

Golden Gate University Law Review

Volume 12

Issue 1 *Ninth Circuit Survey*

Article 12

January 1982

Real Property

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Recommended Citation

Scott Benjamin, *Real Property*, 12 Golden Gate U. L. Rev. (1982).
<http://digitalcommons.law.ggu.edu/ggulrev/vol12/iss1/12>

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REAL PROPERTY

I. CALIFORNIA FAIR VALUE LIMITATIONS APPLIED TO NON-FORECLOSING JUNIOR LIENHOLDER

A. INTRODUCTION

In *Bank of Hemet v. United States*,¹ the Ninth Circuit reevaluated a California Supreme Court decision² rendered nearly two decades ago concerning the applicability of anti-deficiency legislation to holders of second deeds of trust. The court held that California law limits a junior lienholder's recovery from a defaulting debtor to the equivalent of no more than the total amount of the junior debt, rejecting the reasoning of that earlier decision which would allow a junior who has lost his security through the senior lienholder's foreclosure sale to obtain a windfall recovery. Both the reasoning and result of *Bank of Hemet* reveal the Ninth Circuit's superior understanding of the purpose of California's debtor protection laws and provide guidance long lacking on this troublesome issue.

B. FACTS

Plaintiff Bank of Hemet held a non-purchase-money second deed of trust on residential property to secure a \$47,854 debt. The first deed of trust on the property secured an indebtedness of \$33,135 to a third party. Tax liens junior to both deeds of trust had also been placed on the property in the amount of \$35,798.³ The senior lienholder foreclosed and held a private sale⁴ at which the plaintiff purchased the property for \$33,137,

1. 643 F.2d 661 (9th Cir. 1981) (per Sneed, J.; the other panel members were Skopil, J., and Gibson, J., Senior Judge for the United States Court of Appeal for the 8th Circuit, sitting by designation).

2. *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

3. 643 F.2d at 663.

4. A private foreclosure sale may be held, at the creditor's election, pursuant to a power-of-sale clause in a mortgage or deed of trust. *Fogarty v. Sawyer*, 17 Cal. 589 (1861); *Huene v. Cribb*, 9 Cal. App. 141, 98 P. 78 (1908); cf. *Garfinkle v. Superior Court*, 21 Cal. 3d 268, 578 P.2d 925, 146 Cal. Rptr. 208 (1978) (private sales not violative of due process because state action lacking). For the creditor, the principal advantages of a pri-

two dollars more than the amount of the senior lien.⁵ Four months later, the government redeemed the property from the plaintiff for the same amount, plus interest, pursuant to its interpretation of the applicable federal redemption statutes.⁶ It then resold the property shortly thereafter for \$55,000.⁷

The Bank sued, contesting, *inter alia*, the adequacy of the amount tendered by the government. After the district court granted the government's motion for summary judgment, the Bank appealed. The Ninth Circuit held that, in the case of a redemption from a junior lienholder who purchases at the senior's sale, the redemption price paid by the government depends upon the right of the junior lienholder under state law to obtain a judgment for any deficiency between the price paid at the foreclosure sale and the total amount of the indebtedness secured by the liens of the senior and purchasing junior lienholders. While under California's anti-deficiency laws a purchasing junior lienholder would not be precluded from seeking a deficiency judgment, the court determined that the amount of that deficiency would be limited to the difference between the total outstanding indebtedness and the fair market value of the property.⁸ In reaching this conclusion, the Ninth Circuit arguably misinterpreted California law and incorrectly

vate sale over judicial foreclosure are speed, economy and the absence of any right of redemption which might impair the purchaser's title and therefore force down bidding at the sale. R. BERNHARDT, CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE § 6.3 (1979). A private sale also works to the creditor's disadvantage, in that generally, it bars any recourse against the debtor if the proceeds from the sale fail to satisfy the debt. CAL. CIV. PROC. CODE § 580d (West 1976). For text of § 580d, see note 11 *infra*.

5. 643 F.2d at 663.

6. 26 U.S.C. § 7425 (1976); 28 U.S.C. § 2410(d) (1976). Section 7425 gives the government the right to redeem from the sale of any real property upon which the United States has a claim or lien. The amount to be paid to effect such a redemption is prescribed by § 2410(d) as: "[T]he actual amount paid by the purchaser at such sale (which, in the case of a purchaser who is the holder of the lien being foreclosed, shall include the amount of the obligation secured by such lien to the extent satisfied by reason of such sale)" plus interest and expenses. Section 2410(d) is interpreted by the Internal Revenue Service thus:

In the case of a purchaser who is the holder of the lien being foreclosed, the actual amount paid is the sum of (A) the amount of the obligation secured by such lien to the extent legally satisfied by reason of the sale and (B) any additional amount bid and paid at the sale.

Treas. Reg. § 301.7425-4(b)(2)(ii) (1976).

7. 643 F.2d at 663.

8. *Id.* at 669.

anticipated future resolution of the issue in the state courts.

C. CALIFORNIA'S DEBTOR PROTECTION LAWS

California Code of Civil Procedure section 580a was one of several provisions enacted in California during the Depression to limit the ability of a deed of trust beneficiary to obtain a personal judgment against the debtor for the amount of the debt not satisfied from the sale of the security.⁹ Deficiency judgments are made possible in the first instance by the "one-action rule," which requires a beneficiary to first attempt to recover the debt through foreclosure and sale before proceeding against the trustor's personal estate.¹⁰ Generally, if the security is sold at a non-redeemable private sale, section 580d bars a deficiency judgment against the debtor.¹¹ Section 580d is intended to prevent a

9. CAL. CIV. PROC. CODE § 580a (West 1976). Section 580a provides in relevant part:

Whenever a money judgment is sought for the balance due upon an obligation for the payment of which a deed of trust or mortgage with power of sale upon real property or any interest therein was given as security, following the exercise of the power of sale in such deed of trust or mortgage, the plaintiff shall set forth in his complaint the entire amount of the indebtedness which was secured by said deed of trust or mortgage at the time of sale, the amount for which such real property or interest therein was sold and the fair market value thereof at the date of sale Before rendering any judgment the court shall find the fair market value of the real property, or interest therein sold, at the time of sale. The court may render judgment for not more than the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value of the real property or interest therein sold at the time of sale with interest thereon from the date of sale; provided, however, that in no event shall the amount of said judgment, exclusive of interest after the date of sale, exceed the difference between the amount for which the property was sold and the entire amount of the indebtedness secured by said deed of trust or mortgage. . . .

10. CAL. CIV. PROC. CODE § 726 (West 1976). Although § 726 provides simply that "[t]here can be but one form of action for the recovery of any debt, or the enforcement of any right secured by mortgage upon real property," this language has long been read not only to limit the creditor to "one bite of the apple," but also to require him to look to the security first. *E.g.*, *Porter v. Mueller*, 65 Cal. 512, 4 P. 531 (1884); *Winkleman v. Sides*, 31 Cal. App. 2d 387, 88 P.2d 147 (1939).

11. CAL. CIV. PROC. CODE § 580d (West 1976). Section 580d provides in relevant part:

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

double recovery against the debtor which the beneficiary might otherwise obtain by underbidding¹² at the sale, reselling the property for an amount sufficient to cover the debt, and then suing for a deficiency. It is meant to deter underbidding parallel to the possibility of redemption after a judicial sale.¹³

Identifying this purpose in *Roseleaf Corp. v. Chierighino*,¹⁴ the California Supreme Court refused to extend section 580d to bar a deficiency judgment by a junior lienholder whose security has been lost by reason of the senior lienholder's private sale. To do so would work an inequity against the junior, whose rights both to seek a deficiency judgment and to redeem from the sale would be denied simply because the senior has chosen a non-judicial foreclosure. This would defeat the legislative purpose behind section 580d of achieving a parity of creditors' remedies in judicial and non-judicial foreclosure procedures.¹⁵

The *Roseleaf* court also held that section 580a did not apply in the case of a sold-out junior lienholder. Section 580a provides that any deficiency judgment following a non-judicial sale be restricted at least to the amount by which the indebtedness exceeds the fair market value of the security.¹⁶ Since a senior lienholder is in any case denied a deficiency after a private sale by virtue of section 580d,¹⁷ the senior is unaffected by the provisions of section 580a. In *Roseleaf*, the court held that a deficiency recovery by a sold-out junior, not barred by section 580d, is also not limited by the fair value restrictions of section 580a, in part because that section expressly refers to a suit for a deficiency brought by the *foreclosing* deed of trust beneficiary.¹⁸

contained in such a mortgage or deed of trust.

12. The likelihood of underbidding by the foreclosing beneficiary is increased by his ability to "credit bid" up to the amount of the debtor's obligation. The standard power of sale clause in a deed of trust requires all others, including a junior lienholder, to bid cash. *Nomellini Constr. Co. v. Modesto Sav. & Loan Ass'n*, 275 Cal. App. 2d 114, 79 Cal. Rptr. 717 (1969); CAL. CIV. CODE § 2924h (West Supp. 1981).

13. *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d at 43, 378 P.2d at 102, 27 Cal. Rptr. at 878.

14. *Id.*

15. *Id.*

16. CAL. CIV. PROC. CODE § 580a (West 1976). For text of § 580a, see note 9 *supra*.

17. CAL. CIV. PROC. CODE § 580d (West 1976). For text of § 580d, see note 11 *supra*.

18. *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d at 40, 378 P.2d at 99, 27 Cal. Rptr. at 875.

More important to the result reached in *Roseleaf*, however, was the court's belief that the purpose of section 580a would not be served by extending it to sold-out juniors: "Fair-value provisions are designed to prevent creditors from buying in at their own sales at deflated prices and realizing double recoveries by holding debtors for large deficiencies."¹⁹ In light of that purpose, the court noted, some states have distinguished between the sold-out junior who purchases the property at the senior's private sale and the one who does not, holding the purchasing junior to a fair value measure of recovery.²⁰ But, the *Roseleaf* court appeared to emphasize other, contrary considerations which admitted of no such distinction:

The position of a junior lienor whose security is lost through a senior sale is different from that of a selling senior lienor. A selling senior can make certain that the security brings an amount equal to his claim against the debtor or the fair market value, whichever is less, simply by bidding in for that amount. He need not invest any additional funds. The junior lienor, however, is in no better position to protect himself than is the debtor. Either would have to invest additional funds to redeem or buy in at the sale. Equitable considerations favor placing this burden on the debtor, not only because it is his default that provokes the senior sale, but also because he has the benefit of his bargain with the junior lienor who, unlike the selling senior, might otherwise end up with nothing.²¹

It has been noted that, after *Roseleaf*, the debtor may be subject to greater liability than the objectives of the anti-deficiency laws would seem to permit.²² Yet, due largely to the court's authoritative treatment of sections 580a and 580d in connection with sold-out juniors, no subsequent California case has questioned *Roseleaf* and applied those sections to a junior who does attempt to protect its security by buying in at the senior's sale.²³

19. *Id.*

20. *Id.* at 40, 378 P.2d at 100, 27 Cal. Rptr. at 876.

21. *Id.* at 41, 378 P.2d at 100, 27 Cal. Rptr. at 876.

22. R. BERNHARDT, *supra* note 4, at § 4.30.

23. To the contrary, some California appellate decisions seem to suggest that a purchasing junior ought to be treated no differently than the sold-out junior in *Roseleaf*. *E.g.*, *Investcal Realty Corp. v. Edgar H. Mueller Constr. Co.*, 247 Cal. App. 2d 190, 55

D. THE COURT'S ANALYSIS OF SECTIONS 580a AND 580d

Contrary to the rather clear holding in *Roseleaf*, the *Bank of Hemet* court perceived a real difference between a sold-out junior lienor who purchases at the senior's sale and one who does not. As the court put it, the Bank simply could not be considered the equivalent of the pure sold-out junior in *Roseleaf*.²⁴ The significance of this difference, however, does not relate to the applicability of the section 580d bar against deficiency judgments after a private sale. That provision was meant to achieve a parity of remedies between judicial and non-judicial sales, that is, as *Roseleaf* held, to preserve for the sold-out junior some means of recovering the amount owed him. The significance lies, rather, with the purpose of the fair value limitations of section 580a, "viz., to protect against a lienor buying in the property at a deflated price, obtaining a deficiency judgment, and achieving a recovery in excess of the debt by reselling the property at a profit."²⁵ Since such an excessive recovery was clearly a possibility in the case at hand, it was quite consistent with the general purpose of section 580a to limit the Bank's deficiency.

Having so squared its application with the broad purpose of section 580a, the court had little difficulty avoiding a precisely literal reading of the language of that section, which would have required the deficiency to be calculated with reference only to the amount of the senior debt, and concluding that any deficiency would be limited to the amount by which the combined senior and junior debts exceeded the fair market value of the property.²⁶

E. ANALYSIS OF THE COURT'S REASONING

California's anti-deficiency rules, found in only four sections of the Code of Civil Procedure,²⁷ are best viewed, not as a completed system of regulation, but only as a framework for that system. It is left to the courts to build from that framework, a

Cal. Rptr. 475 (1966); *Dickey v. Williams*, 240 Cal. App. 2d 270, 49 Cal. Rptr. 529 (1966).

24. *Bank of Hemet v. United States*, 643 F.2d at 669.

25. *Id.*

26. *Id.*

27. CAL. CIV. PROC. CODE §§ 726, 580a, 580b, 580d (West 1976). Section 580b, not previously discussed, prohibits deficiency judgments to holders of purchase-money deeds of trust.

coherent scheme of debtor protection. Seen in this light, *Roseleaf's* reading of section 580a, which in terms applies only to deficiency judgments obtained by the foreclosing beneficiary, was an unnecessarily literal one. The *Bank of Hemet* court correctly perceived that fair value provisions such as section 580a are intended to prevent *any* creditor from reaping a windfall at the debtor's expense by combining a deficiency judgment with a bargain purchase of the property.

This purpose is not served if a distinction is not drawn between purchasing and non-purchasing junior creditors. Certainly, there is a meaningful difference, with respect to the appropriateness of a deficiency judgment, between the junior lienor deprived of his security in *Roseleaf* and the junior in *Bank of Hemet* who elects to protect his security by purchasing the property at the senior's sale. However valid the fear expressed in *Roseleaf*, that to allow section 580d to bar the junior's only recourse against the debtor would unfairly force the junior to cash bid, the inequity disappears once the junior does find sufficient funds to save his security. Nothing forces the junior to buy in at the sale, and if he does not, his right to seek a deficiency judgment is not lost. But, having elected to purchase, all that is required to give the junior the "benefit of his bargain"²⁸ is to allow him to recoup that portion of his debt not satisfied from the subsequent sale of the property. Section 580a achieves this result, and without subjecting the debtor to a double burden.

Strict application of the *Roseleaf* approach, by contrast, necessarily leads to an inequity. The defaulting debtor, who almost by definition cannot compete at the sale in order to ensure a fair price, loses his equity in the property and then faces a judgment for the full amount of the debt. Moreover, there is the added unfairness to the smaller, cash-poor holders of junior deeds of trust, who, unlike their institutional counterparts, do not have the resources to bid at the sale and consequently are nearly always left with a worthless deficiency judgment against an impecunious debtor.

Underlying the *Roseleaf* court's holding may have been the

28. *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d at 41, 378 P.2d at 100, 27 Cal. Rptr. at 876.

unspoken concern that restricting the junior's access to a deficiency judgment would impose an additional risk on junior lenders contemplating second loans. The result would be to cut off an important source of capital for struggling debtors. But clearly, no such effect is threatened where the junior creditor's legal right to full satisfaction of his debt abides, in the form of proceeds from the sale of the property, a deficiency judgment, or a combination of the two. *Bank of Hemet* properly rejects this unnecessary solicitousness for the sensitivities of potential junior lenders.

F. CONCLUSION

The approach to the sold-out junior problem taken by the Ninth Circuit in *Bank of Hemet* serves well the purposes of anti-deficiency regulation. Assuming that the present economic environment of tight money and rising interest rates persists, junior deeds of trust are certain to become an increasingly common phenomenon. It cannot be long before a junior creditor raises the same issue before a California court, and when such a case does arise, *Bank of Hemet's* incisive reappraisal of *Roseleaf* must be considered. If future decisions choose to follow its lead, an important step will have been taken toward the completion of a comprehensive and rational scheme of anti-deficiency protection in California.

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