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Deficiency Judgments and California Law

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I. Introduction

When a distressed property owner is facing foreclosure or considering a short sale, whether or not

there will be a deficiency is a critical inquiry. What are the rights of the lender and the owner after a short sale or foreclosure? Can the lender go to court to obtain a judgment? And when does the owner not owe the lender anything at all? These questions are foremost in the mind of the distressed property owner.

This article discusses both deficiencies in general and deficiency judgments. A deficiency is simply the difference between the outstanding loan balance and the proceeds received by the lender (or the fair value of the property). A deficiency judgment is a court order for the same amount plus costs. To obtain a deficiency judgment, the lender must file a lawsuit against the borrower/owner and go through the judicial court process. Once having obtained a judgment for the deficiency, the lender can enforce the judgment through all the various collection procedures including liens on real property, seizures of bank accounts or garnishment of wages.

On a practical level, a lender may simply try to collect the deficiency through a collection agency without obtaining a judgment. However, if the borrower refuses to pay, the lender will be forced to go to court to get a judgment or just give up trying to collect.

This article seeks to provide a straight forward explanation of the rules governing deficiencies in foreclosures and short sales. For a discussion of the tax implications of a deficiencies, please see C.A.R. legal article, “Taxation for Foreclosures and Short Sales.” For more information on short sales and deficiency rules, please see C.A.R. legal articles “Short Sale Deficiencies” and “Short Sale Deficiencies Fact Sheet.”

II. The General Rules

The general rules governing deficiencies are as follows:

1. “One Action Rule”: “There can be but one form of action for recovery of any debt or the enforcement of any right secured by a mortgage upon real property.” (California Code Civil of Procedure (“CCP”) § 726(a)).
2. No deficiency judgment is allowed by the foreclosing lender following a non-judicial foreclosure (i.e., trustee's sale), regardless of the type of property foreclosed. (CCP § 580d), and as of January 1, 2014, no deficiency can be owed or collected.
3. No deficiency judgment is allowed when the type of loan is either (a) purchase money for an owner-occupied residential one-to-four unit dwelling (“owner-occupied purchase money”) or (b) seller financing (“seller carry-back”). (CCP § 580b(a)), and as of January 1, 2014, no deficiency can be owed or collected.
4. No deficiency judgment is allowed for a refinance of a purchase money loan for an owner-occupied residential one-to-four unit dwelling, made on or after January 1, 2013, except as to any cash-out portion of the refinance. (CCP § 580b(a)), and as of January 1, 2014, no deficiency can be owed or collected.
5. No deficiency shall be owed or collected, and no deficiency judgment rendered following a short sale on a residential one-to-four unit property. (CCP § 580e(a)).
6. A lender may not require the borrower as a condition to agreeing to a short sale to pay money other than from the proceeds of sale. (CCP § 580e(b)).

A. Breakdown of the Rules:

> **1.** "One Action Rule": "There can be but one form of action for recovery of any debt or the enforcement of any right secured by a mortgage upon real property." (CCP § 726(a).)

This is not exactly a rule that limits deficiencies. But it is nonetheless a primary protection against deficiency judgments and is critical to the whole system governing collection of secured debt.

When a borrower defaults, California law requires a lender with a secured interest in real property to take only one action whether it is to conduct a trustee's sale, sue for the balance of the debt, or judicially foreclose against the borrower. This is known as the "one form of action" rule or "one action rule." (CCP § 726(a)).

While this section appears to give a lender a choice of how to proceed to collect the debt, it has been interpreted to mean that a lender must pursue the secured real estate first ("security first rule"). (Walker v. Community Bank, 10 Cal. 3d 729 (1974).) In other words, suing on the note as the first collection method is not allowed (unless the lender is a sold-out junior, as discussed below).

> **2.** No deficiency judgment is allowed by the foreclosing lender following a non-judicial foreclosure (i.e., trustee's sale), regardless of the type of property foreclosed. (CCP § 580d), and as of January 1, 2014, no deficiency can be owed or collected.

There are two types of foreclosures in California: the first type is "judicial," in which a lender goes to court, gets an order to foreclose and then seeks to be awarded a judgment for the deficiency, if no waiver or prohibition applies. This process is considered "one action" so it does not violate CCP § 726(a). In addition to this complicated, expensive and slow judicial process, there is period of redemption following the judicial foreclosure for the borrower: three months if sales proceeds sufficiently satisfied indebtedness or one year if sales proceeds were insufficient. (CCP § 790.030). For all these reasons, judicial foreclosures are rare, and subsequent deficiency judgments following such foreclosures are as well.

The second is "non-judicial," meaning no court action is required. The property is sold by exercise of power of sale as written into a deed of trust. This is also referred to as a trustee's sale. Due to the lack of judicial involvement, this method is cheaper and faster than its judicial counterpart. Because CCP § 580b prohibits deficiency judgments for owner-occupied purchase money and seller carry-back loans, as discussed below in rule 3, foreclosing lenders are dis-incentivized to pursue judicial foreclosures in those cases. Due to this disincentive, cheaper cost and faster pace, trustee's sales constitute the vast majority of foreclosures in California. And when there is a trustee's sale, no deficiency judgment shall be rendered. (CCP § 580d).

The key to this rule is that it applies to a trustee's sale and doesn't depend on the type of loan or the type of property being foreclosed. For example, for a vacant land property with a refinanced senior loan, if a lender forecloses at a trustee's sale, then that lender will not be able to claim a deficiency judgment. It simply doesn't matter what kind of loan it was or what kind of property it is.

There are two things to keep in mind with this rule: first, it only applies to a foreclosing lender. If there are two loans on the property, and a second (i.e., junior) lienholder forecloses first, it is only that second lender which is affected by this rule.

Second, if a junior lender loses its security as a result of a senior lienholder foreclosing first, then any junior lienholder is considered as a "sold-out" junior. The sold-out junior has yet to exercise its one action against the borrower per CCP 726(a) but the security is gone. Only then is the sold-out junior allowed to collect on its now unsecured note by suing on the note (depending on the other deficiency judgment rules, especially the next one immediately below).

Finally, as of January 1, 2014, this law not only prohibits a lender from going to court to claim a deficiency judgment after a non-judicial foreclosure, but it even prohibits the lender from calling up the borrower/seller and trying to collect upon a deficiency. A lender who seeks to collect in such a situation will be in violation of this law (CCP §580d), and additionally, it would likely be a violation of the California and federal fair debt collection laws.

> **3.** No deficiency judgment is allowed when the type of loan is either (a) purchase money for an owner-occupied residential one-to-four unit dwelling ("owner-occupied purchase money") or (b) seller financing ("seller carry-back"). (CCP § 580b(a)), and as of January 1, 2014, no deficiency can be owed or collected.

These two rules prohibit deficiency judgments based on the character of the loan at the time it is made. A loan made for the purchase of residential property containing one-to-four units, one of which the borrower intends to occupy, and which loan is secured by that same property, is called an owner-occupied purchased money loan. For such loans, the lender may only pursue the security, and will not be allowed a deficiency after either a trustee's sale or a judicial foreclosure.

Additionally, a seller who financed by carrying back a loan as part of the purchase price of the real property (i.e., seller carry-back) is prohibited from obtaining a deficiency judgment against a defaulting borrower. Keep in mind that the seller carry-back rule applies to any type of property (e.g., owner-occupied residential one-to-four, investment, or commercial), while the owner-occupied purchase money rule applies only to residential one-to-four unit property that is occupied by an owner.

These rules apply no matter what type of foreclosure it is or how the loan was positioned. If a senior lienholder forecloses, and as a result a junior lien is wiped out, then the junior lienholder cannot collect on the debt by pursuing the borrower personally if that second loan is either an owner-occupied purchase money or seller carry-back. (Brown v. Jensen (1953) 41 C2d 193,259,P2d, 425.)

The rule has also been interpreted to include not just sellers but also previous lenders who allow their liens to be assumed in order to effectuate a sale. (Costanzo v. Ganguly, 12 Cal. App. 4th 1085 (1993).) Thus, even these prior lenders are prevented from obtaining a deficiency judgment.

As of January 1, 2014, this law not only prohibits a lender from going to court to claim a deficiency judgment after a non-judicial foreclosure , but it even prohibits the lender from calling up the borrower/seller and trying to collect upon a deficiency. A lender who seeks to collect in such a situation will violate this law (CCP § 580b), and additionally, it would likely be a violation of the California and federal fair debt collection laws.

> **4**. No deficiency judgment is allowed for a refinance of a purchase money loan for an owner-occupied residential one-to-four unit dwelling, made on or after January 1, 2013, except as to

any cash-out portion of the refinance. CCP§580b(c), and as of January 1, 2014, no deficiency can be owed or collected.

This rule is an extension of the protection afforded purchase money loans to the refinancing of those same purchase money loans, but it only applies to refinanced loans made on or after January 1, 2013, and not to any cash-out. As explained above, rule three grants anti-deficiency protection to purchase money loans made for owner occupied residential 1-4 properties. Rule number four extends this same protection by applying it to any refinance of such a loan as long as the refinance was applied to the obligations owed under the original purchase money loan or to any fees, costs or related expenses of the refinance.

There are however two circumstances where the refinance will not receive anti-deficiency protection. 1) The refinance must be made on or after January 1, 2013. Any earlier refinance may still be subject to deficiency claims. 2) And the refinance must be used to pay off obligations owed under the original loan. Any cash-out portion of the loan (or as the law states “new principal”) may not receive protection from deficiency claims.

Just as in rule number three, the anti-deficiency protections for refinanced loans apply whether or not a judicial or non-judicial foreclosure is used; whether or not the refinanced loan is in senior or junior position; or whether or not the refinancing lender is the foreclosing lienholder or is a wiped out junior.

As of January 1, 2014, this law not only prohibits a lender from going to court to claim a deficiency judgment after a after a non-judicial foreclosure, but it even prohibits the lender from calling up the borrower/seller and trying to collect upon a deficiency. Should a lender seek to collect in such a situation it would violate this law (CCP §580b), and additionally, it would likely be a violation of the California and federal fair debt collection laws.

5. No deficiency shall be owed or collected, and no deficiency judgment rendered following a short sale on a residential-one to-four unit property. (CCP § 580e(a)).

These new rules came into effect on July 15, 2011 under CCP § 580e. Simply stated, this law prohibits a lender who holds a deed of trust on real property from either claiming a deficiency, attempting to collect a deficiency, or seeking a deficiency judgment from a borrower/seller after having agreed to a short sale. The law applies broadly to deeds of trust on residential one-to-four unit properties.

The type of loan is irrelevant. It doesn’t matter if the loan is made to purchase a property for the owner’s occupancy (i.e., owner-occupied purchase money); to refinance an existing loan to make home improvements; or to pull equity out of a real estate asset (i.e., home equity line of credit) in order to buy goods, pay off debts or make investments.

The type of use of the property is irrelevant. It doesn’t matter if the property is occupied by its owner or a tenant. The property can be purchased for an investment or as a flip.

The lender’s position in priority of title is also irrelevant. This law applies to a senior lienholder as well as to any junior lienholder.

However, the type of owner is relevant. This law does not protect an owner/borrower which is an LLC, corporation, partnership or political subdivision of California.

Finally, this law not only prohibits a lender from going to court to claim a deficiency judgment after a short sale, but it even prohibits the lender from calling up the borrower/seller and trying to collect upon a deficiency. Should a lender seek to collect in such a situation, it would additionally be a violation of the California Fair Debt Collection Practices Act (Civil Code § 1788).

6. A lender may not require a borrower/seller as a condition to agreeing to a short sale to pay money other than from the proceeds of sale. (CCP § 580e(b).)

This final rule is part of the above mentioned new law CCP § 580e. Along with the rules prohibiting deficiencies and deficiency judgment on short sales, this law also prohibits collection of additional money from the borrower/seller during the short sale process. The lender is prohibited from requiring the borrower/seller to pay any additional compensation apart from the proceeds of sale as a condition of granting the short sale approval. See §III F below.

B. What it means when a deficiency is not owed or cannot be collected

The anti-deficiency rules generally bar a lender from going to court to obtain a judgment for the amount of the deficiency, without technically, extinguishing the debt. However as of January 1, 2014, many of these rules will additionally bar the lender from attempting collection on such a debt or even claiming that it is owed.

The reason for this additional rule is that without it, a lender (or a debt collector for the lender) still has the right to demand payment from the borrower after a foreclosure even though that lender may be barred from obtaining a deficiency judgment in court (Herrera v. LCS Financial Services, Corporation (2009 WL 2912517)), In other words, just barring the lender from going to court to claim a deficiency judgment doesn't extinguish the debt. Therefore the lender might be able to harass the borrower for payment; offset the amount of the deficiency against a debt owed by the lender to the borrower; or recover the deficiency when the borrower is subject to bankruptcy.

However, a lender that attempts to collect on a debt that has been barred under the anti-deficiency laws after January 1, 2014 (as described above) will be in violation of those anti-deficiency laws and will also likely be breaking both federal and state laws regarding fair debt collection practices. Moreover, the lender will have no right to claim money from a bankruptcy estate or to offset the borrower's debt from any money owed to the borrower.

A more nuanced question arises concerning the retroactivity of these rules. If the loan was made before January 1, 2014, but a foreclosure is conducted after that date, is the lienholder or sold-out junior barred from collecting upon the debt or even claiming that it is owed? Previously, judges have ruled that where property was foreclosed upon by power of sale after the effective date of the law but the note itself was signed prior to the law, that the law had no effect to bar a claim for deficiency (In re Farley's Estate (1944) 63 Cal.App.2d 130). In other words, the law cannot be applied retroactively to obligations entered into before the law took effect even though the foreclosure sale itself took place after the law came into effect. So it's possible that the same reasoning will be applied to the new rule barring attempts at collection. (See 4 Miller & Starr, Cal. Real Estate (3d ed.

2012), §10:236) But as with many things in law, a definitive answer may have to wait until a judge decides the issue in court.

C. Calculating the Deficiency Judgment

Due to limitations placed by CCP § 580d, deficiency judgments, with limited exceptions such as sold-out juniors, are only permitted following judicial foreclosures. Even on the rare occasion a deficiency judgment is rendered, there are limitations on the amount of a deficiency following a judicial foreclosure. The amount of the deficiency judgment allowed is the lesser of:

- The amount by which the debt exceeds the fair value of the property at the time of the foreclosure sale; or
- The amount by which the debt exceeds the sales price of the property at the foreclosure sale. (CCP § 726(b)).

For example, if a lender was owed $300,000 at the time of the foreclosure sale and a successful bidder at that sale paid $225,000, but the property's fair value was $250,000, then the maximum deficiency judgment allowed would be only $50,000. This is the case because the difference between the debt and the fair value ($300,000 - $250,000 = $50,000) is smaller than the difference between the debt and the sales price ($300,000 $225,000 = $75,000).

In order to obtain a deficiency judgment, a lender must apply to the court for a deficiency judgment within three months of the judicial foreclosure sale. (CCP § 726(b).)

A full credit bid at foreclosure is a bid made by the foreclosing lienholder, equaling the amount of the unpaid debt including principal and interest, as well as all costs and fees related to the foreclosure. Such a bid is considered full satisfaction of the indebtedness leaving no amount for a deficiency. (California Mortgages and Deeds of Trust, and Foreclosure Litigation, 4th ed., Roger Bernhardt, § 2.84, p. 123.)

III. Exceptions to the General Rules

Of course in law, as in life, there are always exceptions to the general rules and such is the case with the law of deficiency judgments.

A. Fraud

In spite of the anti-deficiency rules, a lender is permitted to sue a borrower for damages if the borrower fraudulently induced the lender into making a loan in the first place. This is true whether the foreclosure sale is judicial or non-judicial and whether or not the loan is purchase money. CCP §726 even allows for the collection by the lender of punitive damages up to 50 percent of actual damages.

In fact, a lender, induced by the fraud of a borrower to make a loan, may recover in tort for the fraud, even if the lender made a full credit bid at the foreclosure (and theoretically was satisfied to the full deficiency), if the fraud was proximately the cause of any cognizable loss. (California Mortgages and Deeds of Trust Practice, supra, §§2.121-126, pp. 152-155).

However, if the loan is secured by a single family owner-occupied, residential property in an amount not exceeding $150,000, annually adjusted, then this exemption does not apply. (CCP §§ 726(f)-(h)). In any event, whether or not there is fraud, CCP § 726(a) still requires a lender to pursue the security first before suing on the underlying note or debt.

B. Bad Faith Waste

Waste can be defined as the failure of the borrower to maintain the property. While the general anti-deficiency rules apply if the borrower has allowed a waste to occur, California courts have allowed actions for a deficiency judgment in the event the borrower has committed "bad faith waste." (Cornelison v. Kornbluth, 15 Cal. 3d 590 (1975).) This is true whether the foreclosure sale is judicial or non-judicial and whether or not the loan is purchase money.

Bad faith waste is an injury to the property by the action or inaction of the person in possession which is reckless, intentional, or malicious. Only the damage resulting from bad faith waste, as opposed to decline due to market conditions or ordinary waste, is recoverable. This recovery is a tort action and not a deficiency judgment and may be brought before or after a foreclosure. (California Real Estate 3rd, Miller & Starr, § 10:217, pp.720-722).

C. Non-Standard Transactions

CCP § 580b prohibits deficiency judgments only in standard (i.e., purchase money) transactions. (Roseleaf Corp. v. Chierighino, 59 Cal. 2d 35 (1963); California Mortgages and Deeds of Trust, supra, § 5.29, pp. 362-364; California Real Estate 3rd, supra, § 10:236, pp. 779-783.) For example, a seller who carries back a loan secured by a first deed of trust would be subject to CCP § 580b. The same would be true of a seller who carries back a loan secured by a second deed of trust when the senior lien secures a conventional loan. However, the courts have held that a seller of vacant land who subordinates a seller carry-back loan to a commercial construction loan is not barred from obtaining a deficiency judgment following a judicial foreclosure. (Spangler v. Memel, 7 Cal. 3d 603 (1972).)

One court has held that a construction lender supplying funds for construction of a borrower's personal residence (a situation we may think of as both non-standard and thus non-purchase money) was barred by CCP § 580b from obtaining a deficiency judgment. (Prunty v. Bank of America, 37 Cal. App. 3d. 430 (1974).)

Yet, another court has held a borrower who takes out a construction loan for improvements or repairs, but not to finance the construction of a personal residence, is subject to a deficiency judgment. (Allstate Sav. & Loan Ass'n v. Murphy, 98 Cal. App. 3d 761 (1979).) It is not always easy to determine whether a loan is a standard transaction subject to the owner-occupied purchase money and seller carry-back restrictions on deficiency judgment or a non-standard transaction in which a deficiency judgment may be obtained.

D. Sold-Out Junior Lienholders and Legally Worthless Security

The security first rule does not prohibit a lender from suing directly on the debt when the security is legally worthless. This will typically be in the circumstance where a junior lienholder loses the

secured interest after the first forecloses, i.e., the junior lienholder is “sold-out.”

However, the sold-out junior lienholder is unable to take advantage of this exception if the junior lien secures a standard purchase money loan (Brown v. Jensen, 41 Cal. 2d 193 (1953).); seller carry-back; or a refinance of a purchase money loan made after January 1, 2013.

Legally worthless is to be distinguished from economically worthless. For example, let's say a buyer borrows $800,000 from a lender secured by a first trust deed in order to purchase a $1,000,000 property. Subsequently, the same person borrows an additional $200,000 secured by a second trust deed. The junior lienholder appraised the property at that time at $1,250,000. If market conditions change and the property drops in value to $800,000, and the borrower stops making payments on this second loan, the junior lienholder must foreclosure rather than sue on the debt. While the junior security has no economic value, it is still legally valuable. On the other hand, if in our example, a senior lienholder foreclosed, resulting in the property being conveyed free and clear of the junior lien, then the junior security, in and of itself, has no value. In that situation, the junior lienholder can sue the borrower directly on the note as a “sold-out” lienholder. (Roseleaf, supra, p. 36).

Additionally, the worthless security exception does not apply if the lender itself has taken some action to make the security worthless. A court has held that a lender which had both a first and a third deed of trust on a property could not pursue the borrower directly on the debt secured by the third trust deed if the lender had caused the third lien to be relinquished by foreclosing on its own first trust deed. (Simon v. Superior Court (Bank of America), 4 Cal. App. 4th 63 (1992).) The two liens are merged and under the one action rule, the lienholder is prohibited from taking a second action against the borrower. (California Mortgages and Deeds of Trust, supra, § 4.44, p. 315-316).

E. Environmentally Impaired Properties

For loans, extensions of credit, guaranties or other obligations secured by real property made, renewed or modified between January 1, 1992 and December 31, 1999, a lender may elect to waive its security and pursue its rights as an unsecured creditor, notwithstanding CCP § 726, if the secured real property is environmentally impaired. (California Mortgages and Deeds of Trust, supra, § 5.60, p. 388).

A lender does not have this option, however, if the security is a unit in a residential common interest development or residential property containing 15 or fewer units. A lender also does not have this right if the environmental hazard was not knowingly or negligently created, caused, or contributed to by the borrower or any related entity and, at the time of the secured obligation either the borrower was unaware of any environmental hazard or, if aware, disclosed such information to the lender. (CCP § 726.5).

F. Exceptions to Short Sale Deficiency Rules

As previously stated, CCP §580e now prohibits deficiency and deficiency judgments following a short sale of residential one-to-four unit property. To qualify for this protection a number of requirements must be satisfied. For a borrower to be eligible for the short sale anti-deficiency protection all of the following must be met under CCP § 580e(a):

- Mortgage loan is solely secured by a deed of trust or mortgage;
- Mortgage loan is for a dwelling of not more than four units;
- Borrower sells the property for less than the outstanding loan balance;
- Lender provides written consent for the short sale;
- Title voluntarily transfers to a buyer by grant deed or other document of conveyance recorded in the county where the property is located; and
- Proceeds of the sale have been tendered to the lender or lender's agent in accordance with the parties' agreement.

Additionally, once these requirements have been met, there may be an exception any one of which will impair or defeat the anti-deficiency protection. CCP §§ 580e(a)(2), (c), and (d) list the exceptions:

- Fraud
- Waste to the real property;
- Cross-collateralized loans;
- Borrower is a corporation, limited liability company, or limited partnership;
- Borrower is a political subdivision of the state;
- Deed of trust, mortgage, or other lien securing the payment of a bond or other evidence of indebtedness authorized by the Commissioner of Corporations; and
- Deed of trust, mortgage, or other lien made by a public utility subject to the Public Utilities Act.

For more information on the new short sale anti-deficiency law, please see C.A.R. legal articles "Short Sale Deficiencies" and "Short Sale Deficiencies Fact Sheet."

G. FHA and VA Loans

If a loan is insured or guaranteed by the Federal Housing Administration (FHA) or the Veteran's Administration (VA), there may be personal liability after foreclosure regardless of the anti-deficiency protections. Federal law governing FHA and VA loans may override California's anti-deficiency rules. (Herlong-Sierra Homes, Inc. v. U.S. 358 F. 2d 300(9th Cir. 1966); U.S. v. Ross; 342 F. 2d 505 (9th Cir. 1965)).

IV. Waiver of Anti-deficiency Protection

The anti-deficiency protections cannot be waived by a borrower contemporaneous with or upon renewal of a secured loan. (California Civil Code ("CC") § 2953; Freedland v. Greco, 45 Cal. 2d 462 (1995).) However, anti-deficiency protections can be waived subsequent to the loan being made if the waiver accompanies some event other than a renewal. For example, a waiver in connection with an extension of a loan or some other consideration or concession by the lender can be valid. (California Mortgages and Deeds of Trust, supra, § 4.64, p. 333; California Real Estate 3rd, supra, § 10:237 pp. 783-787).

Each of the anti-deficiency protections must be waived separately. For example, a waiver of the purchase money protection (CCP § 580b) will not have an effect on the protections afforded the borrower after a trustee's sale has been conducted (CCP § 580d).

V. Third Parties

A. Guarantors

In certain situations a lender can look to others besides principal borrower for compensation for the loss suffered by the lender. One of these situations is where the note has been guaranteed by a third party.

1. Trustee's Sales/Non-judicial Foreclosures

One-action and anti-deficiency rules do not provide direct protection against deficiency judgment for a guarantor of an obligation secured by a principal borrower's real property as it does for the principal borrower (unless the guaranty itself is secured by the guarantor's real property). (California Mortgages and Deeds of Trust, supra, § 9:88Z, pp. 819-820). Additionally, the new rules limiting a lender from attempting to collect upon a deficiency after foreclosure or even claiming that a debt is still owed, explicitly do not apply to sureties or guarantors.

However, such guarantor may have an indirect deficiency judgment protection in the form of an estoppel defense against a lender who non-judicially forecloses (i.e., trustee's sale) against a secured property and then seeks a deficiency judgment against the third party guarantor. (Union Bank v. Gradsky, 265 Cal. App. 2d 40 (1968).)

There are broad limitations on this Gradsky rule. First, CC § 2856 permits a guarantor to waive protections under the one-action and anti-deficiency rules. (CC § 2856(a)-(c).) This law also authorizes the waiver of Gradsky's estoppel defense. (CC §2856(a)(2); Mortgage and Deed of Trust Practice 4th, supra, § 9:89M, p. 826.6.) Thus, the guarantor can give up the right to have the lienholder foreclose on the security first before demanding payment by the guarantor. Second, the Gradsky rule doesn't extend to situations when the lender pursued lawful actions for damages against guarantor before foreclosure (Krueger v. Bank of America, 145 Cal. App. 3d 204 (1983).) Once the guarantor pays, the guarantor is subrogated to the security, if any is left, held by the lender and may use it against the principal borrower subject to any defenses the borrower would have against the lender. (California Mortgages and Deeds of Trust, supra, §§ 9.89F- 9.89G, pp. 825-826.1; California Real Estate 3rd, supra, § 10:265, p. 854).

CCP 2856(e) contains an exemption to the broad waiver rules, specifically excluding waiver of anti-deficiency and one-action rules protections in purchase money loans.

2. Judicial Foreclosures

A lender who judicially forecloses against a principal borrower retains a cause of action against the guarantor for any deficiency. It is unclear however, whether the guarantor's liability is limited by the fair value rule of CCP § 726. (California Real Estate 3rd, supra, § 10:269, pp. 869-875).

B. Fraud by Third Party (Appraisers, Mortgage Brokers, Real Estate Agents)

A lender may look to others aside from the borrower and any guarantor when a loss cannot be recovered from the secured property.

In Barry v. Raskov, the court held that a mortgage loan broker is liable to a lender for the fraud or negligence of an independent appraiser it hired to appraise the secured property. (Barry v. Raskov, 232 Cal. App. 3d 447 (1991).)

A lender induced by the fraud of a third party to make a loan may recover in tort for the fraud against such third party, even if the lender made a full credit bid at the non-judicial foreclosure. (Alliance Mortgage Co. v. Rothwell, 10 Cal. 4th 1226, 1226 (1995)). In Alliance, the California Supreme Court held that a mortgage broker, appraiser, title company and other defendants can be held liable for damages suffered by a lender when the defendants conspired to fraudulently induce the lender to issue mortgages for real properties in amounts over fair market value to fictitious borrowers. Damages are measured by statutory measure 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 or the fraud is in the sale of real estate. (Alliance, supra, at 1249). Under Alliance, a lender may recover in damages the difference between the bid and the property value only if the third party defendant's fraud proximately cased the lender to make a full credit bid and thus pay too much for the property purchased at foreclosure. (California Mortgages and Deeds of Trust, supra, §2.126, p. 155).

C. Broker's Commission

A broker who takes a commission in the form of a note secured by the property to be purchased is treated as a lender but not a vendor for purposes of CCP § 580b. (Kistler v. Vasi, 71 Cal. 2d 261 (1969).) Thus, a broker who takes a commission in the form of a note secured by commercial property is not precluded from obtaining a deficiency judgment following a judicial foreclosure sale.

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