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Will There Be a New Definition of "Purchase Money"?

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On June 3, 2010, the California State Senate passed, by a 30–4 vote, SB 1178, sponsored by the California Association of Realtors (CAR). If the Assembly approves and the Governor signs this measure, SB 1178 will significantly modify CCP §580b, the purchase money antideficiency rule, which prohibits all sellers and some lenders from recovering any shortfall in a loan that was secured by the real property that the borrowers had purchased, and extends that protection to refinancings. While we are not certain, at the time of this writing, whether the bill will become law, we nevertheless offer these observations because this issue is likely to reemerge in the future even if the bill fails during the current legislative session.

CAR has urged that it is important to extend deficiency protection to a refinanced loan. CAR argues that:

It is unfair to subject homeowners to new personal liability merely because they refinance the original mortgage..... The unfairness is particularly acute in that almost no borrowers understood the new liability that was being acquired along with the refinance.

Although CAR's position seems to be that purchase money loans should not lose their special nonrecourse character on refinancing, its main emotional appeal appears to be borrower ignorance of this consequence. While it certainly true that many borrowers did not understand that loss of deficiency protection was a consequence of refinancing, it is also true there was never any real certainty that this was, in fact, ever really the case.

Some Background

Code of Civil Procedure §580b generally prohibits the recovery of a deficiency judgment in a purchase-money transaction, but the rule is applied differently to vendors than to lenders. (In this column, we use the terms "vendor" and "seller" interchangeably.) A vendor of real property who has taken back a mortgage or deed of trust (or contract of sale) on the property conveyed as security for the purchaser's promise to pay the balance of the purchase price is subject in all cases to CCP §580b, whereas a third party lender who has taken a mortgage or deed of trust to finance the acquisition of property is barred from deficiency recovery only if the property purchased is a dwelling consisting of 1–4 residential units, one of which is to be occupied by the purchaser. That distinction has been in §580b since 1963.

Section 580b was enacted in 1933. In the 77 years of its existence, it has been the subject of some surprising decisions. In 1953, the California Supreme Court held, in *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425, that a vendor who had been sold out by virtue of a foreclosure sale by the senior lender was prohibited by the statute from suing the purchaser for a money judgment on her note because of its purchase money status, and that such relief would constitute, as a policy matter, pursuit of a deficiency judgment, even though she had never foreclosed on her deed of trust.

Ten years later, in *Roseleaf v Chierighino* (1963) 59 C2d 35, 27 CR 873, the court elaborated that, although a sold-out junior vendor was exempt from the one-action rule (CCP §726) and the other antideficiency statutes (the fair value rule of CCP §580a and the trustee sale bar of CCP §580d), because her security had been rendered worthless, the exception did not apply to §580b, leaving the sold-out junior vendor with no further available relief against her defaulting purchaser.

Another distinction that the supreme court made in *Roseleaf* (and repeated nine years later in *Spangler v Memel* (1972) 7 C3d 603, 102 CR 807) was between the “standard” purchase money transaction—to which §580b applies automatically—and “variant” transactions in which its application depends upon whether §580b’s policies are perceived to apply. Currently, the policies of §580b are held to be those of deterring overvaluation and of stabilizing against depressions—although skeptics have never been able to discern how those policies actually accomplish their purposes, especially when third party lenders (who do not set selling prices) are involved. A foundational question that will need to be addressed under the new statutory definition of purchase money is whether refinancings are standard or variant transactions—and, if variant, just how the judicially perceived policies behind the statute are to be applied.

The policies of §580b were first declared before the statute was amended in 1963 to include third party lenders, but *Prunty v Bank of America* (1974) 37 CA3d 430, 112 CR 370, held that a residential construction loan from a third party was nevertheless a purchase money loan, stating “the anti-deficiency protection of the amended statute is no longer limited to the narrow bounds of the ‘standard purchase money transaction’”—meaning that the lender could not recover a deficiency judgment even though the borrowers owned the residential lot *before* they obtained the construction funds.

Finally, in 1999, the supreme court held, in *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292, that a purchaser could not waive by contract his purchase money deficiency protection in exchange for new consideration during a workout with the seller, despite the fact that the purchaser had received significant benefits in the form of a reduced interest rate and lower monthly payments.

Although one court of appeal has stated that a refinanced loan is thereafter not entitled to purchase money deficie ncy protection (*Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549), the force of that decision is uncertain in light of the supreme court’s later holding in *DeBerard*, as well as other decisions that have focused on different, and more policy-oriented rather than technical, considerations. See, *e.g.*, *Shepherd v Robinson* (1981) 128 CA3d 615, 180 CR 342; *Lucky Invs., Inc. v Adams* (1960) 183 CA2d 462, 7 CR 57; and *Jackson v Taylor* (1969) 272 CA2d 1, 76 CR 891—all inventing various (and sometimes novel) policy reasons for concluding that a purchase money loan retained that character despite subsequent financial rearrangements. Even more remarkably, in *LaForgia v Kolsky* (1987) 196 CA3d 1103, 242 CR 282, an originally nonpurchase money loan was held to have been converted into a purchase money obligation. This muddled background does not make predicting the effect of CAR’s new language an easy undertaking.

Evolution of SB 1178

When SB 1178 was first introduced, the bill provided that a loan used to pay part of the purchase price also included debt incurred to construct or substantially improve the real property—language that would appear not only to endorse the *Prunty* doctrine but also to extend antideficiency protection to subsequent remodelings or additions to existing structures. An amendment added a sentence stating that the borrower had the burden of proof of demonstrating the portion of the subsequent loan that was used to acquire, construct, or substantially improve the real property. However, both of those features were eliminated by the time the Senate acted on June 3. The elimination of the construction and improvement language makes it no longer possible to say what impact this will have on *Prunty*.

The version of SB 1178 that passed the State Senate on June 3 adds the following new paragraph to the statute:

For purposes of this section, a loan used to pay all or part of the purchase price of real property or an estate for years shall include subsequent loans, mortgages, or deeds of trust that refinance or modify the original loan, but only to the extent that the subsequent loan was used to pay debt incurred to purchase the real property.

SB 1178 also states that the law will become operative on June 1, 2011, and applies only to actions filed after its operative date.

According to CAR, SB 1178 was amended to attract additional support because the measure failed to garner 21 votes when it first came up on the floor of the Senate. The legislative analysis listed numerous lending organizations, including the California Bankers Association, the California Mortgage Association, and the California Mortgage Bankers Association, as opposing the measure.

As of the date this column went to press, the Assembly Judiciary Committee had reported the bill with a recommendation for approval.

Potential Issues if SB 1178 Becomes Law

Will lenders who had already made loans that refinanced purchase money mortgages on what they believed was a full recourse basis be able to attack this new definition of purchase money as impermissibly impairing their contractual rights? CAR clearly intended the bill to apply to refinancing loans already made. According to a news release on May 20, 2010, CAR "rejected proposed amendments to the bill from the lending industry that would restrict the legislation from applying to loans originated prior to 2011." CAR's president stated, "The people that really need protection are the folks who refinanced in 2005 and didn't know its effect, not the folks who will get loans next year." The bill will have little effect in this new era of tight money if it is held to apply only to future refinancings, but can be expected to generate great controversy if it is applied to refinancings that have already occurred.

The Senate's legislative analysis does not mention this point, although the Assembly's analysis states that opponents of SB 1178 argue the bill "upsets [lenders'] expectations regarding existing loans" and that the measure "fundamentally alters and impairs the nature of [existing] loan contracts after consummation of the contract." In that regard, *Hales v Snowden* (1937) 19 CA2d 366, 65 P2d 847, and *Birkhofer v Krumm* (1938) 27 CA2d 513, 81 P2d 609, declined to apply §580b protection to deeds of trust and mortgages that were created before §580b became effective, and *Birkhofer* and *Drapeau v Smith* (1939) 34 CA2d 84, 93 P2d 157, refused to apply fair value limitation to security instruments that predated that legislation. Although these decisions can constitute a powerful impediment to any retroactive definition of purchase money, the courts could conclude that the "new" statutory revision was, in fact, already included in the original definition—that purchase money remains purchase money even when a loan is technically restructured—for policy reasons similar to those given in the cases we have already mentioned.

When a purchase money loan is increased, i.e., supplemented with nonpurchase money funds, how will bifurcation between purchase money and nonpurchase money work? The new language makes the subsequent funding purchase money only to the extent it paid off original purchase money debt, which means that most loan increases will not carry purchase money status. This generates many difficult questions.

As loan payments pay down the new, larger loan, to which portion of it are they to be applied? Existing loan documents are no doubt silent on this unforeseen issue. Language in future loans would have to avoid being treated as impermissible attempts to waive §580b.

If the initial principal amount of an original purchase money loan had been already paid down somewhat before the refinancing occurred, is the purchase money portion the full original amount or only the reduced amount that existed immediately before the refinance? Does this principle apply if numerous refinancings occurred over time? The new statutory language makes inconsistent singular and plural references to "subsequent loans," but it is not hard to discern CAR's desire to bring all refinancings within the §580b umbrella. On the other hand, each new refinancing is unlikely to increase the amount of funds carrying purchase money protection.

When there is a foreclosure and sale, is the purchase money portion of the loan paid off before or after the nonpurchase money portion, or are they prorated? If the purchase money component is paid first, then deficiency liability could attach to the balance, rendering the protection slight indeed. Protection would be far more effective if the purchase money portion is paid last, although a deeply underwater property could still expose the borrower to deficiency liability. Because the statute gives no explicit assistance on this issue, courts might even consider some kind of prorating in these situations.

Who has the burden of proving what amount of the funds was used for the original purchase? As noted, a sentence imposing that obligation on the borrower was removed from the bill. Although this might support an argument that the contrary effect was thereby intended, it is clearly easier for a borrower to trace its use of the borrowed funds. Stipulations in future loan documents may start to cover this point.

The Senate's legislative analysis stated that opponents of SB 1178 claimed the measure would "negatively impact" short sales, but it is hard to see why that should happen. By definition, the original loan would have had to have been purchase money (to come under the new provision), and no additional funding would arise (for the sale to be "short"). In such a situation, a new purchaser would not face any recourse exposure, even if he or she did not personally occupy the property and "assumed" the old loan, since there is nothing to assume in a loan that is already nonrecourse. *Case v Egan* (1922) 57 CA 453, 207 P 388. Nor would that former owner lose the protection she previously had, since *DeBerard* is likely to prohibit any kind of waiver in connection with the short sale.

Real estate attorneys will be in for complicated and interesting times if this new definition of purchase money takes effect, especially since there is also pending in the Senate SB 931, which proposes to prohibit deficiencies on first deeds of trust and mortgages arising from short sales of 1- to 4-unit residential dwellings while preserving lenders' claims for fraud and waste.