the borrower or the project, *i.e.,* to engage in more than the usual activities of a money lender.

A lender that engages in conduct beyond that appropriate and usual to a money lender, or that otherwise acts in a manner in which its motives could be characterized as not being based solidly on credit reasons attendant to the loan being administered, could easily expose itself to serious questions of liability. Conduct beyond that of the usual lender can change the relationship between the lender and the borrower and create a "special relationship." Because of this "special relationship," higher standards and duties can be imposed on the lender. See §§12.13, 12.19, 12.24-12.26, 12.119.

The lender's conduct in administering the loan should be based only on legitimate credit-based considerations. If the lender makes decisions during the administration of the loan that are not based on recognized credit principles, it may become subject to charges of a breach of the covenant of good faith and fair dealing implied in every contract (see §§12.18-12.22). The lender's actions and conduct during the loan administration stage may serve to create evidence that could be used against the lender later on when the loan becomes a problem.

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A. Relationship Between Lender and Borrower

§12.118 1. Communication Strategy and Policies

One factor in determining how a lender's conduct and motives during the loan administration phase will be viewed is the relationship between the lender and the borrower as carried out by their respective representatives. For example, attitudes toward the borrower and personal compatibility can weigh heavily in tort actions against the lender. See §§12.9-12.10.

PRACTICE TIP: At times, a lender's agent may have personal animosity toward a borrower. If such animosity is present, it will worsen the situation if the loan was not sound or prudent or if the borrower is weak or fails to perform for any reason. Lenders should conduct regular reviews of the relationships between their agents and borrowers.

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2. Effect on Loan Transaction and Liability

§12.119 a. Creating Fiduciary or Special Relationships

Even if a lender is not a fiduciary of the borrower at the inception of the loan, the lender may become a fiduciary after the loan closes. The administration of a commercial loan requires the frequent interaction between the lender's loan officers and the borrower. This crucial interaction presents the risk of fiduciary, quasi-fiduciary, and other "special" relationships being formed on the basis of the loan officer's conduct. Because it takes more than a mere lender-borrower relationship to create a fiduciary relationship during loan administration, that simple relationship has to change for a fiduciary or "special" relationship to exist.

The lender-borrower relationship *by itself* does not give rise to a fiduciary duty on the part of the lender. See *River Colony Estates Gen. Partnership v Bayview Fin. Trading Group* (SD Cal 2003) 287 F Supp 2d 1213. See also *Cosoff v Rodman (In re W.T. Grant Co.*) (2d Cir 1983) 699 F2d 599, 609; *Farmers Bank of Clinton v Julian* (8th Cir 1967) 383 F2d 314, 322; *Rader v Boyd* (10th Cir 1957) 252 F2d 585, 587. These federal cases from other jurisdictions comport with California precedent that (1) "parties to a contract, by that fact alone, have no fiduciary duties toward one another" and (2) contracts providing for nonmutual profit and advantage between the contrasting parties cannot, as a matter of law, give rise to a fiduciary relationship. *Rickel v Schwinn Bicycle Co.* (1983) 144 CA3d 648, 192 CR 732. Moreover, a fiduciary relationship is not created simply because one places his or her trust in another. *Committee on Children's Television, Inc. v General Foods Corp.* (1983) 35 C3d 197, 197 CR 783, superseded by statute on other grounds as stated in *Gartin v S&M NuTec LLC* (CD CA 2007) 245 FRD 429, 437 n6. For a fiduciary relationship to arise between parties in the commercial context, there must be a merging of interest between the parties or some undertaking of action on behalf of the beneficiary by the fiduciary. See Douglas-Hamilton, *Creditor Liabilities Resulting From Improper Interference With the Management of a Financially Troubled Debtor,* 31 Bus Law 343, 348 (1975).

Under general principles of agency and statutory duties created by California real estate law, a fiduciary relationship may exist between a real estate loan broker and the borrower if the broker participates in loan collection or administration. See, *e.g., Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392 (broker charged borrower with multiple late payment fees and was unable to justify them at trial; court held jury could reasonably infer that fees were imposed as part of scheme to defraud borrower).

In California, there are no cases that hold that a lender without anything more is a fiduciary of a borrower. The California cases usually cited by borrowers for this proposition are inapposite. For example, in *Commercial Cotton Co. v United Cal. Bank* (1985) 163 CA3d 511, 209 CR 551, the court held that a bank owed a "quasi-fiduciary" obligation to a depositor in a noninterest-bearing checking account and breached the duty when it negligently paid on the check over an unauthorized maker's signature. 163 CA3d at 516. There was no lending relationship involved, and there was no administration of a loan involved. This case dealt only with the bank's conduct in settling the matter of the bank's paying the unauthorized check and then refusing to reimburse the depositor once the unauthorized debiting was discovered. 163 CA3d at 516.

An inexperienced loan administrator, or one who is more of a salesperson or marketing person than a skilled loan administrator, can unintentionally put the lender in the position of being more than the usual money lender in a variety of ways. For example, in *Barrett v Bank of America* (1986) 183 CA3d 1362, 229 CR 16, the court held that a lender may become a fiduciary of its guarantor *if* (1) the lender or its officers gave its guarantor business and financial advice outside the lending relationship, (2) the lender or its officers had a "personal stake" in the guarantor's acting on that advice, (3) the guarantor shared confidential information about its business strategy with the lender, and (4) the guarantor "implicitly relied" on business advice from the lender's officer because of a close personal relationship between the guarantor and the lender's officer. 183 CA3d at 1369.

Barrett did *not* hold that a fiduciary relationship arises out of the mere act of lending money to a borrower. Rather, *Barrett* follows the traditional notions that a fiduciary relationship arises when a party undertakes the role of a confidant or adviser. See *Committee on Children's Television, Inc. v General Foods Corp., supra*. *Barrett* extends neither the

Commercial Cotton "quasi-fiduciary" duty to lending transactions nor fiduciary responsibility to the lender-borrower relationship absent the *express undertaking* of the confidant or adviser role by the lender.

For further discussion of breach of fiduciary duties in mortgage transactions and available damages, see §§12.13-12.14, 12.87, 12.99.

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§12.120 b. Formalizing New Agreement or Changes to Loan

Many lenders change staff after a loan has been negotiated by the sales or marketing people. The loan is then turned over to a loan administrator for documenting and administering the loan. This change in staffing permits the documentation to be conducted by people skilled in those basic, necessary tasks. It also eliminates the type of conduct that sales or marketing people often engage in, such as making representations and promises on behalf of the lender that are not reduced to writing. Thus, when a borrower alleged that the bank's employees had promised long-term financing during the administration of short-term loans, the court of appeal reversed the trial court judgment because the parties failed to reach an agreement in that certain terms of the loan were not discussed and the borrower did not prove justifiable reliance. See *Kruse v Bank of America* (1988) 202 CA3d 38, 248 CR 217.

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B. Loan Documentation

§12.121 1. Reviewing Initial Documentation

Once the loan is documented, a lender should conduct a review to be sure the documents (*i.e.,* note, deed of trust, assignment agreements, and guaranties) are not inconsistent with the loan commitment. The lender should also review the loan documents to see if they are consistent with all the lender's written policies and practice manuals. Although drafters of the loan documents are careful to review these matters before the documents are signed by the parties, last-minute changes and evolutionary changes are always possible. If there are any variations from the terms of the loan commitment or from the lender's written policies, the borrower should be required to acknowledge the exception in writing and agree to it, or it should be resolved by further negotiation. It is better for both parties to confront any variation before the administration of the loan goes too far.

The loan documents should also be checked at the start of administration of the loan to ensure that all perfection steps regarding collateral were taken and are in the proper order. To attempt to enforce an improperly perfected security interest would almost certainly lead to a suit by the borrower. Thus, the review of loan documents after their execution is necessary to avoid lender liability in the administration of loans.

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§12.122 2. Relying on Loan Document Terms

If a provision in the loan documents permits a lender to take a certain action, but it would be unreasonable for the lender to do so, may the lender rely on the literal wording of the loan documents and proceed with the action? In many instances, the lender will not be permitted to rely simply on the language of the documents. In *Baypoint Mortgage Corp. v Crest Premium Real Estate Inv. Retirement Trust* (1985) 168 CA3d 818, 829, 214 CR 531, the court held that equity would not allow foreclosure to enforce precise compliance with the terms of the loan agreement, especially when the late-payment clause created a grace period. (The lender recorded a notice of default after the due date but before the 10-day "grace period" after which a late charge would accrue.) In the words of the *Baypoint* court: "This is the functional equivalent of employing a blunderbuss to kill a gnat." 168 CA3d at 831. Thus, the lender may not rely on the strict terms of the loan documents if the action provided for could result in a forfeiture or a highly unreasonable action.

However, other decisions support the strict enforcement of the written terms of loan documents. In *Penthouse Int'l v Dominion Fed. Sav. & Loan Ass'n* (2d Cir 1988) 855 F2d 963, the court enforced written conditions precedent in a loan commitment and reversed a $137 million total judgment (in favor of the borrower and the lead lender against the participating lender) entered by the trial court. Similarly, New York state's highest court, the court of appeals, ruled in favor of a bank, holding that the bank's security agreement, securing repayment to the bank after a letter of credit issued by the bank had been drawn on, was not unconscionable and that the bank acted properly in setting off against the borrower's account without notice. *Gillman v Chase Manhattan Bank* (1988) 537 NYS2d 787, 534 NE2d 824.

The rule of strictly enforcing the terms of a loan agreement was also upheld in *Resolution Trust Corp. v BVS Dev., Inc.* (9th Cir 1994) 42 F3d 1206, in which the Ninth Circuit stated that, generally, a construction lender owes no duty of oversight to subordinating sellers. The court said that, under California law, a lender owes a borrower or third party no duty outside the express requirements of the loan agreement, unless there are special circumstances. See *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735.

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§12.123 3. Further Documentation and Notice

Documenting the administration of the loan is one of the most important tasks of the lender. The lender should document every contact with the borrower in which a material term or fact is discussed, whether or not modifications or alterations are agreed on at the time of the contact. Each inspection should give rise to an inspection report, and each business call should give rise to a call report briefly setting forth what was discussed, including seemingly extraneous matter. A copy of every write-up should be sent to the borrower, and the lender's file copy should show that a copy was sent to the borrower. All such documents should avoid informal or casual assessments of the borrower and the project. Sending copies to the borrower will tend to ensure that this happens.

Documentation during the administration of the loan usually is the most important protection a lender has against lender liability claims. Failing to properly document the course of conduct and interactions between the lender and the borrower during administration will almost always result in the lender's inability to protect itself when lender liability claims are tried in court.

The borrower is also protected if additional agreements or concessions that the borrower believes are granted in meetings with lenders are confirmed by the borrower immediately after the meeting or contact in a letter to the lender and any other parties present. The lender will have to refute in writing any disagreement with the version of the additional agreements stated in the borrower's letter. This will prod the lender to obtain any further necessary authorization if the lender agrees with the contents of the borrower's letter.

Documentation is especially important for giving notice. Each notice required under the loan documents should be given in writing and with a sufficient lead time to ensure that the notice is reasonable. The notice must be adequate in form and content to constitute actual notice. For the notice to be considered adequate, its form and content and the circumstances surrounding it must be sufficient to permit reasonable action to be taken in response to it. Giving sufficient notice is particularly important before the lender takes any steps to enforce any material term of the loan agreement. Failure to do so resulted in a $7.5 million damages award against Irving Trust Company in *K.M.C. Co. v Irving Trust Co.* (6th Cir 1985) 757 F2d 752. The lender failed to give notice to the borrower before refusing to advance further funds up to the maximum credit limit. Although the lender was not required by the terms of the loan agreement to give notice, the jury was instructed that the obligation of good faith and fair dealing may impose on the lender a duty to give notice before refusing to advance funds unless the lender's decision to refuse to advance funds was made in good faith and in the reasonable exercise of its discretion. 757 F2d at 759.

On the other hand, when expressly permitted by contract, a lender's enforcement action taken without notice was found to be appropriate in a commercial setting. In *Gillman v Chase Manhattan Bank* (1988) 537 NYS2d 787, 534 NE2d 824, the Court of Appeals of New York held that the bank's security agreement, which provided for enforcement without giving notice, was not unconscionable in a commercial setting. The court further held that if the bank had given the borrower advance notice of the setoff, the borrower "could have defeated the purpose of the security interest by the simple expedient of withdrawing its funds." 537 NYS2d at 793. Because the parties had agreed to the enforcement provision, the court declined to "readjust" the "agreed allocation of the risks." 537 NYS2d at 793.

Thus, although giving prior notice is the prudent path for a lender before taking enforcement steps, there is solid authority for taking steps without notice in a commercial context when it has been agreed on and there is a credit-based reason for not giving such notice.

In *Tully v World Sav. & Loan Ass'n* (1997) 56 CA4th 654, 65 CR2d 545, a lender engaged in a forbearance failed to give notice to its borrower that it was accepting a $20,000 payment as a "partial payment" on the debt rather than a payment on a new repayment schedule. The court reversed the summary judgment in favor of the lender, holding that a lender may be estopped from proceeding with a foreclosure if it accepts the payments from the borrower without objection. 56 CA4th at 659. See *Melendrez v D & I Inv., Inc*. (2005) 127 CA4th 1238, 26 CR3d 413, for a case distinguishing *Tully* in circumstances involving a borrower's partial performance under a forbearance agreement and approving the resulting foreclosure sale to a professional third party bidder. See also §7.63.

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§12.124 4. Waiving or Modifying Loan Terms

During the course of loan administration, the lender should be careful to avoid any inadvertent waivers or modifications of loan terms. The loan documents generally require the borrower to comply with numerous operating and reporting covenants, such as monthly operating statements, lease reviews, and minimum net operating income. However, lenders commonly do not enforce such covenants as long as the loan is otherwise performing. If the lender has historically failed to require compliance with loan covenants of this type, it will be precluded from relying on such technical defaults when it proceeds to enforce payment of the loan. Thus, *e.g.,* in *Lopez v Bell* (1962) 207 CA2d 394, 24 CR 626, the court held that a lender that had accepted late payments in the past could not declare the borrower in default as a result of a late payment without first notifying the borrower that strict compliance with the payment terms would be required in the future.

To avoid an unintended waiver of the loan covenants, the lender should monitor the loan and require adherence to the terms of the written loan agreement. If variations from the strict language of the loan agreements are appropriate, the lender should document the scope of any agreement either in a formal amendment to the loan documents—when the variation concerns a material term such as an extension of payment dates or loan amounts—or in a confirming letter to the borrower and any guarantors. This practice will reduce the lender's exposure to later claims by the borrower such as that the loan officer had orally agreed to waive defaults, renew credit, or forbear from enforcing the loan.

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§12.125 C. Lender Control and Interference

Lender control and interference was the basis for one of the earliest cases of lender liability in California, *Connor v Great W. Sav. & Loan Ass'n* (1968) 69 C2d 850, 73 CR 369. (See discussion of *Connor* and other cases arising from lender control and interference in §§12.24-12.26. See also lender conduct as basis for liability for property contamination in §§12.151-12.153.) Because few cases have found liability on this basis in the common law, only a few specific helpful loan administration standards and guidelines can be set forth regarding lender control and interference. Certain broad concepts, however, can be identified to assist the lender: If the lender is careful not to engage in conduct that usurps the borrower's prerogatives or that takes control of or exercises undue influence in the borrower's governance or operations, a lender should remain free from meritorious claims or liability on this basis.

A lender should be able during loan administration to prevent later claims of interference and control if it does the following:

- Limits itself to the conduct and involvement of the usual money lender;
- Maintains a good arm's length from the governance and operations of its borrower (*e.g.,* does not put lender representatives on the borrower's board of directors or in management positions or control the borrower's money or liquid assets);
- Watches out for inadvertent or indirect control of governance or operations (*e.g.,* does not give a list of one or two consultants but rather supplies a list of an assortment and only does so when requested in writing); and
- Documents all contacts during loan administration on matters that touch on control and dominion over the borrower, and ensures that the borrower's prerogatives remain with the borrower and that this nature of the relationship can be proven with documentation.

During loan administration, especially while there are no disputes, the lender should be very careful to be only the usual money lender. This imperative is just as important after any dispute has arisen, but trained workout staff, aware of the problems involved, are usually handling matters at that point. See §12.132.

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§12.126 D. Loan Payoff; Reconveyance

Civil Code §§2941 and 2943 describe the steps a lender must take when the borrower pays off a loan, including responding to payoff demands and executing and recording (or forwarding to the trustee for recording) a certificate of discharge or a request for a full reconveyance of the deed of trust.

A lender or its agent, on the written demand of a borrower or his or her authorized agent, must prepare and deliver a payoff demand statement to the person demanding it within 21 days of the receipt of the demand. But if there was a recorded notice of default or a judicial foreclosure action on the loan, the lender has no obligation to prepare and deliver the statement unless the demand is received before the first publication of a notice of sale or the notice of the first date of a court-ordered sale. CC §2943(c).

A lender has 30 calendar days in which to execute and deliver a request for reconveyance. See CC §2941(b)(1). An earlier version of the statute did not specify the period for lenders to execute and deliver the request for reconveyance; consequently, a few courts construed it to require immediate action. See, *e.g., Bartold v Glendale Fed. Bank* (2000) 81 CA4th 816, 97 CR2d 226, which held the bank liable to the borrowers when the bank failed to deliver reconveyance documents within 9 days; furthermore, the bank's subsidiary trustee under the deed of trust failed to record the reconveyances within the statutory period. Note that statutory amendments in 2001 abrogated the decision in *Bartold* to the extent that *Bartold* interpreted CC §2941 differently from the legislature's declaration of existing law in Stats 2001, ch 560, §3. See *Markowitz v Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 524, 48 CR3d 217 (holding that CC §2941 creates no duties or obligations for escrow holders). See also *Kachlon v Markowitz* (2008) 168 CA4th 316, 85 CR3d 532 (rejecting claims by borrower against foreclosing trustee, but allowing tort claims for damages and equitable relief against lender who had refused to reconvey after repeated requests).

Because CC §2941 is penal, provides for a forfeiture, and is not remedial, the 1-year statute of limitations under CCP §340(a) applies rather than the 3-year statute under CCP §338(a); the doctrine of delayed discovery applies to the accrual of a cause of action under CC §2941. *Prudential Home Mortgage Co. v Superior Court* (1998) 66 CA4th 1236, 78 CR2d 566. The statutory penalty under CC §2941(d) is $500.

For comprehensive discussion of California's reconveyance statutes, see §§8.92-8.99.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.127 E. Checklist: Loan Administration Guidelines

§12.127 E. Checklist: Loan Administration Guidelines

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Following the guidelines below during loan administration should help to minimize lender liability claims.

___ (1) Turn over loan administration to trained administrators who are not involved in loan production as soon as loan documentation *begins* (not after the documents are finished).

___ (2) Start with a careful review of the loan documents to ensure that they are not inconsistent with the loan commitment, internal loan approvals, any lender's manual, or any written (or implied) policies of the lender. In addition, the review should include the following:

___ (a) Completeness of loan documents should be verified;

___ (b) Exceptions to loan commitments or manuals should be written up;

___ (c) Borrower and guarantor concurrence to any variance from loan commitments, manuals, or the like should be obtained at the start of loan administration;

___ (d) Perfection of liens and security interests should be verified with post-closing Uniform Commercial Code (UCC) and lien searches obtained together with a post-closing title insurance policy; and

___ (e) Every verbal understanding should be reduced to writing.

___ (3) Give loan administrators training on lender liability to ensure their understanding of and sensitivity to the usual sources of problems.

___ (4) During administration of the loan, be sure that every contact between lender and borrower concerning a material term or condition of the loan is documented:

___ (a) Call reports should be written up and copied to borrower;

___ (b) Telephone conversations should be written up with a confirming letter to borrower;

___ (c) All material matters should be confirmed in writing to guarantors; and

___ (d) All waivers of covenants, modifications, and extensions should be in writing, signed by the borrower, and confirmed to the guarantors (and consented to by the guarantors when possible).

___ (5) Conduct regular file audits:

___ (a) Be sure files are current;

___ (b) Be sure files are created and maintained in the ordinary course of business and in a manner reflecting businesslike conduct and language, and be sure informal notes are discarded or formalized and made a part of the regular file, including any administrator's "desk" files;

___ (c) Be sure credit-based reasons for actions taken are reflected in the written documents in the files; and

___ (d) Be sure all notices are made in writing and copies of the notices are kept in files.

___ (6) Give all notices in writing and be sure the notice is adequate in all regards:

___ (a) Be sure enough time is given for the borrower to respond, paying particular attention to any notice provisions in the loan documents that may be different from the lender's usual notice

practices;

___ (b) Be sure the "best" address is used along with the agreed address if they are different;

___ (c) Be sure the "best" mode of notice is used together with the agreed mode if they are different; and

___ (d) Be sure to document the reason why a better notice is not given if one exists and the reason no notice is given if it is not given.

___ (7) Conduct regular reviews of the loan administration staff:

___ (a) Be sure loan administrators are businesslike and honest with the borrower and make no threats or misleading statements;

___ (b) Be sure the administrator has acted only as a usual money lender;

___ (c) Be sure the administrator has followed the lender's manual for loan administration;

___ (d) Be sure the personal relationship between the lender and the borrower is not impaired by animosity;

___ (e) Be sure no statements are made by the lender to third parties who are involved with the borrower, such as contractors or materialmen, especially with regard to whether a borrower will or can pay a supplier of goods or services;

___ (f) Be sure the administrator is not offering opinions or making representations about the future to the borrower or anyone else, except to the borrower concerning what the lender will or will not do;

___ (g) Be sure the administrator is not becoming personally involved in the operations or management of the borrower or the project; and

___ (h) Change the administrator at the first sign of personal conflict or animosity between the administrator and the borrower.

___ (8) Review all reports, including loan committee and auditor reports, to make sure their language and comments are businesslike and can readily be shown to a jury. Avoid derogatory and pejorative language in internal documents as well as in communications with third parties.

___ (9) Honor promises to extend additional credit, to extend the term of the credit, and to substitute or release collateral when technical defaults may have occurred.

___ (10) Call in experienced workout specialists at the first indication of trouble with the loan.

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V. LENDER LIABILITY IN WORKOUTS

§12.128 A. Analysis of Lender's Position

Before engaging in any workout efforts with respect to a troubled real property project, the lender and its counsel should thoroughly review the lender's position, not merely for issues of perfection and priority but also for potential sources of liability under either primary or developing theories of lender liability. The existence or nonexistence of such potential exposure will greatly influence the course of workout negotiations as well as the contours of any ultimate workout plan. Moreover, when such exposure exists, the loan workout itself affords an opportunity to resolve the existing liability claims.

This chapter focuses primarily on lender considerations and potential liability in workouts. See chap 10 for comprehensive discussion of other relevant considerations in workouts, including blueprint for residential workouts and state-of-the-art forms for commercial loan workouts.

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§12.129 1. Liability to Borrower

The first step in analyzing the lender's position is to determine whether there are any "residual" risks left over from the loan origination and documentation stages. Most such claims are resolved when the lender actually funds a loan, but several types of "lender liability" claims will survive the loan funding and lie dormant until the lender attempts to enforce payment of the loan. Most notable among such claims are those based on assertions of a fiduciary or quasi-fiduciary relationship between the lender and its customer or of constructive fraud on the part of the lender in failing to disclose material information, *e.g.,* that the lender knew (or should have known) at the time the loan was made that the level of funding was inadequate to complete construction, that the repayment schedule was not consistent with realistic income projections, or similar claims of the lender's alleged failure to evaluate the borrower's ability to repay or to disclose adverse information.

Also troublesome are claims of "economic duress," alleging that the lender, after accepting a large (and often nonrefundable) commitment fee or application fee, insisted on unduly harsh provisions in loan documents or required variations from the terms of the original loan proposal or loan commitment. See, *e.g.,* §§12.50-12.116. Although fraud or other statutory theories may be available to a borrower in an affirmative action against the lender (see §§12.5, 12.11), economic duress is not an independent *tort* in California; rather, the doctrine may serve as a *defense* to enforcement of agreements entered into under coercive circumstances (see §12.6) or as a basis for rescission (see chap 7; California Real Property Remedies and Damages, chap 1 (2d ed Cal CEB 2002)).

When there is reason to believe that such exposure exists, the lender and its counsel should thoroughly investigate the circumstances surrounding the loan origination, including interviews with the people who were involved in that stage of the loan process.

The lender should also review the history of the loan's administration and the relationship between the loan officer and the borrower.

- Have any oral representations been made to the borrower? (Keep in mind that what may appear to be general discussions to a loan officer can often be construed as promises by an overly optimistic borrower.)
- Has the lender administered the loan in accordance with the terms of the loan documents and its own policies and procedures? (The lender's counsel should pay special attention to a loan structure that is particularly complex or was heavily negotiated.)

The lender should also candidly consider the relationship between the loan officer and the borrower.

- Is there a history of animosity?
- Has the borrower confided in the loan officer?
- Has the loan officer attempted to assert influence over the borrower's business affairs?

Moreover, the lender should analyze any claims that the borrower might have under the loan documents themselves, such as whether the borrower is entitled to additional advances.

A lender should enter into a workout agreement only in good faith. For example, in *Auerbach v Great W. Bank* (1999) 74 CA4th 1172, 88 CR2d 718, the borrower, which made the erroneous assumption that its obligation on the existing loan was nonrecourse, made payments on the loan at the lender's request as a condition of the pre-workout agreement with the lender to negotiate a loan modification. The court held that when the pre-workout agreement was entered into, the lender did not intend to modify the loan. The payments, however, were not cognizable under the law as reliance damages on the fraud claim. Thus, the court subtracted the loan payments from the compensatory damages award and remanded the matter for a recalculation of the punitive damages, which were out of proportion to the actual damages suffered by the borrower. See §§12.5, 12.22, 12.133.

The lender should also view a workout negotiation as an opportunity to improve its position by reducing or eliminating any existing lender liability exposure as well as a chance to address any perfection or other documentation problems. Frequently, one of the most important benefits that a lender may obtain in a workout is the assurance that

any future enforcement actions will not be met with costly and time-consuming litigation concerning any of the lender's prior acts. Thus, any workout agreement entered into with the borrower should consider any possible claims the borrower may have against the lender and provide for a complete release of such claims. Generally, any additional financial accommodations should be agreed to by the lender only on condition that all prior claims are finally resolved. See §10.4 for discussion of rights and liabilities of lender and borrower.

PRACTICE TIP: When considering a pre-workout agreement with a borrower for a loan modification, a lender should intend to negotiate in good faith before signing the agreement or be subject to claims for fraud or breach of the covenant of good faith and fair dealing (a covenant implied in every contract in California). See sample pre-workout letter form in §10.3.

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§12.130 2. Liability to Third Parties

In addition to reviewing the lender's relationship with the borrower, the lender should also consider possible claims of third parties before beginning to structure a workout agreement. See, *e.g., Glendale Fed. Bank v Hadden* (1999) 73 CA4th 1150, 87 CR2d 102, discussed in §§10.2.

- Has the lender encouraged the borrower to continue to incur trade debt when the lender knew (or should have known) that the borrower lacked funds to satisfy those obligations?
- Has the lender received any stop notices? See CC §§3156-3176.5.
- How has the lender responded to credit inquiries?
- Has the borrower paid all payroll and payroll-related taxes? See IRC §3505; *Citicorp Indus. Credit, Inc. v Brock* (1987) 483 US 27, 97 L Ed 2d 23, 107 S Ct 2694.

See §10.4 for discussion of third party liabilities.

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§12.131 3. Exposure to Environmental Liability

The presence of hazardous substances poses special risks for the lender. See §§12.151-12.153. Accordingly, if the property is (or has been) used for manufacturing operations, if there is other reason to suspect that hazardous materials have been used on the premises, or if there are underground storage tanks at the site, the lender should consult with a reputable environmental expert early on to determine the extent of any environmental risks in connection with the property. Moreover, even when the property consists of residential, office, or retail space, the lender may wish to conduct an environmental site assessment to determine whether materials such as asbestos or formaldehyde pose any risks.

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§12.132 B. Staffing During Loan Workouts

Once a loan has been identified as a "problem" loan, the day-to-day management of the loan should be turned over to an experienced workout department rather than remain with the original loan administration team. This separation of duties affords advantages to the lender. First, an experienced workout officer will often be more sensitive to the areas in which lender liability claims arise and therefore less likely to inadvertently expose the lender to such claims. Second, a new perspective can often facilitate a successful workout agreement; this is particularly true because the workout officer's judgment will not be clouded by prior personal involvement with the borrower. For example, there will be less temptation to downplay or ignore statements made during loan administration or documentation, and the workout officer will likewise not be saddled with the knowledge that "his" or "her" loan has become a problem for the lender.

However, the workout officers should take care to avoid giving the impression that they have been brought in to "get tough" with the borrower or that their sole interest is in foreclosing against the real property (as opposed to obtaining repayment of the loan). Overly aggressive behavior at this stage can easily be interpreted as an indication of bad faith or ill will in a subsequent lender liability suit. The workout officers should be mindful that any statement or writing may ultimately be presented to a jury in the worst possible light.

If there is any personal animosity between the loan officer (or any staff member) and the borrower, the matter should be turned over to another staff member at once. "Motive" for an action by a lender is very important to juries. Be sure each step taken by the lender is made on a legitimate credit-related basis. It is very easy for juries to believe that personal animosity (*i.e.,* bad faith), and not legitimate business concern, was behind a decision to foreclose. See *Sanchez-Corea v Bank of America* (1985) 38 C3d 892, 909, 215 CR 679 (bank officers publicly ridiculed borrowers; jury verdict of $2.1 million upheld).

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§12.133 C. Duty to Negotiate

From both a business and legal perspective, the lender should make an effort to negotiate a resolution of the borrower's financial difficulties rather than proceed immediately to foreclose. From a practical standpoint, the foreclosure often results in the lender suffering a loss—both on account of the loan itself and in the toll on the lender's goodwill. Moreover, a lender that refuses to work with its borrower may be painted as a "predator" lender whose sole goal was to acquire the borrower's property for less than its true value. See *Gonzales v Gem Props.* (1974) 37 CA3d 1029, 112 CR 884 (creditor dodged attempts by borrower to cure defaults). For characteristics of predatory lending at loan inception, see §§12.50-12.116.

The implied covenant of good faith and fair dealing applies to the *enforcement* of a contract as well as to its performance. *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 683, 254 CR 211; Restatement (Second) of Contracts §205 (1981). See Com C §1304. However, it does not necessarily follow that a lender has a *duty* to engage in workout negotiations with a faltering borrower. See, *e.g., Racine & Laramie, Ltd. v Department of Parks & Recreation* (1992) 11 CA4th 1026, 14 CR2d 335 (implied covenant limited to ensuring compliance with express terms of contract; thus no implied duty to negotiate contract modification). Similarly, the implied covenant does not require a creditor to support a debtor's Chapter 11 bankruptcy plan. *Los Angeles Equestrian Ctr., Inc. v City of Los Angeles* (1993) 17 CA4th 432, 21 CR2d 313.

The implied covenant applies to the lender's decision whether to exercise its remedies; thus, the lender may not accelerate a loan for an improper reason, *i.e.,* one not related to security-based credit concerns, without affecting the implied covenant. The lender must comply with statutory and contractual notice requirements. See, *e.g., Bottrell v American Bank* (Mont 1989) 773 P2d 694 (bank held liable for failure to give borrower proper notice before exercising right of setoff).

Although the implied covenant applies to the lender's decision whether to exercise the lender's remedies, a lender may not be compelled, because of good faith requirements, to indulge a borrower who is clearly in default, particularly if the lender has an unrestricted right to foreclose under the loan documents. For example, in *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735, the borrower contended that the bank had breached the implied covenant by taking a hard line in workout negotiations, essentially asserting that the bank owed the borrower a duty of reasonable forbearance in enforcing its creditor's remedies. The court rejected this contention, holding instead that the implied covenant "does not impose any affirmative duty of moderation in the enforcement of legal rights." 213 CA3d at 479. This holding was affirmed by the court of appeal.

PRACTICE TIP: If a lender has decided not to continue its relationship with a borrower, the lender should take care to avoid giving the impression that it is willing to negotiate with the borrower. In *Richter, S.A. v Bank of America* (5th Cir 1991) 939 F2d 1176, the Fifth Circuit upheld a jury award of $1,555,500 against the lender based on negligent misrepresentation when the loan officers indicated to the borrower that the bank was willing to negotiate a restructured loan despite the fact that documents in the bank's files demonstrated that it had already decided to disengage from the borrower.

In another fraud case, *Auerbach v Great W. Bank* (1999) 74 CA4th 1172, 88 CR2d 718, the court found that the lender defrauded the borrower into entering a pre-workout agreement with the lender, at the lender's request, as a condition for negotiating for a modification of the loan, when the lender never intended to modify the loan. The court did not base its finding on a duty to negotiate by virtue of the lending relationship but rather found that a negotiation for a modification was the purpose of the pre-workout agreement. The absence of an intent to negotiate when the pre-workout agreement was entered into constituted fraud. See §12.5, 12.22, 12.129.

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§12.134 D. Oral Representations During Workout or Refinancing Negotiations

At the outset of any workout negotiations with the borrower, the lender and its counsel should make explicitly clear that any discussions are just discussions, that the lender will be bound only when a definitive written agreement is signed by the parties, and that the lender reserves all of its rights and remedies. See form in §10.3. In addition, the loan officer primarily responsible for the workout negotiations should make clear any limitations on his or her authority. When any agreement is subject to senior management, loan committee, or other review, this fact should be disclosed to the borrowers. See *Kruse v Bank of America* (1988) 202 CA3d 38, 55, 248 CR 217 (borrowers not entitled to rely on oral statements regarding additional financing; they knew requested financing was beyond loan officers' authority to approve).

The lender should follow up in writing any substantive discussions in order to document the fact that no waivers or side agreements were intended (or if intended, their exact scope and duration). In engaging in workout negotiations with the borrower, the lender should take care to avoid any unintended agreements to forbear or to extend a sale date if one is imminent. All communications with the borrower should be in writing when possible, should clearly indicate the lender's intentions, and should make it clear that the lender has not waived its rights to institute foreclosure proceedings or exercise any of its other remedies. For example, a letter confirming a meeting might indicate that the lender will defer recordation of a notice of default until the meeting date, but it should expressly reserve the right to record the notice of default immediately after the meeting. See, *e.g., Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 116, 92 CR 851 (borrower challenged sale on grounds that by reason of continued negotiations, borrower was lulled into false sense of security).

In *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735, the borrower alleged that the bank had orally agreed to restructure the borrower's debts. The court rejected this contention because the oral agreement was too indefinite to create a legally binding contract (213 CA3d at 483):

> Unless an agreement to restructure a loan embodies definite terms, capable of enforcement, it is not a legally valid contract. "Preliminary negotiations or an agreement for future negotiations are not the functional equivalent of a valid, subsisting agreement." [Citations.] The [borrowers'] understanding that the notes would be "redone" thus raises no triable issue as to a legally enforceable understanding inconsistent with the written terms of the notes.

See *Champaign Nat'l Bank v Landers Seed Co.* (1988) 165 Ill App 3d 1090, 519 NE2d 957, aff'd (7th Cir 1994) 15 F3d 729 (oral promise to continue financing unenforceable when specific contract terms, such as amount, rate, and duration, were not discussed or agreed to).

Along with the increased focus on basic contract law principles, appellate courts are also paying more attention to the parol evidence rule, rejecting claims that the true understanding of the parties was not reflected in the written agreements.

In *Price v Wells Fargo Bank, supra,* the court expressly rejected testimony offered to contradict the terms of a written agreement as violating the parol evidence rule. In that case, the borrowers had signed promissory notes with a 1-year maturity date. However, the borrowers tried to establish through their own testimony that the bank's loan officer had orally promised that these notes would actually be payable in 5 years. Similarly, in *Calder v Camp Grove State Bank* (7th Cir 1990) 892 F2d 629, plaintiffs, who had guaranteed a loan from the defendant bank, tried to show by oral testimony that the parties intended a subsequent agreement to release plaintiffs from their guaranty obligations, even though the agreement itself made no reference to the guaranties. In rejecting this claim, the Seventh Circuit relied solely on the parol evidence rule, holding that such a provision should have been included in the written agreement. Similarly, in *U.S. v Grayson* (9th Cir 1989) 879 F2d 620, the Ninth Circuit refused to consider evidence of a course of dealing and the lender's generally lenient collection policy that was offered to defeat the express terms of a written guaranty.

In the course of any workout negotiations, the lender should be careful not to mislead the borrower about its intentions. See fraud cases discussed in §§12.5, 12.22, 12.129, 12.133. See also chap 10 for discussion of workout

strategies and §§12.33-12.35 for discussions of oral or unauthorized loan commitments.

Finally, the lender should scrupulously avoid any hostile, disrespectful, threatening, or belligerent actions during the course of the workout. See *Sanchez-Corea v Bank of America* (1985) 38 C3d 892, 215 CR 679.

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§12.135 E. Liability for Precipitous Action

Perhaps the greatest danger for lender liability exposure during the workout process is that of precipitous action, *e.g.,* declaring a default and refusing to fund draw requests in a construction loan, accelerating loan maturity and demanding immediate payment, or even recording the notice of default. See *K.M.C. Co. v Irving Trust Co.* (6th Cir 1985) 757 F2d 752 (lender's termination of credit without sufficient notice was breach of implied covenant of good faith and fair dealing).

Any action to terminate the extension of credit or enforce the lender's legal and contractual remedies should be made only after carefully reviewing the validity and materiality of the default, including notice and cure periods provided in the loan documents. Even if the documents do not specifically provide for notice and an opportunity to cure defaults, the lender would usually be well advised to give the borrower such notice. Whether the lender may act without notice, when notice is not specifically required by the agreement, depends on all the circumstances surrounding the default. See, *e.g., Gillman v Chase Manhattan Bank* (1988) 537 NYS2d 787, 534 NE2d 824, in which the New York Court of Appeals held that the lender was justified in seizing accounts of customers without prior notice.

The lender also should make every effort to ensure that the notice given is reasonable under the circumstances and should take into account any facts that might suggest that the borrower was in a peculiarly vulnerable position at the time a demand for payment was made or additional advances were refused.

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§12.136 F. Structuring Workout Agreement

The lender should take advantage of the workout process as an opportunity to improve its position from both a business and legal standpoint. From a business standpoint, any agreement should make economic sense from both the borrower's and lender's perspectives. A forbearance or loan modification agreement should provide the borrower with a realistic opportunity to resolve its financial difficulties. (See chap 10 for form forbearance agreement and discussion of loan modification agreements.) By the same token, the lender should not suffer a deterioration in its position. If such an arrangement is not possible, the parties should consider a deed in lieu of foreclosure (see chaps 7, 11) or consensual foreclosure (see chap 10 for form of agreed provision for lender to bid at foreclosure sale). An agreement to an uncontested foreclosure could provide for the borrower's release from potential liability for any deficiency and, in appropriate cases, provide some additional cash to the borrower as well.

CAVEAT: The lender should be wary of any workout agreement that the loan officer believes is not capable of being performed. For example, when the agreement provides for stepped-up payments following a "lease up" period, the lender should not enter into the agreement if it does not believe that the borrower's projections are realistic.

However, the lender has no duty to protect the borrower from itself and is not a guarantor of the success of the borrower's business venture. If the lender is willing to allow the borrower additional time or to provide additional advances in order to turn around a troubled project, even though the loan officer does not believe that the borrower's expectations are realistic, the lender may wish to disclose these views to the borrower in writing. This is particularly important when the lender possesses adverse information that the borrower is not aware of. Failure to disclose such adverse information can lead to liability under the theories of actual and constructive fraud. See §§12.5, 12.13, 12.46-12.49. The lender should also be wary of any workout proposal that would improve the lender's position at the expense of other creditors. See *Gulf Oil Trading Co. v Creole Supply* (2d Cir 1979) 596 F2d 515.

The workout also presents the lender with an opportunity to document existing defaults and to attempt to shore up any preexisting documentation problems or remedy any preexisting lender liability exposure. Accordingly, unless the agreement is intended to cure existing defaults, it should contain express recitals describing the defaults, together with the borrower's acknowledgment that the defaults are valid and material. In any comprehensive workout or forbearance agreement, the lender should insist on a general release of all claims by the borrower against the lender arising out of the loan origination and loan administration, including unknown claims otherwise subject to CC §1542. Such a release is appropriate in a workout situation to ensure that a lender will not later be "blindsided" after making significant efforts to work with the borrower. The lender should recognize, however, that it must make material concessions to the borrower if it expects material concessions from the borrower.

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Source: Real Property/California Mortgages, Deeds of Trust, and Foreclosure Litigation/12 Lender and Broker Liability/ §12.137 G. Checklist: Guidelines for Lenders During Workouts

§12.137 G. Checklist: Guidelines for Lenders During Workouts

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Following the guidelines below should minimize lender liability claims during workouts.

___ (1) Start with a careful review of possible lender liability claims arising from the loan organization and administration processes.

___ (2) Turn over management of the workout to an experienced workout team rather than continuing with the existing loan officers.

___ (3) Engage in meaningful workout negotiations with the borrower.

___ (4) Make clear that the lender will be bound only by signed written agreements.

___ (5) Make any limits on the loan officer's authority clear to the borrower.

___ (6) Avoid hostile, derisive, or antagonistic comments to or about the borrower.

___ (7) "Paper the file" with documents preserving the lender's rights and establishing that there are no side agreements or unintended waivers.

___ (8) Provide reasonable written notice of any enforcement actions or demands.

___ (9) Avoid workout agreements that the borrower cannot reasonably perform.

___ (10) Obtain a general release of both known and unknown claims and a waiver of CC §1542, which otherwise would limit the scope of the release to known claims. See *Winet v Price* (1992) 4 CA4th 1159, 6 CR2d 554 (upheld specific release of unknown claims).

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§12.138 VI. LENDER LIABILITY IN FORECLOSURE PROCESS

A creditor who attempts to exercise a power of sale remedy in a deed of trust without complying fully with the terms of the relevant loan documents and the statutory foreclosure scheme can be held liable to the offended borrower. From a very early date, California courts have not hesitated to set aside nonjudicial sales or to award damages against the foreclosing creditor when irregularities have occurred during the foreclosure process. See, *e.g.*, *Mersfelder v Spring* (1903) 139 C 593, 73 P 452; *Py v Pleitner* (1945) 70 CA2d 576, 161 P2d 393; *Holland v Pendleton Mortgage Co.* (1943) 61 CA2d 570, 143 P2d 493. See also authorities in chaps 2, 7. By the same token, the courts have been unwilling to upset sales in which all the statutory requirements have been strictly met and the creditor is acting in a commercially reasonable manner.

Challenges to nonjudicial foreclosure sales generally fall into two categories: (1) claims based on the underlying obligation, *e.g.,* lack of a material default justifying foreclosure or invalidity of the lien itself and (2) claims based on some alleged defect in the foreclosure process, *e.g.,* failure to comply with the statutory notice requirements. Both types of claims can give rise to "lender liability" on the part of the foreclosing creditor as well as provide the borrower with a basis for setting aside the sale.

One case, based on an alleged defect in the foreclosure process, showed why special care should be given to preparing the notice of default and the notice of the trustee sale and to making the cry of the trustee sale to ensure proper disclosure of the obligation secured, the priority of the lien being foreclosed, and the existence of any superior lien to the lien being foreclosed. In *Ostayan v Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 92 CR2d 577, the court of appeal, finding adequate disclosure of the existing superior lien, affirmed a summary judgment for the lender and trustee, holding that there was no liability to a buyer at a trustee foreclosure sale who relied on a third party title report that erroneously showed the junior lien being foreclosed in first position on the property. The court found that the buyer did not rely on any false or misleading representation of the lender or trustee.

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§12.139 A. Action for Wrongful Foreclosure

A lender may be liable in tort for wrongful foreclosure of real property. *Munger v Moore* (1970) 11 CA3d 1, 89 CR 323. The court in *Munger* noted that while the traditional method for attacking a nonjudicial foreclosure sale is an equitable action to set the sale aside, "a trustee or mortgagee may be liable to the trustor or mortgagor for damages sustained where there has been an illegal, fraudulent or willfully oppressive sale of property under a power of sale contained in a mortgage or deed of trust." 11 CA3d at 7. In order to maintain an action for damages, the trustor *need not* have sought to enjoin the sale, although typically the grounds for a wrongful foreclosure action will also support a complaint for injunctive relief prior to the sale. *Hauger v Gates* (1954) 42 C2d 752, 756, 269 P2d 609. See chap 7.

Likewise, although no reported California case has specifically considered the issue, it appears that a complaining trustor has an election of remedies in a wrongful foreclosure action: The trustor may elect to sue in equity to have the sale set aside or may elect to let the sale stand and sue for damages. See *Owens v Grimes* (Tex Civ App 1976) 539 SW2d 387, 390. When the property has passed to a bona fide third party purchaser, damages are the only available remedy. *Gonzales v Gem Props.* (1974) 37 CA3d 1029, 112 CR 884; *Strutt v Ontario Sav. & Loan Ass'n* (1970) 11 CA3d 547, 90 CR 69.

The consequences of a plaintiff's election to sue for damages (or to include a cause of action for damages in the complaint) can be significant. In an action for damages, the plaintiff has a right to a jury trial, even if other equitable relief is also sought. *Raedeke v Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 111 CR 693. Moreover, courts generally require that a borrower seeking equitable relief "do equity" by tendering the amount of the underlying debt as a precondition to granting any equitable relief. *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 117, 92 CR 851. For further discussion on election of remedies, see California Real Property Remedies and Damages §1.29 (2d ed Cal CEB 2002).

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§12.140 B. Grounds for Wrongful Foreclosure Action

Almost any defect in the foreclosure process—from the nature of the default, to the method of sale, to the conduct of the sale—can give rise to a claim of wrongful foreclosure, which may be asserted by way of a cross-complaint in a judicial foreclosure action or a complaint to enjoin or set aside a trustee sale. See chap 7 for full discussion of various grounds for attacking trustee sale.

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§12.141 1. Existence of Default

A foreclosure sale must be predicated on a valid, material default in the obligation secured. It is axiomatic that the breach for which a lender seeks to foreclose must in fact constitute a default under the terms of the note and deed of trust. The trustor's failure to make timely payments of principal and interest, as and when due under the terms of the promissory note, ordinarily constitutes a sufficiently material default under the deed of trust to permit foreclosure. However, particular attention must be given to any notice or grace periods provided by the deed of trust before declaring the obligation to be in default.

In addition, the lender should consider whether the lender's course of conduct during loan administration might have constituted a waiver of any of the terms of the loan documents. If this is the case, the lender must first give the borrower reasonable notice that strict compliance with the loan terms will be required in the future. For example, a lender that has a history of accepting late payments cannot declare the loan to be in default as a result of a late payment unless it has first put the borrower on notice that it will require that future payments be timely made. See, *e.g., Lopez v Bell* (1962) 207 CA2d 394, 398, 24 CR 626; *Boone v Templeman* (1910) 158 C 290, 110 P 947.

The default must be continuing on the date of any sale. The lender's exercise of the power of sale after the stated default has been cured will give rise to liability. The lender's wrongful rejection of a tender of cure can give rise to a lender liability claim (see, *e.g., Munger v Moore* (1970) 11 CA3d 1, 89 CR 323). In particular, the trustor is required only to cure the defaults specified in the notice of default, and the lender cannot condition reinstatement of the loan on the trustor's cure of additional defaults or payment of additional sums. *Little v Harbor Pac. Mortgage Investors* (1985) 175 CA3d 717, 221 CR 59; *Bisno v Sax* (1959) 175 CA2d 714, 346 P2d 814. Moreover, even if the trustor has failed to cure the defaults within the statutory reinstatement period (see CC §2924c(e)), the equitable policy against forfeiture will cause courts to scrutinize a sale conducted when all delinquencies have been cured and the lender is relying only on an acceleration clause in the note or deed of trust. *Lopez v Bell, supra*.

Some courts have held that minor delays in payment do not give rise to a default under the deed of trust. In *Bisno v Sax, supra,* the court found that a 1-day delay in payment did not constitute a default. The court found that the underlying loan documents did not by their terms declare time to be of the essence. Moreover, the court went on to suggest that because the beneficiary's exercise of its remedies under the deed of trust was limited by the statutory reinstatement period during which time the trustor could cure such defaults, time could never be of the essence with respect to a late payment under a deed of trust. 175 CA2d at 721.

Similarly, in *Baypoint Mortgage Corp. v Crest Premium Real Estate Inv. Retirement Trust* (1985) 168 CA3d 818, 214 CR 531, the court suggested that the "harsh remedy" of foreclosure was not available solely on account of minor delays in payment, even though the beneficiary had expressly notified the trustor that timely payments would be required in the future. In *Baypoint,* the lender sought to foreclose on the basis that the underlying payment of principal and interest had been made after the due date but before the date that late charges could be assessed under the terms of the loan documents.

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§12.142 2. Nonmonetary Defaults

While the most common default is a breach of the borrower's payment obligations, deeds of trust typically contain numerous monetary and nonmonetary covenants, each of which, if breached, may give rise to a right to foreclose. Typical nonmonetary covenants include due-on-transfer or due-on-encumbrance clauses as well as clauses requiring the borrower to maintain and insure the property and pay taxes, rents, assessments, lender advances, and senior liens when due. Deed of trust instruments typically provide that the trustor's failure to perform any such covenant constitutes a default under the deed of trust, giving rise to the right to accelerate the loan and foreclose against the property. See, *e.g., Hwang v Stearns* (*In re Hwang)* (Bankr CD Cal 1995) 189 BR 786, cited in §12.143. See also California Real Estate Finance Practice: Strategies and Forms, chaps 3-4 (Cal CEB 2000).

Nonmonetary covenants relating to payment of insurance premiums, taxes, rents, assessments, and lender advances are enforceable regardless of whether a borrower's breach of the covenant actually impairs the lender's security. CC §2924.7. In enacting §2924.7, the California legislature expressly abrogated the holdings of *Freeman v Lind* (1986) 181 CA3d 791, 226 CR 515, and *Kreshek v Sperling* (1984) 157 CA3d 279, 204 CR 30, "to the extent those holdings in any way restrict the right of a beneficiary or mortgagee under a deed of trust or mortgage on real property to enforce the express provisions of the deed of trust or mortgage." Stats 1988, ch 179, §3. (*Freeman* and *Kreshek* had held that an action for wrongful foreclosure would lie when the lender attempted to foreclose solely on the basis of a lapsed insurance policy.)

Despite the existence of nonmonetary covenants and their enforceability under §2924.7, the courts have applied the implied covenant of good faith and fair dealing to nonforeclosure situations, requiring the lender to show impairment of security before taking action or asserting a right that appears to be allowed without conditions by the language of the deed of trust. For example, in *Milstein v Security Pac. Nat'l Bank* (1972) 27 CA3d 482, 103 CR 16, the deed of trust provided that all condemnation proceeds should be paid over to the lender and applied to reduce the outstanding loan balance. When the city took a 10-foot strip of the property by eminent domain, the lender sought to have the entire award applied against the loan. The court of appeal found that the implied covenant of good faith and fair dealing precluded the lender from claiming the entire sum. Noting that the trial court's order apportioning the award compensated the lender for any impairment in its security occasioned by the eminent domain taking, the court found (27 CA3d at 487):

> The purpose of the note and deed of trust is that [the borrower] shall have the use of the funds loaned on the terms and at the interest rate specified in the note, and that [the lender] shall have the security provided by the deed of trust.

Similarly, in *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57, the court upheld an award of damages against a lender that, after the trustor's residence had been destroyed by fire, refused to allow the trustor to use the fire insurance proceeds to rebuild and instead applied the proceeds to satisfy the loan balance. Basing its holding on the implied covenant of good faith and fair dealing, the court found: "The lender does not have the right to unilaterally cut off the borrower's right to use the loaned funds unless he can show that his security is impaired." 81 CA3d at 80.

The rulings in *Milstein* and *Schoolcraft* were not affected by CC §2924.7. See Stats 1988, ch 179, §3.

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§12.143 3. Proper Notice

Before conducting a trustee sale, notice of the default as well as notice of the sale itself must be given in compliance with the applicable statutes. (For extended discussion of effects of improper notice, see chaps 2, 7.) In addition, the lender's counsel should carefully review the relevant loan documents, which often impose specific requirements regarding the time period for and the manner of giving notice or the place where such notice is to be sent.

Although the foreclosing creditor may be required to do no more than strictly comply with the statutory notice requirements (*Lupertino v Carbahal* (1973) 35 CA3d 742, 747, 111 CR 112; *United States Cold Storage v Great W. Sav. & Loan Ass'n* (1985) 165 CA3d 1214, 1227, 212 CR 232), the prudent lender will make all reasonable efforts to give adequate actual notice to the defaulting trustor. As of January 1, 2006, CC §2924b(b)(3) provides that notices must be sent to the last known "physical address" of the trustor or other interested parties. An address is deemed to be "actually known" by the person recording the notice if the address is contained in the original mortgage or deed of trust or in any subsequent *written* notification of a change of physical address. E-mail addresses and other forms of electronic addresses are specifically excluded from the definition of "physical address." See §2.46. In addition, the lender should give notice to any guarantors, junior lienholders, and anyone else claiming an interest in the property or who might be affected by the sale, whether or not these people have requested notice under CC §2924b. See chaps 2-3, 7.

Failure to give the statutory minimum notice to the borrower is a material defect in the trustee sale, rendering it void in the absence of conclusive presumptions in the trustee deed. *Little v CFS Serv. Corp.* (1987) 188 CA3d 1354, 233 CR 923. Junior creditors to whom notice is not given must show the ability to tender the amount necessary to cure the default in order to set aside the sale. *Arnolds Mgmt. Corp. v Eischen* (1984) 158 CA3d 575, 579, 205 CR 15.

Mistakes or omissions in the notice of sale can also give rise to challenges to the sale. For example, a bankruptcy court held a foreclosing beneficiary liable for wrongful foreclosure under California law because the alleged property tax delinquency was not stated in the notice of default and the note and deed of trust contained no provision requiring the trustor to pay property taxes on a current basis (court noted that provisions of the short-form deed of trust incorporated under CC §2952 were not in evidence). See *Hwang v Stearns* (*In re Hwang)* (Bankr CD Cal 1995) 189 BR 786 (setting further hearing regarding damages, including loss of tenants and of refinancing commitment). In an analogous situation, another court found that a notice of a Uniform Commercial Code (UCC) sale was defective because the notice incorrectly identified the place of sale, even though the creditor posted employees at the erroneous address listed in the notice to direct potential bidders to the correct auction site, located nearby. See *C.I.T. Corp. v Anwright Corp.* (1987) 191 CA3d 1420, 237 CR 108.

PRACTICE TIP: A lender finding a defect in the notice of default or sale, in most instances, would be better advised to renotice the sale after assessing the possible prejudice to the borrower. See *Little v CFS Serv. Corp.* (1987) 188 CA3d 1354, 1361, 233 CR 923 (trustee properly refused to execute deed and sought to renotice sale when it learned that original notice was defective). See also *Knapp v Doherty* (2004) 123 CA4th 76, 20 CR3d 1.

As long as the trustee complies with the foreclosure statutes regarding oral announcements of postponement of a trustee sale, the borrower's lack of actual notice of a continued sale will not invalidate the sale. See *Hicks v E.T. Legg & Assocs.* (2001) 89 CA4th 496, 108 CR2d 10, discussed in §§2.54, 2.57, 2.88-2.93, 12.22. On whether postponing foreclosure sale during borrower's bankruptcy requires another written notice to be served on borrower, see §2.94.

On postponing sale, postsale considerations, conclusiveness of recitals in trustee deed, and setting aside sale, see chaps 2, 7.

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§12.144 4. Manner of Sale

The required manner of a trustee sale is that the sale must be conducted by a properly appointed and serving trustee under the deed of trust at the time of:

- the recordation of the notice of default;
- the trustee sale; and
- the issuance of the trustee deed.

Former trustees and all others who are not the properly appointed and serving trustee (see §§2.21-2.26) at the time of the step taken will be unable to convey title and the sale will be "void" and not just "voidable." See *Dimock v Emerald Props., LLC* (2000) 81 CA4th 868, 97 CR2d 255. In *Dimock*, the trustee service agent abandoned the notice of default recorded by a substituted-in trustee when it discovered an earlier notice of default recorded by the predecessor trustee. Without nullifying the documents installing the new trustee, the service agent conducted a trustee sale and had the former trustee sign the trustee's deed. The court of appeal held that the sale was "void" and not just "voidable," because the former trustee had no power to convey title at the time of sale. Moreover, the borrower was not required to tender a payoff of the loan as it would have been required to do if the borrower were seeking an equitable remedy. For further discussion of *Dimock*, see §§2.25-2.26, 2.74, 7.67.

The holding in *Dimock* was distinguished in *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859, which held that when a former trustee mistakenly conducts the foreclosure sale after the substitution of a new trustee, the foreclosing party may obtain reformation to validate the sale. The court in *Jones* noted that the court in *Dimock* had not considered reformation. Whether or not the sale is validated, a trustee in that situation owes no duty to subsequent purchasers because the trustee has a limited role as a common agent of the borrower and the lender. See *Heritage Oaks Partners v First Am. Title Ins. Co.* (2007) 155 CA4th 339, 66 CR3d 510, which rejected causes of action for damages on theories of negligence and equitable subrogation.

An analysis similar to the one in *Dimock* was applied in *Pro Value Props., Inc. v Quality Loan Serv. Corp.* (2009) 170 CA4th 579, 88 CR3d 381, in which a substitution of trustee had not been recorded before a purported trustee sale. The approach taken in both *Dimock* and *Pro Value* casts considerable doubt on the viability of the "reformation" approach taken to a similar "wrong trustee" issue in *Jones*.

Some lenders act as their own trustees or form subsidiary corporations to conduct foreclosure sales. This introduces more risk into the process. See §§2.25, 2.33.

Although loan documents typically give a beneficiary or trustee considerable latitude in selecting the manner of sale, the trustee is bound to exercise that discretion in good faith and for the benefit not only of the beneficiary but also of the trustor and junior creditors. In other words, the trustee has a duty to conduct the sale in a manner that will maximize the price realized. In *Humboldt Sav. Bank v McCleverty* (1911) 161 C 285, 119 P 82, the court set aside a trustee sale, although regular in all other respects, because the trustee had disregarded the owner's request that the property be sold in parcels and instead sold the encumbered property as a whole, and it was shown that one of the two parcels sold had a value sufficient to satisfy the debt, even though the loan documents expressly permitted the property to be sold en masse. Compare *Humboldt* with *Baron v Colonial Mortgage Serv. Co.* (1980) 111 CA3d 316, 168 CR 450 (trustee has no duty to adjourn sale to obtain higher bids). On adequacy of price as basis for wrongful foreclosure action, see chaps 2, 7; §12.147. On bid chilling, see §§2.80, 12.146.

The doctrine of marshaling, codified in CC §2899, could also restrict the order in which the trustee can sell multiple parcels securing a single debt. Under this doctrine, the trustee must foreclose first on any security in which no junior lien creditor has an interest and then on the least encumbered property. See chap 9.

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5. Conduct of Sale

§12.145 a. Statutory Formalities

As with all other aspects of the foreclosure process, the trustee sale should be conducted in strict compliance with the statutory requirements. "The sale must be made fairly, openly, reasonably, and with due diligence and sound discretion to protect the rights of the mortgagor and others, using all reasonable efforts to secure the best possible or a reasonable price." *Kleckner v Bank of America* (1950) 97 CA2d 30, 33, 217 P2d 28. Thus, any action taken by the beneficiary or foreclosure trustee that discourages competitive bidding or might otherwise result in a lower price being realized can constitute grounds for setting aside the sale or awarding damages against the secured lender (although inadequacy of price alone is not grounds for setting aside a sale; see §12.147).

In *Baron v Colonial Mortgage Serv. Co.* (1980) 111 CA3d 316, 168 CR 450, the court allowed an action for damages to proceed because the trustee recognized bids only from bidders holding cashiers' checks payable to the trustee and did not recognize bids from parties holding cashiers' checks payable to themselves, to be endorsed to the trustee upon a successful bid. Similarly, in *Bank of Seoul & Trust Co. v Marcione* (1988) 198 CA3d 113, 244 CR 1, the court held that the trustee improperly disregarded the attempted bid of a party who stated only "we bid" but failed to specify the amount bid, noting that the crier of the sale could easily have interrupted the sale to explain the mechanics of bidding. 198 CA3d at 118. (But see *Kleckner v Bank of America, supra,* in which the court held that the trustee had no duty to adjourn a sale to permit the highest bidder to go to his bank and obtain cash.)

For further discussion, see chaps 2-3.

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§12.146 b. Bid-Chilling or Control

Attempts by any party to control the bidding also invalidate the sale. *Russell v Soldinger* (1976) 59 CA3d 633, 131 CR 145 (agreement between bidders not to bid against each other void as against public policy); *Gonzales v Gem Props.* (1974) 37 CA3d 1029, 112 CR 884 (attempts to discourage competitive bidding at sale). Bid-rigging is a misdemeanor. CC §2924h(g).

For a junior creditor to get money damages in a suit alleging that the trustee under the senior deed of trust chilled the bidding, the junior would have to produce a ready, willing, and able buyer who would have paid a higher price but for the wrongful conduct. *FPCI RE-HAB 01 v E&G Invs., Ltd.* (1989) 207 CA3d 1018, 255 CR 157. Arguably, the same standard would apply to a borrower seeking damages from a lender or to set aside the sale.

Finally, attempts to circumvent the auction itself will expose the foreclosing creditor to claims by *prospective bidders* as well as by the borrower. *Block v Tobin* (1975) 45 CA3d 214, 119 CR 288 (beneficiary repeatedly postponed sale in order to discourage bidding).

For further discussion, see chaps 2-3.

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§12.147 6. Adequacy of Price

The rule is often stated that mere inadequacy of price, without more, does not constitute sufficient grounds for challenging a foreclosure sale. See, *e.g., Central Nat'l Bank v Bell* (1936) 5 C2d 324, 54 P2d 1107. If there is a gross disparity between the sales price and the value of the property sold, courts will scrutinize the sale and not hesitate to invalidate such a sale if any "irregularities" can be found. See, *e.g., System Inv. Corp. v Union Bank* (1971) 21 CA3d 137, 153, 98 CR 735, describing the judicial view of the power of sale under a deed of trust. However, miscommunication related to an oral agreement for postponement of the sale is not the type of irregularity that justifies setting the sale aside. See *Nguyen v Calhoun* (2003) 105 CA4th 428, 129 CR2d 436, cited in §§2.73, 7.67.

Inadequacy of price combined with bid-chilling conduct at the trustee sale supports a wrongful foreclosure action. See §12.146. For further discussion, see chaps 2-3, 7.

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§12.148 C. Measure of Damages for Wrongful Foreclosure

The proper measure of damages for a lender's wrongful exercise of a power of sale is generally the difference between the fair market value of the property at the time of the sale and the amount of all liens against it. In other words, the damages award should compensate the borrower only for the value of the borrower's "lost equity" in the property. *Munger v Moore* (1970) 11 CA3d 1, 11, 89 CR 323; *Murphy v Wilson* (1957) 153 CA2d 132, 314 P2d 507. Arguably, however, when the property is subject to more than one lien, any liens junior in priority to the foreclosing creditor's lien should be counted in calculating the award of damages to the borrower because the borrower usually remains liable to these sold-out juniors. See chaps 4-5.

On the other hand, the juniors themselves may have a cause of action against the wrongfully foreclosing creditor for loss of security. *Howe v City Title Ins. Co.* (1967) 255 CA2d 85, 63 CR 119. If the borrower does not already have a judgment against the foreclosing creditor that includes the amount owed to the juniors, the borrower should be able to bring the foreclosing creditor into any action on the junior debt by way of a cross-complaint for indemnity or, alternatively, the borrower should be subrogated to the junior creditor on its claim against the foreclosing creditor. The measure of damages when the plaintiff is the junior creditor is the fair market value of the property on the date of the sale, less prior liens and taxes, but not exceeding the outstanding balance on the junior creditor's note. *Howe v City Title Ins. Co., supra; Stephans v Herman* (1964) 225 CA2d 671, 37 CR 746.

Despite the unambiguous manner in which the courts have stated the measure of damages in wrongful foreclosure cases, because the *Munger* court clearly based its holding on tort principles (and in fact cited CC §3333 as the basis for awarding damages), it is likely that, in an appropriate case, a complaining trustor should be able to recover not only the value of its "lost equity" but also all damages proximately caused by the wrongful sale—the traditional measure of damages in tort cases. See CC §3333.

For further discussion, see chap 7.

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§12.149 D. "Bad Faith" Foreclosure and Other Sources of Liability

A lender's use, or threatened use, of the power of sale remedy in a deed of trust can, in particularly egregious circumstances, be actionable under one of the "developing" theories of lender liability (see §§12.12-12.23). The specter of such claims, however, should not deter a lender from properly proceeding to foreclose its lien in an ordinary case.

In one case, the court rejected the plaintiff's claim for intentional infliction of emotional distress in connection with the bank's liquidation of her business and sale of her home, finding that the bank's conduct in liquidating the security for its debt was privileged. *Kruse v Bank of America* (1988) 202 CA3d 38, 248 CR 217. "A party is not subject to liability for infliction of emotional distress when it has merely pursued its own economic interests and properly asserted its legal rights." 202 CA3d at 67. Although acknowledging that when a lender's *conduct* in enforcing its rights becomes truly "outrageous," a cause of action for intentional infliction of emotional distress may lie in accordance with ordinary tort principles, the court pointed out that mere knowledge by the lender that foreclosure would be "upsetting" or distressing to a borrower, without more, will not support such a claim. In so holding, the court observed that "the axis of the financial world turns more on economic reality than human compassion." 202 CA3d at 68 n22.

If, on the other hand, a lender's foreclosure is motivated more by ill will toward the borrower than by sound business reasons, it is doubtful that a claim of privilege would prove to be a successful defense to an action based on a bad faith breach of the implied covenant of good faith and fair dealing or on intentional infliction of emotional distress.

Similarly, liability is sure to attach to a lender that intentionally seeks to use the lending relationship to acquire the borrower's property for less than its true value. See *Block v Tobin* (1975) 45 CA3d 214, 119 CR 288 (cause of action for deceit allowed when beneficiary allegedly postponed trustee sale on numerous occasions in attempt to acquire property without competitive bidding). See also *Gonzales v Gem Props.* (1974) 37 CA3d 1029, 1033, 112 CR 884 (judgment upheld when defendants "had acted collusively, deliberately and oppressively to obtain plaintiff's property at a minimal price, for their own gain").

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§12.150 E. Waiver of Lender Liability Claims in Bankruptcy

Chapter 11 debtors, and perhaps their general creditors, should review lender liability claims before formulating a plan of reorganization to avoid inadvertent waiver of those claims through plan confirmation. See discussion and authorities in §11.116.

CAUTION: Counsel should be aware of *Siegel v FHLMC* (9th Cir 1998) 143 F3d 525, in which a lender liability claim was rejected because of the prior allowance of the lender's claim in the debtor's Chapter 7 case. The allowance was held to be res judicata on amounts owed and the parties' obligations to each other even though the claim was simply "deemed" allowed, without entry of an order, because the debtor and the trustee did not dispute the claim. See *Calabria v CIT Consumer Grp. (In re Calabria)* (Bankr WD Pa 2009) 407 BR 671 (distinguishing *Siegel* because parties orally stipulated in bankruptcy court record that lien validity would be tried in separate court action).

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§12.151 F. Environmental Concerns

Lenders face potential liability under both federal and state law for environmental contamination of properties held as loan collateral or in trust. See §§12.152-12.153.

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§12.152 1. Federal Environmental Law Issues

Historically, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA or "Superfund") (42 USC §§9601-9675) was held to impose strict liability for environmental cleanup costs on a broad spectrum of "potentially responsible parties," including, in some cases, foreclosing mortgagees. See *U.S. v Maryland Bank & Trust Co.* (D Md 1986) 632 F Supp 573 (liability imposed on creditor purchasing at foreclosure sale); *Tanglewood E. Homeowners v Charles-Thomas, Inc.* (5th Cir 1988) 849 F2d 1568 (court rejected contention that CERCLA's strict liability applies only to persons generating hazardous wastes and not to businesses such as banking or real estate development); *U.S. v Mirabile* (ED Pa 1985) 1985 US Dist Lexis 15411 (possible liability for lender who may have participated in management of borrower). But see *In re T.P. Long Chem. Co.* (Bankr ND Ohio 1985) 45 BR 278, 288 (no liability even if creditor had taken possession of toxic wastes).

However, federal legislation enacted in 1996 amended CERCLA and clarified and limited the liability of lenders and fiduciaries for environmental contamination on properties held as loan collateral or in trust. See 42 USC §§6991b(h)(9), 9601(20)(F), enacted as part of the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (Pub L 104-208, 110 Stat 3009-462, 3009-468).

Case law during the 10 years preceding the 1996 legislation created considerable uncertainty about lenders' potential liability under CERCLA for environmental hazards on real property collateral before and after foreclosure. Potentially, a lender enjoyed a "security interest exception" to owner or operator liability as a person "who, without participating in the management of a … facility, holds indicia of ownership primarily to protect his security interest in the … facility." 42 USC §9601(20)(A). The scope of the security interest exception was not adequately defined under CERCLA and was the subject of conflicting judicial interpretations.

For example, in *Guidice v BFG Electroplating & Mfg. Co.* (WD Pa 1989) 732 F Supp 556, the lender resold property on which it had foreclosed 8 months earlier, transferring title more than 2 years before an Environmental Protection Agency (EPA) investigation and cleanup of the site. In denying the lender's motion for summary judgment, the court found that there were issues of fact regarding whether wastes may have been released while the lender held title and opined that a lender who successfully bids at foreclosure is as liable as any other party who assumes ownership of contaminated property. Such a reading of CERCLA was at sharp variance to that eventually given in *Monarch Tile, Inc. v City of Florence* (11th Cir 2000) 212 F3d 1219, 1220, in which the court ruled that the governmental body that acquired indicia of ownership in a property "for the purpose of securing repayment of the development bonds" qualified for CERCLA's secured creditor liability exception, and to that given in *U.S. v Mirabile* (ED Pa 1985) 1985 US Dist Lexis 15411, in which the court found that the bank's 4-month ownership of a contaminated site need not result in the loss of its claim to the security interest exception.

Addressing a lender's preforeclosure liability in *U.S. v Fleet Factors Corp.* (11th Cir 1990) 901 F2d 1550, the court explicitly rejected the "active participation" test applied in *U.S. v Mirabile* and held instead that a secured creditor may incur liability under CERCLA as an operator (901 F2d at 1557)

> by participating in the *financial* management of a facility to a degree indicating a *capacity* to influence the corporation's treatment of hazardous wastes. It is not necessary for the secured creditor *actually* to involve itself in the day-to-day operations … nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste. [Emphasis added.]

The *Fleet Factors* holding was criticized by the Ninth Circuit Court of Appeals in *In re Bergsoe Metal Corp.* (9th Cir 1990) 910 F2d 668. In *Bergsoe Metal,* the court held that "there must be *some* actual management of the facility before a secured creditor will fall outside the [secured creditor] exception.… What is critical is not what rights [the creditor] had, but what it did." 910 F2d at 672. Lenders were thus uncertain about potential CERCLA liabilities they might incur in acquiring title to contaminated collateral at foreclosure and lacked guidance regarding a permissible level of preforeclosure involvement with their collateral and their borrowers' affairs.

To come within the expanded "innocent landowner" defense under the 1986 Superfund amendments (Superfund Amendments and Reauthorization Act of 1986 (SARA); Pub L 99-499, 100 Stat 1613), a foreclosing creditor had to

conduct an environmental site assessment or demonstrate other "due diligence" prior to taking title to property where hazardous substances may have been stored or used. See 42 USC §9601(35). When the property was known to be contaminated and the lender was unwilling to undertake the risks associated with cleaning up the property, the lender avoided taking title at all but rather relied solely on the power of sale provisions of the deed of trust to sell the property to a third party willing to undertake the risks associated with owning contaminated property. When the costs of cleanup exceeded the value of the property, the lender had no reasonable alternative but to abandon its collateral and write off the complete balance of the loan.

In April 1992, the EPA attempted to clarify the security interest exception by publishing a rule addressing the exception and providing guidelines for determining a lender's status under CERCLA. See former 40 CFR §§300.1100, 300.1105. The EPA rule was vacated by the District of Columbia Circuit Court of Appeals in *Kelley v EPA* (DC Cir 1994) 15 F3d 1100, and the rule was later withdrawn by the EPA. See 60 Fed Reg 33914.

After significant legislative effort, the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (Pub L 104-208, 110 Stat 3009-462, 3009-468) was enacted. (See Note, *Relief From CERCLA's "Rock and a Hard Place": The Asset Conservation, Lender Liability and Deposit Insurance Protection Act,* 3 Envt'l Lawyer 859 (1997); Comment, *Potential Responsibility Under CERCLA*: Canadyne-Georgia Corp. v Nationsbank, N.A. (South): *An Illustration of Why We Need a Common Federal Rule Defining "Owned" and "Operated,"* 12 Villanova Envt'l L J 119 (2001).)

Relevant provisions of the Act, codified at 42 USC §9601(20)(E)-(G), adopted virtually all elements of the security interest exception previously defined by the EPA rule. Section 2504 of the Act provides that the EPA rule is "deemed to have been validly issued under authority of [CERCLA]." Pub L 104-208, 110 Stat 3009-468. Also significant is the provision that a lender's preforeclosure "participation in management," to the degree that triggers lender liability, requires the lender's actual (not potential) participation in management through decision-making control over the handling or disposal of hazardous substances or through day-to-day decision making with respect to environmental compliance. See Pub L 104-208, 110 Stat 3009-465; 42 USC §9601(20)(F).

The Act had the effect of defining CERCLA terminology, including "participation in management" and "indicia of ownership primarily to protect a security interest," in a manner more protective of the secured creditor than the interpretations previously given them by certain courts. See Pub L 104-208, 110 Stat 3009-465. Under the former EPA rule incorporated into CERCLA (see 42 USC §9601(20)(E)-(G)), the lender may engage in the following without incurring liability under CERCLA:

> (1) may, but need not, undertake or require an environmental audit of the property before accepting it as security;
> (2) may require and police environmental compliance by the borrower without fear of incurring "operator" liability;
> (3) may engage in workout negotiations so long as the borrower remains the ultimate decision maker for operation of the facility;
> (4) may foreclose upon or accept a deed in lieu of foreclosure to real property collateral; and
> (5) may hold for disposition title to real property obtained through foreclosure or deed in lieu of foreclosure and continue to be within the exemption—provided that the lender seeks to sell the property at the earliest practicable, commercially reasonable time, taking into account market conditions and legal and regulatory requirements.

On applying the security interest exemption to redevelopment efforts by lenders and prospective purchasers of foreclosed property, see Tellier, Gregory & Swain, *Turning Brown into Green: Practical Considerations for Lenders and Buyers of Contaminated Property in a Red Economy,* 27 Cal Real Prop J 20 (No. 2, 2009).

Lenders' counsel will continue to draw guidance from cases decided while the EPA rule was in effect. Regarding lender liability during the term of the loan, see, *e.g., Grantors to Silresim Site Trust v State St. Bank & Trust Co.* (D Mass 1992) 1992 US Dist Lexis 20612 (in response to fraud by officer of borrower, lender required officer's removal, froze debt, and began collection of accounts receivable; no participation in management sufficient to bar security interest exception); *Kemp Indus., Inc. v Safety Light Corp.* (D NJ 1994) 857 F Supp 373 (sale leaseback transaction; lender-lessor who participated in construction planning, inspected, and collected rents was eligible for security interest exception). Regarding the lender's liability after taking title, see, *e.g., U.S. v McLamb* (4th Cir 1993) 5 F3d 69 (lender took title as sole bidder and resold within months; security interest exception defeats buyer's CERCLA contribution action); *Waterville Indus., Inc. v Finance Auth*. (1st Cir 1993) 984 F2d 549 (lender took deed in lieu and sold 6 months

later; not liable for cleanup at closed mill); *Northeast Doran, Inc. v Key Bank* (1st Cir 1994) 15 F3d 1 (no CERCLA liability for mortgagee who resold within 5 months of foreclosure). Lenders should be aware that even with the codified EPA rule in place, they are not immune to environmental lawsuits based on state law causes of action (see §12.153).

Addressing the lien that may be recorded by the EPA against a property on which it has expended cleanup funds, the First Circuit found the lien granted under CERCLA §107(*l*) (42 USC §9607(*l*)) to be a taking and, in light of the lack of prior notice or any provision for judicial review until the lien was enforced, held the lien statute an unconstitutional violation of process. *Reardon v U.S.* (1st Cir 1991) 947 F2d 1509.

Section 2502(a) of the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 provides that a fiduciary's liability is limited to the assets held in the fiduciary estate unless "negligence of a fiduciary causes or contributes to the release or threatened release" of a hazardous substance. 42 USC §9607(n)(3). Additionally, several statutory "safe harbors" are provided to protect fiduciaries from personal liability. 42 USC §9607(n)(4)(A)-(I).

City of Phoenix v Garbage Servs. Co. (D Ariz 1993) 827 F Supp 600 was a decision that has greatly troubled trustees and others who held legal title to contaminated property for another's benefit. Earlier, the district court had determined that a bank that held title to the contaminated property as trustee of a testamentary trust would be personally liable as an "owner" under CERCLA for the cost of cleaning up the site. See *City of Phoenix v Garbage Servs. Co.* (D Ariz 1993) 816 F Supp 564, 568. In the later-reported decision, however, the district court held that the trustee would be liable only in its fiduciary capacity, and thus only to the extent of the trust assets, unless the trustee owned the property at the time it became contaminated, had the power to control the use of the property, and knowingly allowed the property to be used for disposal of hazardous substances. 827 F Supp at 607. See *In re Sundance Corp.* (Bankr ED Wash 1993) 149 BR 641 (receiver not immune from liability for pesticide use if authorizing order obtained without disclosure of risks; receiver must then defend pesticide use as exercise of reasonable business judgment). These decisions are less troubling in view of the federal statutory provisions in CERCLA §107(n). See 42 USC §9607(n).

In one of the most significant cases applying the 1996 CERCLA amendments (Pub L 104-208, 110 Stat 3009-462) regarding fiduciaries, the Eleventh Circuit held that a bank serving as both trustee and executor of a general partnership interest was an "owner" under local law and thus a potentially responsible party under CERCLA. On this basis, the court permitted the plaintiff to go forward with an action alleging that the bank's actions were sufficient to incur CERCLA liability beyond the assets held in its fiduciary capacity. *Canadyne-Georgia Corp. v Nationsbank, N.A.* (11th Cir 1999) 183 F3d 1269. The court emphasized, however, that to prove its case the plaintiff would need to establish that the bank itself took actions contributing to the contamination rather than merely failing to prevent the contamination by others, even if such malefactors were partners in the partnership in which the bank held an interest. In a later proceeding, the trial court granted the bank's summary judgment motion because the plaintiff had no evidence of bank conduct contributing to the contamination. See *Canadyne-Georgia Corp. v Nationsbank, N.A.* (MD Ga 2001) 174 F Supp 2d 1360.

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§12.153 2. State Environmental Law Issues

Although lender liability under federal environmental law has attracted the most publicity, lenders have also faced potential liabilities under California statutory law. See Carpenter-Presley-Tanner Hazardous Substance Account Act (Health & S C §§25300-25395.45); Hazardous Waste Control Law (Health & S C §§25100-25250.28); Porter-Cologne Water Quality Control Act (Wat C §§13000-14958); Hazardous Materials Release Response Plans and Inventory (Health & S C §§25500-25546.5). For full discussion, see California Real Property Sales Transactions, chap 7 (4th ed Cal CEB 2007).

A regime that specially governs the liability of lenders and fiduciaries for hazardous material contamination was established in Health & S C §§25548-25548.7 by SB 1285 (1996). See Stats 1996, ch 612. It exempts a person who is acting in the capacity of a lender from liability under any state or local statute, regulation, or ordinance that would require remedial action, payment of a penalty, or otherwise authorize damages in connection with a release or threatened release of hazardous materials. Health & S C §25548.2(a)(1). This exemption applies to property in which the lender holds a security interest or other "indicia of ownership," property the lender acquires through foreclosure of its lien or deed in lieu, and property owned by the borrower in which the lender has not taken a security interest. Health & S C §25548.2(a)(2). A lender is denied such immunity if it participated in the management of the contaminated property (Health & S C §25548.5(i)), engaged in conduct not in its capacity as a lender (Health & S C §25548.5(e)), made the loan primarily for the purposes of investing in the property (Health & S C §25548.5(k)), failed to divest itself of foreclosed contaminated collateral in a reasonably expeditious manner (Health & S C §25548.5(a)), or contributed to the release or threatened release by an act or failure to act (Health & S C §25548.5(j)). The statute does not excuse a lender from complying with other state requirements that measures be taken to secure a contaminated site or that certain operational procedures be followed for hazardous substances and their disposal. Health & S C §25548.4(d), (i).

Similarly, with reference to the same statutes, regulations, and ordinances, the potential liability of a fiduciary is limited to the assets held in the fiduciary estate (Health & S C §25548.3(a)); however, this limitation will not apply when the fiduciary's negligent, intentional, or reckless conduct has contributed to the release or threatened release (Health & S C §25548.5(c)). As with lenders, the bill does not excuse a fiduciary from complying with other state requirements that certain operational procedures be followed for hazardous substances and their disposal. Health & S C §25548.4(d).

The statute provides a detailed set of defined terms and standards of conduct in an attempt to clarify the parameters of the immunities provided to lenders and fiduciaries in light of the issues raised by prior state and federal (see §12.152) environmental case law.

Notwithstanding the enactment of SB 1285, lenders who come into title may continue to face private actions basing environmental claims on common law doctrines and their offshoots, including negligence, trespass, battery, assault, ultrahazardous activity, and nuisance. See *KFC W., Inc. v Meghrig* (1994) 23 CA4th 1167, 28 CR2d 676 (suit against former owner for continuing trespass); *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 23 CR2d 377 (suit against former owner for negligence, public nuisance, continuing trespass); *Rosenblatt v Exxon Co.* (Md 1994) 642 A2d 180 (surveying common law claims).

In mid-1995, a major bank stipulated to $425,000 in civil penalties and made an additional $450,000 available for cleanup of a California dry cleaning plant on which it held a mortgage but did not foreclose. The bank further stipulated that it would revise internal policies so that test results were delivered to its borrowers and, if no responsible person could be located, would inform state agencies. The bank settled district attorneys' charges that it had violated Health & S C §25189 by (1) failing to remove testing wastes it generated and (2) delaying report of soil and water contamination to the borrower and authorities. The first charge echoes facts in *U.S. v Fleet Factors Corp.* (11th Cir 1990) 901 F2d 1550, discussed in §12.152; however, the charge that the bank failed to disclose test results suggests a burdensome duty for lenders. See 8 Lender Liability News, No. 8 (Sept. 8, 1995).

The Department of Toxic Substances Control has the power to apply to the appropriate court for a judgment to collect an administrative penalty imposed by administrative order or decision issued under the existing hazardous waste control laws or the Hazardous Substance Account Act. Health & S C §25184.1.

See discussion of statutory environmental exceptions to antideficiency and one-action laws in §§4.54-4.57, 5.60.

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§12.154 G. Checklist: Guidelines for Lenders During Foreclosure Process

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If followed, the guidelines below should reduce the lender's risk of liability arising out of a foreclosure sale.

___ (1) Conduct a default materiality review and confirm that a material default actually exists under the terms of the note and deed of trust.

___ (2) Carefully review the underlying loan documents. Have all required demands or notices been properly given? Have reasonable times for the notices been provided? Have all cure periods or grace periods expired?

___ (3) Review its own conduct in administering the loan for possible de facto waivers of any provisions of the loan documents. Is there a history of accepting late or partial payments? Has the lender failed to require strict compliance with nonmonetary covenants?

___ (4) Reconsider its *motive* in foreclosing and be sure it is based on solid, credit-related reasons.

___ (5) Confirm that the sale is being conducted by the properly named and serving trustee under the loan documents and that all documents are properly recorded. See §12.144.

___ (6) Draft the notice of default carefully. Do not overstate or understate the nature or amount of the default. However, include all defaults that clearly exist.

___ (7) Include in the notice of default and notice of sale, and have cried at the sale, a description of the *priority* of the lien being foreclosed. The liens (both superior and junior) should be described with all information in the possession of the foreclosing lender. See §12.138.

___ (8) Send copies of the notice of default and notice of sale to the borrower's last known physical address as well as to the address listed in the deed of trust. Give written notice to guarantors and junior lienholders. If there is any doubt about who should get notice or where it should be sent, err on the side of superfluous notice. See CC §2924b, cited in §2.43.

___ (9) Conduct the sale in strict compliance with the notice of sale, the underlying loan documents, and the applicable statutes.

___ (10) Do not discuss the possible resale of the property until after the foreclosure sale has been completed. Give all inquirers the name of the borrower, and tell the inquirers that the borrower still owns the property. Document the contact.

___ (11) Do not enter either a full credit bid or a nominal credit bid. Carefully consider the consequences of the amount of the credit bid. See chap 2; Hansen, *Wielding the Two-Edged Sword: What Every Attorney Needs to Know About Real Property Secured Transactions* (2 parts), 22 CEB Real Prop L Rep 159 (July, Aug. 1999).

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VII. POSTFORECLOSURE LENDER LIABILITY CONCERNS

§12.155 A. Clearing Title to Property

It is well established that the title obtained through judicial or nonjudicial foreclosure is free from any junior liens or other interests subordinate in priority to the deed of trust. *Sain v Silvestre* (1978) 78 CA3d 461, 144 CR 478, overruled on other grounds in *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 129, 158 CR 1; *City Lumber Co. v Brown* (1920) 46 CA 603, 189 P 830. Even so, the holders of these interests may continue to assert their claims after a trustee sale, particularly by means of mechanics' lien claims against a failed construction project. See §12.156. Consequently, the lender's title insurance company may be reluctant to provide the lender with adequate assurance that its foreclosure sale has, in fact, cut off subsequent claims and interests, unless the lender is willing to purchase additional insurance coverage. See §12.159.

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§12.156 1. Priority Concerns

The presence of mechanics' lien claims poses several priority concerns for the foreclosing lender. There is always a risk that the mechanics' lien claim may have inadvertently attained priority over some portion of the lender's lien. See §§2.99, 9.54, 9.64. See also California Mechanics' Liens and Related Construction Remedies §§2.63-2.73, 3.73 (3d ed Cal CEB 1998).

A lender's deed of trust recorded before any work on the project begins will have priority over subsequent mechanics' lien claims, to the extent that the advances made are required under the construction loan agreement or, if optional, are in fact used to fund construction and do not exceed the original loan commitment. CC §3136. On the other hand, when any construction work has begun before the construction deed of trust is recorded, all subsequent mechanics' liens will take priority over the construction lender's deed of trust. CC §3134.

Optional advances, *i.e.,* advances that are not required to be made under the terms of the loan agreements, are junior in priority to any intervening mechanics' lien claims and thus will not be affected by the sale. To establish this priority, however, the mechanics' lien claimant must show that the lender had actual (not merely constructive) knowledge that mechanics' liens had attached to the property before making the additional, optional advance.

Claims that the lender has made optional, rather than obligatory, advances often arise in situations where the lender has either made advances beyond the initial loan commitment, has made advances after the occurrence of an event of default, or has otherwise deviated from the terms of the underlying loan agreements. See, *e.g., Cal-West Nat'l Bank v Superior Court* (1986) 185 CA3d 96, 229 CR 431 (alleged conspiracy between general contractor and lender to misappropriate loan funds; lender had made premature advances). Thus, before making any advances that might be characterized as optional, the lender would be well advised to obtain appropriate title insurance endorsements insuring the priority of those advances. (Endorsements Nos. 108.8, 122.2, and 122.4 insure the priority of future advances and are available for either optional or obligatory advances. See §9.72.) Likewise, in structuring a workout agreement, the lender should be careful not to endanger its title insurance coverage and, in most cases, should require appropriate title insurance endorsements as well. Finally, if there is a potential priority problem resulting from possible optional advances, the lender would be well advised to adjust its bid at the foreclosure sale accordingly.

Most lenders obtain an American Land Title Association (ALTA) lender's policy of title insurance at the time the deed of trust is recorded. This policy affords broad protection against mechanics' lien claims. The lender should therefore promptly tender to its title insurer any actual or threatened mechanics' lien claims, whether arising before or after the foreclosure sale. See California Title Insurance Practice §§8.30-8.38 (2d ed Cal CEB 1997).

A second deed of trust has priority over a delinquent assessment lien recorded later by the condominium homeowners association. In *Thaler v Household Fin. Corp.* (2000) 80 CA4th 1093, 95 CR2d 779, the purchaser of a condominium at a foreclosure sale by the homeowners association sued a lender on a second deed of trust to quiet title. The sequence of events was as follows: In 1984, CC&Rs were recorded containing provisions for a lien when assessments become delinquent. In 1992, Household Finance Corp. (HFC) recorded a second deed of trust. In 1997, the homeowners association recorded a notice of delinquency assessment (assessment lien). In 1998, Thaler purchased the condominium at a foreclosure sale arising out of the assessment lien. The court of appeal held that the interest purchased at the assessment lien foreclosure was subject to the HFC second deed of trust, basing its ruling on CC §2897's "first in time, first in right" system of priorities and on CC §1367, which provides that a delinquent condominium assessment becomes a lien on the recording of a notice of delinquent assessment. The court rejected the argument that the assessment lien derived its priority from the CC&Rs and not CC §1367.

Concerns over priority can be raised in creative ways. For example, in *Campbell v Scripps Bank* (2000) 78 CA4th 1328, 93 CR2d 635, the court held that a sold-out junior lienholder was collaterally estopped from suing the escrow agent of the original sale for failure to comply with the loan terms because, in an earlier action between the two lienholders, a judgment was issued holding that the lenders had entered an agreement regarding the relative priorities of their respective liens and the seller had agreed to subordinate to the first lienholder. The *Campbell* court said that the escrow agent's possible negligence could not have affected the priority of the liens because priority had been

established by agreement between the lienholders in the earlier action.

On lender liability after consensual workouts allowing foreclosure, including priority issues and third party claims against lender's postforeclosure, see §§7.78-7.84, 10.33-10.36.

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§12.157 2. Stop Notice Claims

Mechanics' lien claims are often accompanied by stop notices, which constitute, in effect, a garnishment of undisbursed construction loan proceeds. CC §§3156-3176.5. See California Mechanics' Liens and Related Construction Remedies §2.82 (3d ed Cal CEB 1998). A lender's obligation to honor a properly served, bonded stop notice is independent of the lien claim itself and is not affected by the foreclosure sale. In other words, unpaid subcontractors and suppliers can assert stop notices directly against the construction lender. CC §§3110-3112, 3159. See Mechanics' Liens §2.83.

Service of a stop notice on a construction lender on private works permits (or, in the case of a bonded stop notice, requires) the lender to withhold any undisbursed portion of the construction loan fund for the benefit of the stop notice claimant. CC §3162. Stop notice claims are independent of any other remedy the claimant may have, such as mechanics' lien rights or contract rights against the general contractor or the property owner. Because these claims are made directly against the construction loan fund and not against the real property, the lender's title insurance policy will not insure against them, and title insurers usually will not defend against them.

The effect of a stop notice is to garnish any undisbursed construction loan funds that would otherwise be available to the project owner and, in turn, to the general contractor. On receipt of a bonded stop notice, the construction lender must withhold the amount claimed from any loan fund it controls, and it may become personally liable to the claimant if it fails to do so. *Connolly Dev., Inc. v Superior Court* (1976) 17 C3d 803, 813, 132 CR 477. The stop notice will reach an undisbursed loan fund, even following a default by the borrower terminating the borrower's right to obtain further disbursements from the construction loan fund. *A-1 Door & Materials Co. v Fresno Guar. Sav. & Loan Ass'n* (1964) 61 C2d 728, 40 CR 85. In *A-1 Door,* the lender funded the construction loan but was supposed to actually advance the loan proceeds to the borrower in five progress payments as construction progressed. When the borrower defaulted, the lender sought to apply the undisbursed portion of the loan fund to reduce its own debt. However, because the stop notice statutes speak in terms of "the construction fund" (CC §3162), when a lender has not actually funded the loan but instead has only committed to make advances on the satisfaction of certain conditions, the stop notice should be of little effect since there is no loan fund to which it can attach.

Finally, just as a stop notice claim is not covered by the lender's title insurance policy, it is similarly not affected by the lender's foreclosure of its lien against the subject real property. *Connolly,* 17 C3d at 809.

The prerequisites to asserting a valid stop notice claim are numerous and technical. Often overlooked, *e.g.,* is the requirement that subcontractors and suppliers serve a preliminary notice on the construction lender within 20 days after beginning work on the project. CC §3160. Courts generally require strict compliance with the statutory scheme. Thus, when faced with a stop notice claim, the lender's counsel should examine the claim carefully to verify that all statutory requirements have been properly met.

For further discussion of construction lender liability and stop notice rights, claims, and remedies, see California Mechanics' Liens and Related Construction Remedies, chaps 1-4, 11 (3d ed Cal CEB 1998).

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§12.158 3. Other Claims by Suppliers and Laborers

Unpaid suppliers and contractors sometimes seek compensation for their work from a foreclosing lender on various common law theories, such as unjust enrichment. The effect of CC §3264, however, is to make the mechanics' lien and the bonded stop notice the exclusive remedies against the project and the loan fund. Civil Code §3264 provides:

> The rights of all persons furnishing labor, services, equipment, or materials for any work of improvement, with respect to any fund for payment of construction costs, are governed exclusively by [CC §§3156-3176.5, 3179-3214], and no person may assert any legal or equitable right with respect to such fund, other than a right created by direct written contract between such person and the person holding the fund, except pursuant to the provisions of such chapters.

Civil Code §3264 bars nearly all postforeclosure actions against a construction lender arising out of the lender's actions in connection with the loan. See *Nibbi Bros., Inc. v Brannan St. Investors* (1988) 205 CA3d 1415, 1424, 253 CR 289, in which the court observed:

> If the lender's duties to the supplier survived section 3264 the supplier would retain the right to bring an action against the lender based on its activities in establishing and administering the construction loan fund. This is precisely the kind of right that section 3264 was intended to abolish.

See also *Boyd & Lovesee Lumber Co. v Western Pac. Fin. Corp.* (1975) 44 CA3d 460, 118 CR 699.

In *Nibbi*, the supplier had alleged that the construction lender had induced it to continue to supply materials to the project after the lender had recorded a notice of default by indicating that there were sufficient funds in the construction loan account to cover the anticipated labor and materials charges. The court found that although the lender had "dealt warily with Nibbi, encouraging it to provide the work but refraining from making promises or factual representations," such conduct was not actionable. "Since enactment of section 3264, lenders will incur liability only by making such promises or representations." 205 CA3d at 1425.

CAVEAT: The *Nibbi* decision left the door open for an unpaid contractor or supplier to assert a claim against a construction lender for unjust enrichment; however, the court did recognize that such actions are extremely limited, quoting a well-known treatise: "It must ordinarily appear that the benefits were conferred by *mistake, fraud, coercion,* or *request;* otherwise, though there is enrichment, it is not unjust." 205 CA3d at 1422. See, *e.g., Cal-West Nat'l Bank v Superior Court* (1986) 185 CA3d 96, 229 CR 431 (allowed subcontractors to sue lender for intentional fraud).

For further discussion of remedies beyond liens and stop notices that may be asserted by construction participants, see California Mechanics' Liens and Related Construction Remedies, chap 1 (3d ed Cal CEB 1998).

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§12.159 4. Title Insurance for Foreclosed Properties

The coverage of a standard American Land Title Association (ALTA) lender's policy will continue in effect following a foreclosure sale or other conveyance through which the insured lender acquires title to the subject property. ALTA Loan Policy Conditions and Stipulations 2(a) (1992 rev). See California Title Insurance Practice, App I (2d ed Cal CEB 1997). Thus, the policy will continue to insure against loss of priority to mechanics' liens and other defects in the lender's title following a foreclosure sale. However, the preexisting lender's policy will not insure the strength of the title acquired by the lender, *i.e.,* it does not insure the validity of the foreclosure sale or lieu deed itself. See Title Ins §§8.48, 9.4. Nor will its protection pass to a subsequent purchaser. ALTA Loan Policy Conditions and Stipulations 2(b) (1992 rev). If the title insurer has insured against known title defects or breaks in priority, the lender may therefore wish to resolve these claims before reselling the property.

On continuation of insurance following foreclosure, see Title Ins §§6.63-6.65. On advantages of obtaining owner's policy, see Title Ins §§6.66-6.67, 8.42-8.45. For comparison of owner's and lender's policies generally, see Title Ins, chaps 6-8.

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§12.160 B. Foreclosure Actions and Actions Against Guarantors

In foreclosure efforts on a typical commercial real estate loan, the lender will frequently "double track," *i.e.,* record a notice of default and simultaneously commence a judicial foreclosure action against the borrower. (The primary aim of the judicial foreclosure action is often to obtain the appointment of a receiver in order to prevent the borrower from dissipating the rents during the required notice period before a nonjudicial sale can be conducted. See chaps 3, 6.) A judicial foreclosure action will usually draw out any potential lender liability claims. These claims will almost always be asserted as defenses to the foreclosure action or in a cross-complaint. If the borrower's principals or others have guaranteed the borrower's obligations to the lender, these guaranties often can be used to facilitate a settlement of the lender liability claims. If there are guarantors to which the lender may turn to recover any deficiency, a cause of action against the guarantor should be included.

California's antideficiency statutes (see chaps 4-5) create additional considerations for a lender seeking to enforce a guaranty agreement after a nonjudicial sale. Unless the lender has taken specific steps to preserve the guaranty, the nonjudicial sale will render the guaranty unenforceable. In *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64, the court of appeal affirmed the dismissal of an action to enforce a guaranty following a nonjudicial sale of the subject real estate. The court based this holding on the principle that, on satisfaction of its guaranty obligations, the guarantor is subrogated to the rights of the original lender against the borrower. Ordinarily then, the guarantor would be able to pay the guaranty and thereafter seek reimbursement from the borrower for the full amount of the debt. In *Gradsky*, however, Union Bank had first elected to sell the encumbered property under its power of sale and thereafter sought to recover its deficiency claim from the guarantors. Under CCP §580d, the nonjudicial sale prevented Union Bank from seeking a deficiency judgment against its borrower through its right of subrogation. The court found that Union Bank had precluded the guarantor's ability to obtain reimbursement from the borrower; as a result, the court found that the guarantor was no longer liable on his guaranty. The *Gradsky* rule does not, however, apply to bar a lender from proceeding against the guarantor following a nonjudicial foreclosure on a purchase money note because CCP §580b would prevent the guarantor from recovering against the principal in any event in a purchase money situation. *Bauman v Castle* (1971) 15 CA3d 990, 93 CR 565. For extensive discussion of *Gradsky*, see §§5.10, 7.39, 7.58, 9.95-9.97, 9.103-9.104, 9.106, 9.111. See also California Real Estate Finance Practice: Strategies and Forms, chap 6 (Cal CEB 2000).

Both the *Gradsky* court and the court in *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238, recognized that a guarantor could waive that defense either explicitly or by conduct. In *Mariners*, the guaranty itself contained a specific waiver of any defense based on CCP §580d. See Real Estate Finance §6.77 for a form of *Gradsky* waiver. In addition, shortly before the scheduled sale, the lender tendered the note and deed of trust to the guarantor, subject to payment of the guaranty obligations. The guarantor refused this offer. In affirming a judgment against the guarantor, the court seized on the guarantor's preforeclosure refusal to accept the tender of the loan to establish a waiver of the defense that the foreclosure had destroyed the guarantor's subrogation rights.

PRACTICE TIP: As a result of California's statutory antideficiency scheme, the lender should be sure to include specific *Gradsky* waivers in its guaranty agreements. In addition, in those cases in which the lender may wish to continue an action against a guarantor following a foreclosure sale, the lender should tender the loan to the guarantor for full payment prior to the sale in order to preserve its ability to recover any deficiency under the guaranty. Lender's counsel should also consider recommending that credit support be obtained from those who profit from the loan transaction by, for instance, securing broker indemnities in loan brokerage transactions. For an example of such credit support, see *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 37 CR3d 83. Such arrangements can discourage brokers from bringing the lender "trash for cash" transactions.

From a practical viewpoint, a postforeclosure action against a guarantor should be filed only after careful consideration. In particular, the lender should take into account both the likelihood of actually collecting any deficiency from guarantors and the possibility that lender liability might be alleged as a defense or in a cross-complaint as a result

of the lender's administration of the loan or its conduct during the foreclosure process. For example, in *Centerre Bank v Distributors, Inc.* (Mo App 1985) 705 SW2d 42, the lender filed suit against its borrower and the borrower's guarantors, seeking to recover the deficiency remaining after the bank had liquidated the borrower's inventory and accounts. Although the judgment was later reversed on appeal, the jury awarded the defendants a total of $7,528,800 on their lender liability cross-claims against the bank.

In a decision later ordered not published in the official reports, a court of appeal extended the benefits of CCP §580a to guarantors in an opinion that acknowledged the statutory authority for obtaining a guarantor's §580a waiver under former CC §2856, found the bank's *Gradsky* waiver too narrow for the purpose, and suggested, in dictum, that public policy may not after all permit a guarantor to waive CCP §580a. *Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 46 CR2d 656). This case had been the first published decision to extend CCP §580a protections to a guarantor.

For further discussion of guaranty enforcement, see chap 9.

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