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Foreclosing While the Property is Burning

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MIDCOURSE CORRECTIONS

Foreclosing While the Property Is Burning

Roger Bernhardt

Thoryk v San Diego Gas & Electric Co.

I fear readers may skip past the decision in *Thoryk v San Diego Gas & Elec. Co.* (2014) 225 CA4th 386 (reported at p 120) because its complicated procedural background may incline them to believe it involves too unusual a set of facts. However, those facts conceal common issues that lenders frequently must confront. So I will begin by retelling the story in a more simplistic form.

- The trustor (Thoryk) owned farmland subject to a first deed of trust (held by PFI) and a second deed of trust (held by Highland).
- In 2007, the property suffered major damage from a wildfire, allegedly caused by third parties, including San Diego Gas & Electric (SDG&E) (the “third parties” or “tortfeasors”).
- In 2008, the holder of the second deed of trust foreclosed by trustee sale, acquiring title by a partial credit bid, some \$850,000 less than it was owed.

- In 2009, the trustor sued the third parties for negligence and also inverse condemnation (SDG&E is a public utility).
- In 2010, the holder of the first deed of trust foreclosed by trustee sale and acquired title by a full credit bid.
- Along the way, both the first and second lenders sought to intervene in the trustor's tort action, seeking imposition of liens on any judgment he might obtain in it (the "tort recovery"). The trial court refused to let the senior lender intervene because its full credit bid at its foreclosure sale had eliminated any claim it could make for additional recovery. On the other hand, it did allow the former junior lender (Highland) to have a lien on any such future tort recovery.
- The court of appeal disallowed the lien given to Highland, holding that it constituted an impermissible deficiency judgment.

It is not uncommon for a secured lender to discover that its security has become inadequate when its debtor has other assets that—if they can be reached—will cover its loss from the insufficient security. The lender's question is whether it can get to those other assets.

Counsel's answer to the lender's question should be multifaceted:

- "Yes," if those other assets furnish additional security for the loan;
- "Yes," if not additional security, the assets constitute substitute security; or
- "Yes," if neither additional nor substitute security, but the assets can be reached by way of execution on a deficiency judgment against the debtor.

Additional Security

In *Thoryk*, the junior lender's first claim to the potential tort recovery against the parties who started the fire was that that right had been given to it as additional security for the loan because its deed of trust defined the real property securing the note as including money related to it. Although money is personal rather than real property, the deed of trust provided that it also constituted a security agreement under the UCC with regard to such assets (commercial tort claims). If that language worked, then the junior lender was secured by both land and any money related to the land. Thus, it could go after those two assets in piecemeal fashion—conducting a trustee sale of the real estate and then imposing a lien on any tort judgment if the trustee sale did not fully satisfy its claim—and that procedure would not violate our one-action or antideficiency rules because the trustee sale was not an action and the tort claim was only additional security. See *Dreyfuss v Union Bank* (2000) 24 C4th 400, reported at 24 CEB RPLR 52 (Jan. 2001). If that technique had worked, then other lenders could get the same benefits for themselves (obtaining additional security almost by accident) simply by being sure to incorporate the language of the *Thoryk* deed of trust into their own documents.

But the technique did not work because the court of appeal did not think that the junior's deed of trust adequately gave it a security interest in the trustor's potential tort recovery, given that the language was not that clear on the issue. The court stated that

As an after-acquired property asset, this tort claim does not constitute a security interest, without more specific assigning language.... We cannot see how Appellant's chose in action against the third party tortfeasors was expressly or impliedly included in the "personal property" defined by the trust deed, as money "related to the Real Property."

225 CA4th at 405. (Uniform Commercial Code §9108 frowns on Mother Hubbard descriptions, saying that the phrase "all assets" does not "reasonably identify the collateral.")

So that easy solution is out: A lender cannot hope to claim security interests in all of the debtor's other assets just by including "and everything else" in its deed of trust. Lenders' counsel who want to improve their clients' chances of reaching more than just the land are going to have to do a better job of anticipating and identifying what that "more" consists of. Obviously, no one was thinking about a wildfire when this loan was being made.

Substitute Security

If the potential tort recovery did not qualify as additional security for the junior lender, it might have been accessible to the lender as substitute security instead. When land is taken from an owner by condemnation, the money that the governmental entity pays for the take equitably replaces the land it took, and the lender's lien on the land is equitably converted into a lien on the money paid. What is true for direct condemnation is also true for inverse condemnation, making a judgment in favor of the owner for the damage done by the wildfire equal to the lost value of the land. The same is probably true for trespass or negligence damages caused by a private party (although it is not true for an insurance award for property damage, which was the result of a private wager between the insured and the insurer, and not an equitable replacement of the property damage with the insurance money).

One nice feature of the theory of substitute security, as opposed to additional security, is that the lender needs no special enabling language in its loan documents (although such language is common). The doctrine that land may be equitably converted into a money award comes from judges' rulings, not clauses in deeds of trust.

But another mortgage doctrine can cloud the picture at this stage. A secured lender is not an owner. It is entitled to only so much of the original security or substitute security as it needs to be repaid. If property suffered damage of \$1 million but the loan balance was only \$800,000, the lender cannot automatically also claim the other \$200,000; it has to show that this excess needs to be applied to reduce the loan balance and maintain a decent loan-to-value ratio, lest its security remain impaired. See *People ex rel Department of Transp. v Redwood Baseline, Ltd.* (1978) 84 CA3d 662.

However, that cloud of uncertainty (as to how much of the award should go to the secured lender to assure that its security for the remaining balance is not impaired) makes sense only in cases when the lender has not yet

foreclosed. In situations when the lender has foreclosed before any substitute security arose, the original security has already been utilized (as in the *Los Angeles Trust & Sav. v Bortenstein* (1920) 47 CA 421 decision, described in the *Thoryk* opinion), so no loan-to-value calculation is necessary. It is only a question of making up whatever shortfall the lender suffered at its foreclosure, out of the substitute security of the tort award. The *Thoryk* court said that for a lender to reach substitute security, it must have retained a security interest in the original collateral (or, in an alternate version, that there must remain mutual debts between the parties). But I don't know that either version is really so: Under the right circumstances, I suspect that a lender who has received less than it was fully owed from its foreclosure sale probably can go after any substitute security that was not consumed in the original foreclosure. (I think any later court would simply treat those statements in *Thoryk* as unnecessary dictum, as I shall discuss below.)

I do think that there does have to be a shortfall arising from any earlier foreclosure for the lender to thereafter pursue any substitute security that does exist. The senior lender in *Thoryk* was denied a judicial lien on the tort recovery because it had made a full credit bid at its previous trustee sale (a result made even plainer by another decision in this case rendered in August, but unpublished). California courts love the fiction that a full credit bid equals full payment of the debt, so nothing more was owed to that lender. Further, the effect of the senior lender's full credit bid also would have been to wipe out any ability to reach the tort award even if its deed of trust had expressly included it as additional security. The lesson, if I am correct, is not that a lender should not foreclose if there is substitute security in sight, but that it should not make a full credit bid if it does foreclose.

The junior in *Thoryk* thought that it had escaped that blunder by making only a partial bid at its trustee sale. Thus, it could far more readily say that it was still owed an additional \$840,000, that its security was absolutely impaired (by virtue of its own foreclosure sale), and that the tort award constituted substitute security that was not required to have been specified in its deed of trust.

Deficiency Liability?

At this stage, I run into difficulty understanding the *Thoryk* decision. The opinion declares that giving the junior a lien on any tort recovery "effectively amounts to a deficiency judgment, 'a personal judgment against the debtor-mortgagor for the difference between the fair market value of the property held as security and the outstanding indebtedness.'" 225 CA4th at 408 (quoting *Cornelison v Kombluth* (1975) 15 CA3d 590). This seems to me to directly contradict its earlier declarations that pursuing additional security does not constitute seeking a deficiency judgment. (The lender's recovery would be only on that judgment rather than against the debtor personally.) Being uncertain of exactly what the *Thoryk* court is saying makes it all the harder for me to offer intelligent advice concerning it.

If pursuing substitute security (rather than additional security) is like pursuing a deficiency judgment, then CCP §580d comes into play, meaning that the lender's previous foreclosure sale cannot have been nonjudicial. Any trustee sale, regardless of the amount of the bid, eliminates deficiency liability and thus, according to *Thoryk*, precludes recourse to any substitute security as well. To reach the tort award, the lender had to have foreclosed

judicially, “underbid,” and perhaps also obtained a timely hearing as to the fair market value of the damaged land. (Indeed, if it was going to do all that, it might have just as well requested a deficiency judgment—good against all other assets of its debtor and not limited to the tort award.) Alternatively, the lender might have sought the easier protection of sold out junior status by not foreclosing at all and waiting for the senior lender to do that.

The strategy this lender actually followed—trustee sale, underbid, and then reach for the tort award—might sound sensible (and I might have tried it or recommended it to others), but our topsy-turvy land of deficiency law does not make life that easy.

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