

FEAR AND LOATHING CALIFORNIA LAW: NON-RECOURSE CARVE-OUTS ON CALIFORNIA LOANS

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Some think California law relating to the "one-action rule" and obtaining deficiency judgments against borrowers and guarantors is like pornography.

The reverse is the case. We know pornography when we see it, but that is rarely the case with California's one-action rule and law relating to deficiency judgments. Too often even seasoned loan closing professionals across the country do not know or fully understand issues relating to deficiency judgments in California.

There is an enormous body of law causing the difficulty in obtaining a deficiency judgment following a non-judicial foreclosure sale of commercial property in California. (See June, 1999 issue of Commercial Mortgage Insight). National lenders need to be reminded repeatedly that not only is a borrower entitled to protections against a deficiency judgment in California, but a guarantor of the indebtedness in many circumstances is also entitled to the same anti-deficiency protection as the borrower - particularly when the guarantor is a general partner of the borrower.

But what about "non-recourse carve-outs" after a non-judicial foreclosure (sometimes referred to in other states as a foreclosure under the power of sale provision of a deed of trust)? The conduit lending industry made popular the concept of non-recourse loans, while obtaining certain exceptions or non-recourse carve-outs. These exceptions are commonly known as "bad boy" exceptions. They are now found not only in conduit lending industry loan documents, but also loan documents for life insurance companies and major national banks.

The "thinking" behind non-recourse carve-outs is that the borrower will still be personally liable for certain losses and those providing a limited guaranty or indemnification will also be liable for any bad boy conduct. We commonly see some 16 categories of non-recourse carve-outs in most promissory notes. Included are the following:

1. Losses for fraud or intentional misrepresentation;
2. Losses for waste;
3. Losses for misappropriation of tenant security deposits or rents;
4. Specific performance of the loan documents;
5. To foreclose and obtain title to the collateral;
6. To enforce any guaranty;
7. To enforce any indemnity;
8. To enforce any environmental indemnity;
9. To enforce any release of liability;
10. To obtain a receiver;
11. To enforce the assignment of leases and rents;

12. Losses regarding required insurance of the collateral;
13. Losses from the failure to pay over insurance proceeds;
14. Losses from the failure to pay over condemnation awards;
15. Voluntary bankruptcy or insolvency; and
16. Involuntary bankruptcy or insolvency.

California's anti-deficiency legislation for large commercial loans is largely embodied in Code of Civil Procedure Section 580d. Each non-recourse carve-out must be outside the intended legislative purview and historical appellate interpretations of CCP 580d and other applicable law to survive a non-judicial foreclosure. In effect, the election to foreclose non-judicially on commercial property pledged as collateral, pursuant to terms of a deed of trust, converts a recourse note into a non-recourse note for most claims. No claim is born with even the potential to survive a non-judicial foreclosure sale of the real property unless (i) there remains a deficiency, a difference between the amount owing on the loan and the amount obtained at the non-judicial foreclosure sale; and (ii) there is some exception by statute or common law to CCP 580d. Additionally, if the lender bids at the sale, and obtains the property, or if someone else buys the property, the amount bid or received from the other buyer must be deducted from the amount owing. Thus a full credit bid retires the entire debt.

Below is a checklist for each carve-out after a non-judicial foreclosure sale of the real property pledged as collateral pursuant to the terms of a deed of trust. Each assumes that a deficiency remains after the non-judicial foreclosure.

1. Losses for fraud or intentional misrepresentation - California's anti-deficiency legislation does not bar a lender from suing a borrower after a non-judicial foreclosure for losses arising from fraud that induced the loan or that affect the bid price.
2. Losses for waste - Only claims for "bad faith" waste against a borrower can be pursued after a non-judicial foreclosure by the lender. What conduct constitutes bad faith waste is not clearly set out in California case law or by statute. It has been suggested that deliberate acts that impair the security may qualify as bad faith waste, while omissions that impair the security will be more difficult to characterize as bad faith waste. Note also that loans insured by the Federal Housing Administration are not subject to California's "bad faith waste" rule. Ordinary waste is sufficient to support a waste claim after a non-judicial foreclosure sale involving a FHA insured loan.
3. Losses for misappropriation of tenant security deposits or rents -The lender can pursue its rights to the security deposits or rents as additional security under the loan documents, since a lender's resort to any and all security for a debt does not implicate the anti-deficiency provisions that bar a deficiency judgment after a non-judicial foreclosure. If the security deposits or rents are unavailable, then the lender is left with seeking a personal judgment against the borrower for the missing security, and the lender could pursue tort claims such as for conversion. Additionally, rent skimming is using revenue from the rental of residential real

property at any time during the first year after acquiring the property without first applying the rent (or an equivalent amount) to the mortgage payments. California's anti-deficiency legislation does not apply to a claim for rent skimming.

4. Specific performance of the loan documents - If no monetary demand is involved, Code of Civil Procedure Section 580d does not appear to bar a claim for specific performance of an obligation remaining after non-judicial foreclosure of the real property security.
5. To foreclose and obtain title to the collateral - This carve-out can only concern personal property collateral remaining after the non-judicial foreclosure, since the real property and any personal property included for foreclosure with the real property already has been sold. (When the lender holds mixed real and personal property collateral, the lender has three options. First, the lender can foreclose the real property separately from the personal property. Second, the lender can include the personal property with the real property for foreclosure. Third, the lender can include only part of the personal property with the real property for foreclosure, and proceed separately against the non-included personal property.) Where personal property collateral remains after a non-judicial foreclosure, California's Commercial Code preserves Code of Civil Procedure Section 580d's ban on a deficiency judgment after the non-judicial foreclosure of the real property security. The lender will not be able to sue to collect on the remaining personal property collateral and, if the collateral proves insufficient, then demand a deficiency judgment as well. The lender can only proceed judicially or non-judicially to foreclose the remaining personal property collateral itself.
6. To enforce any guaranty - Making the borrower personally liable just to enable enforcement of a guaranty to collect a deficiency makes no sense once a non-judicial foreclosure occurs. If the guaranty contains comprehensive surety defense waivers, the guarantor already is liable. If the guaranty does not contain such waivers, then it will not be enforceable anyway in almost all situations. Also, the guarantor must be different than the borrower or an alter-ego of the borrower (e.g., a general partner is not different from the partnership for guaranty purposes. If not, the guaranty is a sham. If the idea behind the language in the note is to cut off certain surety defenses, the language should be superfluous because the surety defenses should be explicitly waived.
7. To enforce any indemnity - An indemnitor has the same protection as a guarantor. Thus absent an applicable waiver, or perhaps if the indemnity is to protect the lender from tortious loss, or bad faith waste, recovery of a deficiency from an indemnitor will be barred by Code of Civil Procedure Section 580d.
8. To enforce an environmental guaranty - An environmental indemnity will survive a non-judicial foreclosure sale. A lender may sue for money or to enforce an "environmental provision" (a representation or covenant concerning hazardous substances) without violating California's anti-deficiency laws. However, the lender may not recover for remediation and related costs if the loan was for less

than \$200,000, and the lender obtained an environmental assessment when deciding to make the loan, and the borrower did not contribute to the hazard, and the deed of trust has not been discharged.

9. To enforce any release of liability -- A release of liability should survive a non-judicial foreclosure sale because a release has nothing to do with obtaining a deficiency, or otherwise trying to enforce a monetary obligation of the borrower.
10. To obtain a receiver - This carve-out is not needed after the non-judicial foreclosure sale of the real property security since the real property has been sold. (Simply suing the borrower prior to the non-judicial foreclosure sale to obtain a receiver is also allowable since it does not result in liability to the borrower.)
11. To enforce the assignment of leases and rents - This carve-out is not needed after the non-judicial foreclosure sale of the real property security since the real property has been sold. If the lender underbid at the non-judicial foreclosure sale, then after the sale, the lender can still obtain pre-sale rents held by a receiver under an assignment of rents clause, up to the amount of the deficiency, since the assignment of rents is treated as additional security. (Simply suing the borrower prior to the non-judicial foreclosure sale for enforcement of the assignment of rents and lease provisions of a deed of trust is also allowable).
12. Losses regarding required insurance of the collateral - Insurance proceeds are treated as additional security that is available to the lender if the non-judicial foreclosure sale left a deficiency owing. If the borrower neglected the required insurance, and loss occurred that should have been insured, probably the lender will not be able to proceed against the borrower. Arguably the lender would be seeking a personal money judgment against the borrower for its breach of the loan documents, and that is a deficiency judgment barred by Code of Civil Procedure Section 580d. The lender might be better served by trying to characterize the failure to insure as bad faith waste.
13. Losses from the failure to pay over insurance proceeds - After a non-judicial foreclosure leaving a deficiency the lender can seek to recover insurance proceeds to which it is entitled under the loan documents. If recovering the proceeds from the borrower proved impossible, then the lender is left with seeking a personal judgment against the borrower for the missing proceeds. The lender could sue in tort for conversion.
14. Losses from the failure to pay over condemnation awards - This assumes a partial condemnation since condemnation of all the real property security would leave nothing to non-judicially foreclose. A lender in California should never have to worry about what happens to a condemnation award. When real property is taken for public use, the award must compensate the lender for the loss of its security. The lender may share in the award only to the extent necessary to prevent impairment of its security, as determined by the court. If there is a way

for an ingenious borrower to misappropriate a condemnation award belonging to the lender, the lender apparently may still sue in tort for conversion.

15. Voluntary bankruptcy or insolvency - A voluntary bankruptcy is not an exception to Code of Civil Procedure Section 580d. Making the borrower personally liable in the event of bankruptcy will not make a deficiency collectible that is otherwise barred.
16. Involuntary bankruptcy or insolvency - An involuntary bankruptcy is not an exception to Code of Civil Procedure Section 580d. Making the borrower personally liable in the event of bankruptcy will not make a deficiency collectible that is otherwise barred.

National lenders should still be wary of enforcing many non-recourse carve-outs against guarantors. Although a bad boy provision seemingly may be enforceable, if the lender bids at the sale and obtains the property, or if someone else purchases the property, the amount bid or received must be deducted from the amount owing. Additionally, the lender will always need to prove its actual losses directly caused by breach of any bad boy provision. For example, if the lender sues the borrower for "bad faith" waste, the lender must prove the diminution in value. In those instances where the lender simply failed to make a full credit bid, the burden of proof may be difficult to sustain.

Perhaps most frustrating about any commentary provided on California's anti-deficiency legislation is that no article or presentation may be concluded with a paragraph that begins, "[I]n the final analysis." There has never been or, in the foreseeable future, will there be a conclusive analysis upon which lenders may rely. Almost each calendar year brings yet another interpretation of law in this area. Lenders and their counsel must maintain a sharp focus on these issues.