

# CALIFORNIA'S ANTI-DEFICIENCY LAW

## Pertaining To Short Sales, Summary Of California Code Of Civil Procedure §580e

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### INTRODUCTION

On January 1, 2011, California Code of Civil Procedure §580e was enacted as an

addition to existing Anti-Deficiency laws, protecting borrowers from deficiencies that occur as a result of short sales of certain types of real property. Section 580e was later amended on July 15, 2011 as an "urgency statute" to take immediate effect and to expand the anti-deficiency protections for owners of distressed residential real properties.

### APPLICABILITY TO SUBORDINATE LOANS

The first major change to the statute as

amended is an expansion of coverage to include "all loans on a home, not simply the first note." The current language has been changed from covering a "first deed of trust or first mortgage" to a note "secured solely by a deed of trust or mortgage." Under the original statute, borrowers were protected vis-à-vis their first mortgages but were exposed to liability for second or subsequent mortgages or HELOCs. The comments to the legislative history clearly indicate that the statute will apply to

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"all loans on a home," not just a first mortgage

**WAIVER**

The original language of §580e left open the question of the validity of any purported waiver. If left unaddressed, lenders would undoubtedly include a waiver in the contractual language of their mortgage agreements. The legislature closed that door with authority when it amended the current version of §580e to include the verbiage that "[a]ny purported waiver" of §580e is void, whether in advance of, or subsequent to, origination of the loan.

**PROPERTY TYPE AND LOAN SIZE**

In the vast majority of cases §580e will apply only to residential real property of four units or less. However, a commercial loan made to a borrower who is an individual or a trust, if that loan is secured by a dwelling of 1-4 units itself or as part of the collateral package, appears to be subject to §580e if the lender should agree to a short sale. While there is no statutory language indicating that a second home or rental property would or

would not be covered by §580e, the legislative comments evince a desire to promote short sales of properties beyond just the primary residence.

The statutory language states that no deficiency judgment shall be requested or rendered for "any deficiency upon a note." Use of the word "any" clearly means all loan sizes as the legislature could have limited loan amounts by dollar amount or by making the statute applicable only to conforming loans. Moreover, an interpretation that the benefits the legislature sought to bestow upon borrowers, lenders, and the community should exclude those who live in more expensive homes (with larger loan amounts) is untenable.

**EFFECT OF SHORT SALE**

With the addition of 580e, the effect of a short sale consented to by the lender is effectively, the same as if there was a non-judicial foreclosure. Under 580d, there is no right to a deficiency after a non-judicial foreclosure. Similarly, now under 580e, no deficiency shall lie against the borrower after a short sale that was consented to by the lender. However, in cases in which the loan is cross-collateralized with other properties, a lender may not be precluded from pursuing the other collateral.

Further, 580e will also not absolve guarantors from liability for the shortfall. Assuming the lender has a valid guaranty from someone other than the borrower and it contains the appropriate waivers contained in Civil Code section 2856, the lender should be allowed to pursue the guarantor for the shortfall. In other words, 580e is intended to protect borrowers but not guarantors or other collateral pledged by the borrower.

**CONCLUSION**

Under the current version of §580e, property owners benefit from encouraging short sales due to lesser negative impact on their credit compared to a foreclosure; financial institutions benefit from promoting short sales because they do not incur the costs associated with selling the property if it goes back to them after foreclosure; and the surrounding community benefits by having an actual person buy the property as opposed to being sold at foreclosure and remaining vacant for months as the financial institution attempts to sell the property.



- L-shaped Risk Retention: The sponsor retains an equal combination of vertical and horizontal risk retention.

A range of optional risk retention structures would provide some flexibility for sponsors and other market participants. Critics contend that risk retention requires the use of sponsor and originator balance sheet resources rendering certain transactions economically unfeasible, causing the costs of borrowing to increase and access to capital to decrease.

**RETAINED RISK MUST BE RETAINED**

The proposed rules generally prohibit the sponsor from transferring, selling, hedging or financing the retained risk. Commentators have suggested that the risk retention hold period should be limited, such as to three years, with the ability to sell, transfer or hedge the risk thereafter.

**ALLOCATION OF RISK TO ORIGINATORS**

Sponsors may allocate a pro-rata share of the retained risk to an originator that contributes at least 20 percent of the mortgage assets to the securitized pool. The term "originator" refers to the person that "creates a financial asset that collateralizes an asset-backed security" and does not refer to a subsequent purchaser or transferee of such loan. The originator is subject to the same hedging and other limitations applicable to the sponsor's portion of the retained risk.

There may be unintended consequences of this proposal. Will sponsors have an incentive to accept loans from originators to whom they can shift a portion of the retained risk? Will originators unable to contribute the requisite 20 percent be turned away from a securitization?

**ALLOCATION OF RISK TO B-PIECE BUYER**

Recognizing the customary risk management role played by so-called "B-piece buyers," the proposed rules provide that the sponsor's risk retention requirement may be satisfied by a third-party purchaser of the five percent horizontal first loss interest in the securitization, that is, the "B-piece." Under the proposed rules, the B-piece buyer must pay in cash, perform due diligence on each asset in the pool before issuance, be unaffiliated with other parties to the securitization transaction, and comply

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with the hedging prohibition and other limitations.

The proposed rules also aim to motivate the B-piece buyer to be diligent in assessing credit quality before securitization without relying on an ability to offset the consequences of poor underwriting through servicing actions. Thus, the proposed rules provide that the B-piece buyer may not acquire any rights as a controlling class in the securitization, including acting as special servicer. Under a proposed exception, the B-piece buyer may have control rights over special servicing where the servicing is supervised by an independent "Operating Advisor" that is required to act in the best interests of the investors as a whole.<sup>2</sup>

Many in the industry are concerned that these proposals will severely restrict the B-piece market. The proposed restrictions, including the prohibition on financing, may limit the number of B-piece buyers. B-piece buyers may demand higher yields as compensation for increased demands and reduced control. It is unclear whether an Operating Advisor can improve servicing or whether the investors even want such a control party. Many commentators would seek limits on the Operating Advisor's role and instead favor increased transparency, increased disclosure by B-piece buyers, and other means to address conflicts of interest in special servicing.

### PREMIUM CAPTURE RESERVE ACCOUNT

Regulators believe that the sale of premium or interest-only tranches promotes riskier loans and allows sponsors to cash out upon securitization the excess spread expected to be generated by the mortgage assets over time. The proposed rules

capture the entire purchase price of any excess spread and hold it in a reserve account to cover losses before losses are allocated to any bond class. The premium capture applies over and above the required five percent risk retention.

Critics have declared that the premium capture reserve will severely damage the CMBS market. The premium capture reserve acts as a penalty that removes transaction profit and limits expense recovery, and penalizes the sponsor and originators for making profitable loans that generate a premium. Many commentators have proposed alternative means to enhance the effectiveness of risk retention and risk mitigation and would eliminate the premium capture requirement altogether.

### EXEMPTION FOR QUALIFYING CRE LOANS

The proposed rules include a limited exemption for issuances collateralized exclusively by qualifying CRE loans.<sup>3</sup> A qualifying CRE loan has the following characteristics:

- A fixed rate loan, or a floating rate with an interest rate swap
- A 65 percent LTV
- A 10-year term and 20-year amortization
- A DSCR of 1.7:1.0 or greater (or 1.5:1.0 or greater for properties with demonstrated history of stable NOI)
- Demonstrated borrower ability to pay, including a two-year lookback

The standards for qualifying CRE loans are so stringent that many commercial mortgage loans would fail to qualify for the exemption. Well-crafted underwriting standards may be more effective

than rigid guidelines in identifying low risk commercial mortgage loans for securitization.

The final credit risk retention rules will define the next phase of commercial mortgage loan securitization. The regulators have two years to issue the final rules



1. Under the proposed rules, the defined term "sponsor" has a similar meaning to the term "securitizer" used in the Dodd-Frank Wall Street Reform and Consumer Protection Act referring to "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." "Issuer" refers to the entity that issues the asset-backed securities.
2. An "Operating Advisor" is defined as "a party that (i) is not affiliated with any other party to the securitization, (ii) does not directly or indirectly have any financial interest in the securitization other than in fees from its role as Operating Advisor, and (iii) is required to act in the best interest of, and for the benefit of, investors as a collective whole
3. The proposed rules defined a "CRE loan" as "a loan secured by a property with five or more single-family units, or by nonfarm non-residential real property, the primary source (50 percent or more) of repayment for which is expected to be derived from: (a) the proceeds of the sale, refinancing, or permanent financing of the property; or (b) rental income as associated with the property other than rental income that is derived from an affiliate of the borrower." This definition does not include a land development or construction loan.