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With property values declining, many homeowners find themselves owing thousands if not hundreds of thousands of dollars more than their properties are currently worth. As a result, many have chosen to allow their properties to go into foreclosure rather than continue to pay on loans that exceed the value of their homes. This month's article discusses the risks of simply walking away from a property that is worth less than the mortgage or mortgages which it secures.

WHAT HAPPENS AFTER FORECLOSURE?

As most homeowners know, foreclosure is the process a lender goes through to obtain the value of the property that secures a debt. What many homeowners do not know, however, is that letting a home go into foreclosure may not end a homeowner's obligation to pay the debt. This is particularly true in situations where homeowners have more than one mortgage on their homes. Whether a homeowner will have to pay a debt after foreclosure depends on a number of factors, including whether the debt was a purchase-money loan or a non-purchase-money loan, and whether the foreclosure was judicial or non-judicial (these terms are explained in the remainder of this article).

In a lender's perfect world, the value of the mortgaged property (security) would always exceed the amount loaned so that if the lender had to foreclose, the lender would always recover the amount loaned (plus foreclosure costs). The current real estate market, however, is far from what a lender would consider a perfect world. These days, the vast majority of foreclosures involve properties worth much less than the mortgages they secure. Additionally, many homeowners have borrowed money from more than one lender (mortgage holders). Quite frequently, the value of the property is lower than the amount owed to just one of the mortgage holders (usually the mortgage holder in first position). In this situation, when the first mortgage holder forecloses, all other mortgage holders are "wiped out," which means they lose the security that normally guarantees they will get their money back.

It is important for homeowners to recognize that a foreclosure only "wipes out" a lender's security interest (the right to collect the debt by foreclosing on the property); a foreclosure does not necessarily "wipe out" the debt. With certain types of loans, the mortgage holder may obtain a judgment against the homeowner for the amount owed. This can happen even when the property secures only one mortgage, but occurs more often when there are multiple mortgages on a property. Thus, a homeowner who goes through foreclosure on a property that secures more than one mortgage may find himself or herself still owing thousands of dollars on a second or third mortgage.

Purchase-Money Versus Non-Purchase-Money Loans

To know whether or not a homeowner may owe money after a foreclosure, it is important to determine the type of loan involved. California law recognizes a special situation in which a loan is used to

purchase property (a purchase-money loan). When qualifying property¹ secures a purchase-money loan, California anti-deficiency statutes prevent the mortgage holder from suing for the difference between the amount owed by the purchaser and the amount recovered through the foreclosure process (the deficiency). These anti-deficiency statutes also apply to holders of second and third mortgages *if* the loans were used to purchase the property. Thus, as long as the loan is a purchase-money loan, the lender's only option is to foreclose on the property. If a second or third mortgage holder on a purchase-money loan is "wiped out" by the foreclosure, that mortgage holder has no recourse against the homeowner, and the debt is therefore also effectively "wiped out."

Currently, a significant number of foreclosures do not involve purchase-money loans. With property values skyrocketing a few years ago, and mortgage rates declining, many property owners refinanced their original loans. The refinancing often resulted in the new loans being considered non-purchase-money loans (a technical legal issue beyond the scope of this article). Additionally, many homeowners obtained home equity lines of credit (HELOCs), which allowed them to borrow from the equity in their homes. Such non-purchase-money loans present a more complicated scenario in the foreclosure arena. In many cases, homeowners may still owe the debt on a non-purchase-money loan even after the property goes through foreclosure.

Judicial Versus Non-Judicial Foreclosure

To understand a homeowner's risks and obligations when a lender forecloses on a non-purchase-money loan, it is important to distinguish between two types of foreclosure. The type of foreclosure with which most people are familiar is the non-judicial foreclosure. This type of foreclosure, which is permitted by the terms of the mortgage and governed by statute, involves the recording of a Notice of Default and the eventual foreclosure sale. The second type of foreclosure is a judicial foreclosure, in which the lender brings a lawsuit against the homeowner and asks the court to determine the rights of the parties in the foreclosure. In order to recover the deficiency on a non-purchase-money loan, a lender normally must go through the process of a judicial foreclosure. If a lender chooses to pursue a non-judicial foreclosure, that lender cannot recover any deficiency. A different situation arises, however, when a second or third mortgage holder is "wiped out" by a first mortgage holder's non-judicial foreclosure.

If a non-judicial foreclosure completely "wipes out" a second or third non-purchase-money mortgage, the lender has the right to sue the homeowner directly for the amount owed. With property values as low as they are now, a foreclosure sale often fails to provide sufficient funds to satisfy even the first mortgage holder. In such a case, the first mortgage holder is prevented from recovering the deficiency on its loan, but a second or third mortgage holder is free to seek a judgment against the homeowner for the amount owed.

The California case which first determined that a "wiped out" second mortgage holder could sue the homeowner for the amount owed is *Bank of America v. Graves* (1996) 51 Cal.App. 4th 607. In this San Bernardino County case, a married couple opened an equity account (HELOC) with Bank of America. The account was secured by a second trust deed against the couple's home. When the couple defaulted on the loan, Bank of America initiated foreclosure proceedings, but postponed the trustee's sale to allow the first mortgage holder to foreclose. The first mortgage holder bought the property at its own

¹ A qualifying property is normally residential property consisting of one to four dwelling units in which the owner occupies one of the units, though certain other properties may also qualify under the anti-deficiency statutes.

sale, which “wiped out” Bank of America’s security interest. Bank of America then sued the couple for a deficiency judgment. The trial court held that Bank of America was entitled to a judgment against the couple, and the Court of Appeal agreed.

Under current California law, homeowners may not be able to simply walk away from their homes “debt free” after a foreclosure. If a mortgage holder pursues judicial foreclosure on a non-purchase-money loan, the homeowner may have to pay a deficiency judgment. More importantly, if a homeowner has a non-purchase-money second or third mortgage, that homeowner risks a judgment even after a non-judicial foreclosure. It should be noted that a lender must seek a judgment against a homeowner within three months of the foreclosure sale or forever lose its rights to obtain a judgment on the debt. With this minor limitation, however, lenders can and do recover from homeowners money owed on mortgages that are “wiped out” by foreclosure.

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