Foreclosure Law in California and Related Matters
by William A. Markham, San Diego Attorney © 2000 (with certain updates made in 2008)

Lenders often require that their loans be secured by real property. If the borrower defaults, the lender is entitled to sell the property to pay the borrower's entire debt at once. This act of selling the property to pay the borrower's debt is called a foreclosure: It is the pre-emptive or premature closing of a loan transaction by summary sale of the collateral that secured the loan, with an immediate pay-off of the entire loan obligation from the sale proceeds.

This article aims to provide an overview of the laws on foreclosure proceedings in California and related matters. As it a rather dry subject, your author has tried to enliven it by providing colorful illustrative examples.

A Commonplace Example. Suppose you recently bought a home in the Silicon Valley for, say, $680,000. The home is nothing spectacular at all: It is split-level, and has two bedrooms, one bathroom, a cramped kitchen, a small garage, and a fenced-in tiny backyard that is not large enough for a decent football game for your kids and their friends. But in today's roaring real estate market, you were forced to pay $680,000 for this modest property, which ten years ago very likely would have sold for $250,000, and ten years before that for $70,000 or less.

Those familiar with the Silicon Valley or California generally will know that my above example is by no means an exaggeration. I have personally known people who have paid about as much to get far less (though I have one close friend, whose name I shall withhold to protect him from the fury of the envious, who somehow managed to get a lovely home in the heart of Palo Alto for a mere $360,000!)

So there you have it then: You, who are an ordinary, routine purchaser, have just agreed to pay $680,000 for your ordinary, routine home. Like most purchasers, you must provide a down-payment of 20% of the purchase price, which in this case is $136,000 - a sum that you raised by selling all your stock, emptying your savings account, emptying your wife's saving account, foregoing vacations for the past two years, and getting loans from relatives and in-laws who live in less expensive places and chortle at your struggle to stay alive in the booming new age of California prosperity.

You have thus posted a down-payment of $136,000 and have taken a loan of $544,000 for the remainder of the purchase price. You got the loan from, say, the Wells Fargo Bank. Did the bank give you the loan on the strength your solemn promise "to repay every penny if it's the last thing I ever do"? No, of course not. Did they give you a loan because of your fantastic good looks? Or because the stars were aligned properly when you applied? No. Did they do so in reliance on your future earnings from your employer, which is an unknown dot-com that doesn't provide any useful service and has no visible source of ongoing revenues? Again, the answer is no.

Rather, Wells Fargo (or any other sensible lender) must consider the value of the property that you mean to purchase with the loan, your financial history, your likely ability to pay the loan according to its terms, and other, related criteria.

A Purchase-Money Loan, Defined. Above all, Wells Fargo made the loan to you only on condition that it be secured by your new home, that is, by the very property that the loan was used to purchase. In other words, Wells Fargo made a purchase-money loan - i.e., a loan which is made for the purpose of purchasing a parcel of real estate, and which is secured by the very same parcel. The security aspect of this loan means the following: If you default on the loan, Wells Fargo will become entitled to sell your property to satisfy the balance owed on the loan.

More exactly, a purchase-money loan under the California statutes is defined as either a seller carry-back loan (*i.e.*, a loan made by the seller of the property to its buyer, and made in the form of a promissory note secured by a deed of trust against the property itself, and given as part or all of the purchase price that the buyer pays for the property); or a third-party purchase-money loan for a owner-occupied residential property that has no more than four units (*i.e.*, a loan that is (1) made by a lender to the buyer, (2) used by the buyer to pay for all or part of the purchase of the property, (3) stated in a promissory note secured by deed of trust recorded against the property, and (4) concerns a property that has four or less residential units, one of which the buyer occupies as his residence.)

The Loan Agreement. Your loan is explained, or rather obscured, in a confusing series of documents written in impenetrable legalese that Wells Fargo will present to you for signing on a "take-it-or-leave-it-basis". Of course, you will sign. These documents, taken together, constitute a contract, or a loan agreement, between you, who are the borrower, and Wells Fargo, which is the lender.

The loan agreement will include a promissory note, a deed of trust, a disclosure statement that satisfies the "Truth-in-Lending Act" and all other lender disclosure requirements, as well as the other ordinary terms and conditions of a typical purchase-money loan.

Secured Loan Agreements: The Promissory Note and Deed of Trust. The promissory note recites the schedule of payments that you must make to pay off your loan. Typically, you will have monthly payments for twenty-five to thirty years, and your payments will be the same amount each month if the interest charged is at a fixed-rate, but they will differ in amount if the interest is charged at a variable rate (variable-rate loans usually call for the lender to raise or lower the amount of the monthly payment once each year, typically according to a complicated formula that depends upon the rise or fall of a specified index).

Your promissory note, by which you legally obligate yourself to pay Wells Fargo according to the terms recited in the promissory note itself, is secured by the deed of trust, which is the central document in a foreclosure. If you fail to make the payments scheduled in the promissory note, you will default on the loan, and the lender will become entitled to foreclose the deed of trust, which is a proceeding by which it sells your property, pays off the loan (along with all kinds of unpleasant late fees, penalty fees, foreclosure fees, and attorney's fees), then gives any remaining funds to you or others according to law. The entire procedure is sometimes referred to as foreclosing upon the property, though technically the lender has foreclosed the deed of trust that secures its loan, and by so doing has become authorized to sell your property at a special sale, pay itself your entire loan debt from the sale proceeds, then allot any remainder to you or others according to law.

This concept can be explained in another way. The purchaser buys the property with a down-payment and loan proceeds given by the lender. The purchaser becomes the owner of title to the property, but the lender is authorized to sell the property to pay off the loan if the purchaser fails to make the loan payments. The schedule of loan payments is given in the promissory note, and, if this schedule is not kept, the lender invokes its powers under the deed of trust to sell the property. The selling of your property to satisfy the debt is an act of foreclosure - a premature closing of the entire loan transaction by a liquidation of the asset that secured the loan.

When you acquire the property, you record your ownership of title to it at the recorder's office of the county where the property sits. Likewise, the lender records its deed of trust at the same place. This way everyone in the world is deemed to have constructive notice of (1) your ownership of the property, and (2) the lender's security interest in the property until the loan is paid off. If you pay off the loan, the lender will reconvey the deed of trust to you, and you will record the reconveyance, so that the lender will no longer have a recorded security interest against the property, and you will have an official record of having paid off the loan that you took from the lender.

Pre-Payments and The Usury Laws. To return to our colorful example, you have just acquired title to your $680,000 home, but have given a deed of trust to Wells Fargo, which authorizes it to sell your home if you fail to make the payments called for in the promissory note that you have just made in favor of Wells Fargo (you are the "maker" of the promissory note, and Wells Fargo is its "holder").

If all goes well, you will dutifully pay off the loan according to the schedule of payments set forth in the promissory note, or "note". Or perhaps you will pay the entire loan before you are obliged to do so because you have won the lottery, or, what is much the same thing, you have liquidated your momentarily valuable stock-options. If you defray your loan in advance, it becomes important that the loan agreement not include a pre-payment penalty, which is a special fee that some lenders charge if you are prosperous enough to pay their entire loan before you must do so: In such an arrangement, you are charged extra if you pay late or if you pay early! Wells Fargo and most institutional lenders do not charge pre-payment penalties, but these fees are perfectly legal so long as they are properly disclosed to you in the loan agreement and do not violate California's usury laws, which recite a formula to specify how much interest a lender can lawfully charge on its loans, though the usury laws have many exceptions, exclusions, and special rules for certain kinds of loans and certain categories of lenders. One type of loan that receives special, indulgent treatment under the usury laws is a loan secured by real property.

No serious lender will ever violate the usury laws, a violation of which will entitle the borrower to avoid paying any interest at all on the loan, and, in the most egregious cases, to more serious remedies as well.

An Obnoxious, All-Too-Commonplace Example. Suppose your boss has an affair with your wife and the two of them fall in love. One day, when you return home, rather than find yourself greeted with the usual barrage of derision and complaints from your wife, you discover that she, the children, and all the belongings are gone. You then read the letter that she has left for you, in which she announces that she and your boss have decided to live openly as a couple, and that you shouldn't bother showing up for work, because you will just be an eyesore and embarrassment if you do so. Naturally, you decide that you will take a long road trip to the Hudson Bay, taking with you a crate of whiskey and your dog, Scooter. You intend to spend a little time with Scooter in the northern hinterlands, where you hope to "sort things out" before returning to start your life anew.

But of course there is the little matter of the "note" - as in, the promissory note that is secured by the deed of trust, which in turn is recorded against your property, which therefore might be sold by your lender to satisfy your obligation under the note. If the lender forecloses the deed of trust, there will be a black mark against your credit when you return. Besides, the foreclosure provides the lender with a perfect opportunity to impose all kinds of late fees, penalties, special surcharges, attorney's fees, and foreclosure fees - all of which will be taken from the proceeds from the sale of your home at the foreclosure sale.

Surrender of Title Deed in Lieu of Foreclosure. Here is your problem. You know that you will inevitably default on the note (because you are headed north to frolic with your dog while drinking whiskey from a crate). But you do not wish to suffer the credit stigma or pay the many fees and extra costs of the inevitable foreclosure. You therefore tell your lender that it needn't bother with the formalities and technical requirements of a foreclosure because you will simply turn over your title to the property, which is called your deed of title, rather than lose it by a foreclosure proceeding. This is called a surrender of title in lieu of foreclosure. Some lenders will sometimes accept the surrender, while others typically refuse to do so, but the matter is often one that can be negotiated.

As with all other debts, the one thing that you must not do is simply ignore the debt, hoping that somehow it will miraculously disappear. Unlike your ex-wife, your debts will not disappear, but rather will increase and involve you in further and further complications until you attend to them.

A surrender of title in lieu of foreclosure suggests to future onlookers that you acted responsibly upon realizing that you would be obliged to default on your note. It is not nearly as good as paying off the note on time or before it fell due, but it is better than a foreclosure.

To arrange such a surrender, the borrower should probably consult an attorney who has experience handling these kind of matters.

It is also clear that, if a borrower surrenders his deed to the lender, the lender will certainly report the matter to credit rating agencies, and the borrower's credit will be significantly impaired. Even so, a borrower can point to the surrender to indicate that at least he did not simply disregard a mounting debt problem that he could no longer manage.

Short Sales (Added in 2008). Sometimes property values undergo a period of general decline either in a distinct region owing to strictly local problems or perhaps across broad parts of the entire country owing to, say, misguided speculative investments in a phantom housing bubble. If this occurs, many borrowers might find themselves burdened with loans that exceed the dwindling value of their properties.

Some might decide that the struggle is not worth the effort, and they will wish to renounce ownership and the accompanying burden of paying the loan. If the loan qualifies as a purchase-money loan (see above), the borrower can try to surrender the deed or merely suffer the indignity and worsened credit of a foreclosure, but he will owe nothing after the lender has foreclosed upon his loan and sold the property to satisfy the debt. This is because a lender is forbidden under California law to obtain a deficiency judgment against the borrower for the difference between the unpaid debt and the amount that it recoups at foreclosure (see below).

But if the unlucky borrower wishes to avoid the stigma of a foreclosure, or if he has a loan that does not qualify as a purchase-money loan (again, see above), he might try to work with an experienced real estate broker in effort to coordinate a "short-sale" -- i.e., the sale of the property for less than is owed on the loan, done with the lender's approval, so that the lender removes its lien against the property upon the sale and releases the borrower from further liability. Short-sales require the lender to agree in advance to the arrangement, and if the borrower has more than one lender or other encumbrancers, it is likely necessary to have an arrangement in place that satisfies all the lenders and encumbrancers.

Distressed borrowers should be mindful, however, that a short sale will have a very adverse effect on their credit, yet it will yield a commission to the real estate agent who makes the sale. If the borrower is not at risk of owing a deficiency after foreclosure, it is not always the case that a short sale is a better option than foreclosure. The seller of a property owes certain obligations of disclosure and by contract to its purchaser -- obligations that the borrower would not owe to his lender after the lender has taken the property by foreclosure. Moreover, if a borrower must default on his loan and lose his property, perhaps it is easier for him to surrender the deed or simply allow a foreclosure to occur, than it is to engage a real estate agent and otherwise become involved in the difficult task of selling a property in a troubled market. After all, the only benefit to the borrower is that the lender will agree to accept the sale proceeds and not seek the remainder of the debt from the borrower -- and by law this is all the lender is entitled to get either for a purchase-money loan or for any foreclosure by trustee sale (see below).

Short sales would appear to make the most sense when the borrower wishes to avoid a public record of foreclosure (even though short sales result in very harmful credit reports) or when the borrower is at risk of owing a deficiency judgment to one or more lenders.

A borrower who contemplates negotiating a short-sale should work with an experienced real estate broker or real estate attorney to make certain that the matter is properly conducted.

Bankruptcy (Added in 2008): A distressed borrower can also seek protection under the United States Bankruptcy Code by initiating a proceeding in his local federal bankruptcy court. This will have the effect of imposing an "automatic bankruptcy stay" on all further proceedings by creditors and claimants against the borrower, save in bankruptcy court. This stay applies to lenders and their servicers, including foreclosure agents. Ordinarily, a foreclosing lender is entitled on demand to obtain "relief" from the bankruptcy stay in order to proceed with its foreclosure. In certain complicated cases, or when the lender wishes to pursue other claims against the borrower, it might nevertheless decide to pursue its claims against the borrower in the bankruptcy proceeding itself. Bankruptcy law is a complex labyrinth, and this brief sketch is not intended to serve as any sort of definitive explication of the matter. As a general matter, bankruptcy would seem to make sense for a distressed borrower, if at all, only if he is at risk of owing a substantial deficiency after foreclosure, or if he also has other obligations that cumulatively have become unmanageable.

Bankruptcy law is now more complicated than ever, and a distressed debtor should seek financial and bankruptcy counseling from an attorney or financial advisor before deciding whether or not to seek relief. Bankruptcy obviously entails significant harm to the debtor's credit rating.

At present, bankruptcy courts lack significant authority to modify contracts for loans secured by real property, but the U.S. Congress is currently contemplating giving these courts limited authority to modify certain kinds of loans secured by residential real property, so as to assist beleaguered homeowners who can no longer manage their home loans. If such a measure becomes law, it will probably concern only subprime mortgages that meet certain technical requirements.

Foreclosure Proceedings. Let's return now to the main thread of this article, which concerns the essentials of foreclosure law.

Suppose that your lender refuses to agree to a short-sale or to accept a surrender of your deed, or that bankruptcy is inappropriate for you? Or suppose that you are in no mood right now to have humorless exchanges with your lender about surrendering your title or negotiating an ill-advised short-sale from which you gain nothing but a future lawsuit from the disgruntled buyers of your property?

No, right now you are a man who must at once escape to the Great North, where you hope to forget your wife's treachery and gain a fresh perspective on things.

If you default on the loan and make no arrangement such as a short-sale or surrender of your title deed, your lender will become entitled to conduct foreclosure proceedings against your property. Remember, the note and deed of trust that you gave to your lender in order to get its loan entitle the lender to foreclose the deed of trust and sell the property in foreclosure if you fail to pay the loan according to the terms stated in the note.

The only question now is whether the lender will conduct a speedy private sale or initiate a much longer proceeding called a judicial foreclosure.

Private Sale or Judicial Proceeding? The foreclosure process can take place in one of two ways. Either the lender will invoke its powers of a private trustee's sale, which are given under the deed of trust, or it will bring a lawsuit for a judicial foreclosure, pleading that it has a deed of trust against the property, that you have defaulted on the loan secured by the deed of trust, and that the Court should therefore order the deed of trust foreclosed and decree that the property be sold to pay off the entire loan debt.

In either event, the lender will send you and all other lienholders written notices of your default on the loan and its intention to conduct a foreclosure unless you cure your arrears and pay all late fees. If the lender fails to do so in the manner prescribed by the foreclosure statutes, it will not be entitled to a foreclosure at all.

A private sale is far faster than a judicial foreclosure: It will happen 120 days after the lender first gives notice of the default, while a judicial foreclosure takes as long as any other lawsuit on the regular civil calendar - that is, approximately one year, unless there are special, complicating factors, as is often the case. A private sale is therefore much better for the lender, unless the property lacks sufficient value to pay off the borrower's entire debt. In this one instance, the judicial foreclosure is better because it allows the lender to obtain a personal judgment against the borrower for the outstanding amount owed on the loan after the foreclosure sale. This outstanding amount is called the deficiency, and the judgment against the borrower is called a deficiency judgment. However, a lender cannot obtain a deficiency judgment if the underlying debt arises from "purchase-money loan," which is either a "seller carry-back loan" (see above) or a third-party purchase-money loan for a owner-occupied residential property that has no more than four units (see above).

The matter can be summarized as follows. A lender cannot get a deficiency judgment if it forecloses by private sale, nor can it do so if the underlying loan was a purchase-money loan. Therefore, a lender will choose to sell the property at a private sale if (1) the sales proceeds will pay the entire loan or (2) the loan was a purchase-money loan.

It is often the case that the lender will forgo a judicial foreclosure and use a private sale even if (1) the sale will likely or certainly fail to yield funds sufficient to pay the full debt; and (2) the lender is entitled to a deficiency judgment for the remainder against the borrower. Often the lender will simply prefer the convenience and swiftness of a private sale, but this will depend in part on whether it would be profitable for it to pursue the borrower for the likely deficiency, and this depends on the likely amount of the deficiency and the borrower's ability to pay it.

There is an additional advantage to conducting a foreclosure by private sale. The purchaser of property at a private sale will become its owner, save where the defaulted borrower is able to attack the sale on grounds of procedural irregularity or gross lack of fair consideration for the sale. (Moreover, a foreclosing lender cannot claim more from the sales proceeds than what it is strictly entitled to take under the foreclosure statutes.) Generally speaking, the purchaser of a property at a private sale take the property and owns it free and clear of any lien subordinate to the deed of trust under which the foreclosure has been conducted.

In contrast, the purchaser of a property at a judicial foreclosure might be required to sell back the property to the defaulting borrower under the redemption statutes, which entitle the defaulting borrower to redeem his property by paying the foreclosure purchase price to the purchaser at foreclosure (along with redemption fees and related surcharges). For this reason, a property in judicial foreclosure is typically sold at a special discount, which compensates the purchaser for the risk of being forced to sell the property at a specified price to the defaulting borrower under the redemption statutes.

There are thus "pros" and "cons" to each kind of sale. The private sale is far quicker, and gives certain title to the new purchaser, therefore allowing the sales price to be higher, but the lender cannot recover the deficiency for any outstanding balance.

The judicial sale entitles the lender to a deficiency judgment, unless the loan was a purchase-money transaction. At the same time, it entitles the defaulting borrower to redeem his property if he can pay the necessary charges and cure his arrears.

Lastly, a judicial foreclosure is the proper approach when there are several encumbrancers, and dispute has arisen between them as to the priority of their rival liens. In a judicial foreclosure, the court will rule on the order of priority of the competing liens, thereby resolving the dispute.

Tax Consequences. A borrower who is relieved of part of his debt obligation to a lender because of a short-sale, a surrender of his deed, or a foreclosure might have certain tax liabilities in consequence. The forgiveness of the unpaid part of the debt might be deemed "income" to the borrower. A borrower who faces this prospect should confer with his accountant or attorney about the tax consequences arising from the forgiveness of his debt.

Our Example Revisited. To return to our lovely example, in which you find yourself driving north to forget your wife's abandonment and the simultaneous loss of your job under humiliating circumstances, we can now easily apply the above rules. Wells Fargo, having made a purchase-money loan to you, has no interest in convening a judicial foreclosure: It cannot recover any deficiency because the loan was a purchase-money transaction (you used the loan to buy the home). Moreover, the value of your home is so high that Wells Fargo will have its entire loan paid off from the sales proceeds. Moreover, there is no controversy between competing lenders, and therefore no need for any sort of judicial determination of priorities. Wells Fargo will therefore foreclose upon your home by use of a private sale, which will take place 120 days after you first receive a formal notice of your default from Wells Fargo, unless you cure your default in the meantime, or, failing this, convince Wells Fargo to accept your title deed in lieu of foreclosure.

But suppose you encumbered the property not only with the Wells Fargo loan, but also with a second loan from Second Place Loans, Inc., which made a loan to you of $100,000 and secured it by a deed of trust, which was second in priority, after Wells Fargo's deed of trust. In this case, Wells Fargo is said to hold the first deed of trust, and Second Place Loans, Inc. is said to hold the second deed of trust.

If you default on the Wells Fargo debt, and Wells Fargo forecloses, the foreclosure will have the effect of extinguishing Second Place's deed of trust: The foreclosure of a senior lien always has the effect of extinguishing all junior liens. In this event, Second Place will no longer be your secured creditor, but will find that it is merely an unsecured creditor for its entire loan in the exact same manner as, say, Visa is your unsecured creditor for credit-card charges that you have made but not yet paid. Second Place will therefore not allow Wells Fargo to foreclose; it will "cure" your arrears to Wells Fargo rather than suffer the loss of its security, and will make these payments part of your obligation to Second Place; if you fail to meet this obligation, Second Place will foreclose its second deed of trust, and most likely it will use a private sale to conduct its foreclosure, since this is the quickest way to have the property sold and your debt paid.

But suppose the value of the property falls significantly after you take the loan from Second Place. In this instance, Second Place might decide that it is better to conduct a judicial foreclosure, so that after the property is sold it can obtain a judgment against you for the outstanding amount still owed after the sale. Unlike Wells Fargo, Second Place did not make a purchase-money loan to you, and therefore it is entitled to a deficiency judgment if there is a shortfall after the foreclosure sale.

Remember, if the lender uses a private sale, it can only recover the proceeds from the sale of the property, but cannot otherwise recover a penny more of the debt that the borrower might still owe even after the foreclosure sale. But in a judicial foreclosure, the lender is entitled to a deficiency judgment against the borrower for any outstanding amount still owed after the sale of the property. Therefore, a lender might wish to use a judicial foreclosure, despite the long delay that it entails, if there will likely be a significant debt owed on the loan even after the foreclosure, since at a private sale the lender waives this outstanding amount (or "deficiency"), but at a judicial foreclosure the lender gets the foreclosure proceeds, plus a personal judgment against the borrower for any deficiency, so long as the loan was not a purchase-money loan.

Let us again consider that accursed home that you unwisely purchased in the Silicon Valley when you still loved your ex-wife and loyally reported to your ex-boss every day. You will recall that you paid $680,000 for it by making a down-payment of $136,000 and using a Wells Fargo loan of $544,000. Suppose that the foreclosure happens five years later - after you have paid down the loan to, say, $525,000 (typically, you pay mostly interest during the early years of loan repayment, then begin to retire principal more and more quickly as your repayment continues). Suppose that the fair-market value of the home has since risen to, say, $800,000.

You have also taken the second loan for $100,000 from Second Place. You therefore hold $175,000 of equity in the Property - that is, the $800,000 value of the property, less the Wells Fargo encumbrance of $525,000, less the Second Place encumbrance of $100,000.

If you default on the Wells Fargo note but not on the Second Place note, Second Place will cure the Wells Fargo arrears and charge you for it (otherwise, Wells Fargo will foreclose, thereby extinguishing Second Place's second deed of trust). If you fail to pay Second Place for its "service" of curing the Wells Fargo arrears, it will foreclose on the second deed. It will do so by private sale, since the property has enough value to support its lien: A purchaser will pay at least $100,000 to buy the property with the Wells Fargo encumbrance of $525,000. Indeed, a sensible purchaser will be willing to pay up to $200,000 - $250,000 to buy the $800,000 property with the $525,000 encumbrance. In this instance, $100,000 and fees price goes to Second Place, and the remainder, which is called the surplus, is disbursed to junior lienholders in order of priority, with the remainder to you (in our example, there are no such junior lienholders, and therefore the entire surplus would be remitted to you).

But if real estate prices have tumbled since Second Place made its loan, it might elect to conduct a judicial foreclosure, even though it will take a long time to be done, and even though the sales price will be a little lower to account for the defaulting borrower's right of statutory redemption: After the judicial foreclosure, Second Place will receive a judgment against you personally for the outstanding balance.

Say that real estate prices have fallen dramatically: The country has been dragged into a catastrophic depression, and your home is no longer worth $800,000, but rather is worth only $200,000. In this instance, Second Place will conduct the judicial foreclosure, since no one will pay $100,000 (plus the surcharge for curing the Wells Fargo debt) to acquire a $200,000 property that is encumbered by a $525,000 purchase-money loan. After the judicial foreclosure, Second Place will have a deficiency judgment against you for the outstanding amount owed on your obligation.

If you never took a second loan, but merely owe $525,000 to Wells Fargo at the time of foreclosure, Wells Fargo will perform the foreclosure by a private sale, even if the value of the property has fallen far below the amount of the debt, since there can be no deficiency judgment on a purchase-money loan. The rationale for this should by now be clear: If there is a general collapse of the economy, a simple homeowner who borrowed only to purchase his home should not be forever undone by a deficiency judgment for the balance of his loan; his loss should be limited only to the loss of his home, unless he has taken additional loans against it after acquiring title.

The One-Action Rule. In addition to all the foregoing, there is the one-action rule, which requires the lender in a secured loan transaction to foreclose on the real property before seeking to recover the debt from the borrower by any other means, save where the property has become worthless to the lender as a practical matter or where the lender's lien has been extinguished by a prior foreclosure of a senior lien. Unless one of these two exceptions apply, the lender must recover the loan obligation by foreclosing on the property, and cannot use other judicial or even quasi-judicial proceedings in effort to collect the debt: The lender is limited to a foreclosure (a quick private sale or a judicial foreclosure along with a deficiency judgment). This is the one authorized action that a secured lender may properly take, and the entire concept is referred to as the one-action rule. If the lender violates the rule, it might find itself unable to proceed against the borrower at all, or at best it will become an unsecured creditor.

The one-action rule does not apply to claims of fraud that the lender might assert against the borrower, say, for having provided misleading information on his loan application.

Practically speaking, secured lenders who know their business always look first to recover the property by foreclosure, and if they wish to obtain something else from the borrower they conduct a judicial foreclosure and seek a deficiency judgment, and when so doing they have the prerogative to assert claims for fraud against the borrower.

What It All Means. If you find yourself hopelessly confused by all of this, do not despair. The law on foreclosures in California are perplexing and counter-intuitive even to attorneys who specialize in real estate matters. It is easiest to understand the laws if you grasp their underlying principles, which are as follows:

1. No borrower should be forever ruined, or plunged into insuperable debt, merely because he took a single loan to buy a property whose market value later collapsed during a general downturn in real estate values. This explains the one-action rule and the prohibition on deficiency judgments in purchase-money foreclosures: If the borrower defaults, he loses his property to the foreclosing lender, but nothing else. But this also explains why lenders insist upon a substantial down-payment before they will loan money for the purchase of real estate: The lender wants to ensure that the borrower truly has a stake in preserving his title to the property. (Lenders obviously stopped observing this practice during the recent subprime boom, and now the birds have come home to roost!)
2. If the borrower takes a loan for purposes other than the purchase of a property, and he later defaults on the loan, the lender must first foreclose upon the property to satisfy the debt, but can thereafter obtain a deficiency judgment for the balance of the loan. But any such deficiency can be recovered only if the lender uses a judicial foreclosure rather than a private sale. If the lender pursues a judicial foreclosure, the borrower will have the redemption right to buy the property from the purchaser at the foreclosure sale. If the lender uses a private sale, it cannot obtain a deficiency, nor can the borrower redeem the property after the sale. If the lender tries to circumvent all of this, it might find itself barred under the one-action rule from recovering any part of the debt from the borrower, or at best its secured debt will become an unsecured one.
3. A junior lien is extinguished by the foreclosure of a senior lien, but no foreclosure may take place without written notice in the statutory manner to the borrower as well as to all lienholders, who therefore have occasion to cure the default of the senior lien before it is foreclosed.
4. A borrower can slightly mitigate the harm to his credit report and avoid certain foreclosure fees by surrendering his title in lieu of losing it in a foreclosure proceeding. A surrender of the deed at least suggests that the borrower sought to act responsibly when confronted with his inability to pay the loan, but many lenders make the process complicated and use it to (1) force the borrower to continue to make payments on the doomed loan while the request is administered; and (2) determine whether the borrower of a non-purchase-money loan has sufficient means to pay a deficiency. Even so, a defaulting borrower should think twice before deciding to squat in his property until his lender forecloses. This is often a fool's bargain: The borrower gains a short period of free rent, but the ensuing foreclosure is then listed on his record, harming his credit and good name for many years. Yet again, a surrender of the deed also entails significant harm to the borrower's credit, but there is no public record of a foreclosure. Sometimes deliberate squatting is the last best option. Each case turns on its own facts.

I certainly hope that none of my readers ever undergo the indignity of a faithless wife, a conniving boss, or a foreclosure of overpriced real estate that was an insufferable burden all along. If you are a secured lender, I hope you never lose your loan for having failed to follow the foreclosure rules. Lastly, I hope that this short article has provided a useful overview of California's bewildering foreclosure laws.