

## California Supreme Court Allows Deficiency Judgment on Junior Lien

In the recent decision in *Black Sky Capital v. Cobb*, the California Supreme Court held that Code of Civil Procedure, section 580d does not preclude a creditor holding two deeds of trust on the same property from recovering a deficiency judgment on the junior lien that was extinguished by a nonjudicial foreclosure sale on the senior lien.

Under California law, a creditor can recover a debt secured by a deed of trust on real property through a nonjudicial foreclosure action to sell the property at a public auction.

Code of Civil Procedure section 580d provides that a creditor cannot collect a deficiency judgment — that is, the difference between the amount of indebtedness and the fair market value of the property — if the property is sold for less than the amount of the outstanding debt.

The question the Supreme Court considered was: Where a creditor holds two deeds of trust on the same property, can the creditor recover a deficiency judgment on a junior lien extinguished by a nonjudicial foreclosure on the senior lien?

The trial court applied section 580d to bar such a recovery, and the Court of Appeal disagreed and held such deficiency judgment could be recovered.

The Supreme Court affirmed the ruling of the Court of Appeal, and held that under the circumstances in *Black Sky Capital*, section 580d does not preclude a creditor holding two deeds of trust on the same property from recovering a deficiency judgment on the junior lien extinguished by a nonjudicial foreclosure sale on the senior lien.

In 2005, defendants Michael and Kathleen Cobb borrowed approximately \$10 million from Citizens Business Bank by executing a promissory note secured by a deed of trust, on a parcel of commercial property in Rancho Cucamonga. In 2007, the Cobbs borrowed an additional \$1.5 million from Citizens Business Bank by executing a second promissory note secured by a separate deed of trust on the same property.

The second deed of trust said the lien “may be secondary and inferior to the lien securing payment of an existing obligation . . . to Citizens Business Bank described as: First Deed of Trust dated August 18, 2005.”

In 2014, Citizens Business Bank sold both loans to plaintiff Black Sky Capital, LLC (Black Sky), and after Cobbs defaulted on the first trust deed, Black Sky sent the Cobbs a notice of default and election to sell the property under the first deed of trust.

Black Sky acquired the property at a public auction for \$7.5 million, and then filed a lawsuit to recover the amount still owed on the second deed of trust extinguished by the foreclosure sale.

Applying the decision in *Simon v. Superior Court*, which held that section 580d precludes a deficiency judgment for a junior lienholder who was also the foreclosing senior lienholder, the trial court concluded that section 580d bars the monetary judgment sought by Black Sky and granted the Cobbs' motion for summary judgment.

On appeal, the Court of Appeal declined to follow *Simon* in light of the Supreme Court's decision in *Roseleaf Corp. v. Chierighino*, which held that section 580d does not preclude a deficiency judgment for a non-selling junior lienholder.

The Court of Appeal observed that although the senior and junior lienholder are the same, any debt owed on the junior note in this case had no relationship to the debt owed on the senior note, and by no contortion of the definition of a deficiency judgment can the unpaid balance on that note be deemed a deficiency with respect to the senior note, within the meaning of section 580d. Rather, the unambiguous language in section 580d indicates that section 580d applies to a single deed of trust, and it does not apply to preclude Black Sky from suing for the balance due on the junior note.

California has an elaborate and interrelated set of foreclosure and anti-deficiency statutes relating to the enforcement of obligations secured by interests in real property. Most of these statutes were enacted as the result of the Great Depression and the corresponding legislative abhorrence of the all too common foreclosures and forfeitures which occurred during that era for reasons beyond the control of the debtors

Under Code of Civil Procedure section 726, there is only 'one form of action' for the recovery of any debt or the enforcement of any right secured by a mortgage or deed of trust; that action is foreclosure, which may be either judicial or nonjudicial.

In a judicial foreclosure, a creditor may seek a deficiency judgment to recover the difference between the amount of the indebtedness and the fair market value of the property if the property is sold for less than the amount of the outstanding debt. But the debtor has a statutory right of redemption, which provides an opportunity to regain ownership of the property by paying the foreclosure sale price, for a period of time after the foreclosure.

In a nonjudicial foreclosure, also known as a trustee's sale, the creditor exercises the power of sale given by the deed of trust, and the debtor has no statutory right to redemption. But under section 580d, the creditor may not seek a deficiency judgment after a nonjudicial foreclosure.

Section 580d, subdivision (a) provides that no deficiency shall be owed or collected, and no deficiency judgment shall be rendered for a deficiency on a note secured by a deed of trust or mortgage on real property or an estate for years therein executed in any case in which the real property or estate for years therein has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.

Black Sky contended that section 580d does not apply because it is seeking a deficiency on the note secured by the second deed of trust and no sale occurred under power of sale contained in that deed of trust.

The plain language of section 580d, subdivision (a) bars a deficiency judgment on a note secured by a deed of trust on real property when the trustee has sold the property under power of sale contained in "*the . . . deed of trust.*" The definite article in the phrase "the . . . deed of trust" makes clear that the statute applies where sale of the property has occurred under *the deed of trust securing the note sued upon*, and not under some other deed of trust. The phrase refers to the instrument securing the note sued upon. Nothing in the text of section 580d indicates that the statute applies where no sale has occurred under the trust deed securing a junior lien, even if the lien is held by a creditor who has foreclosed on a senior lien on the same property.

Where there is evidence of gamesmanship by the holder of senior and junior liens on the same property, a substantial question would arise whether the two liens held by the same creditor should — in substance, if not in form — be treated as a single lien within the meaning of section 580d. It is unclear that the Legislature, in enacting section 580d, intended to permit such gamesmanship to affect the amount of recovery under a junior lien.

But the Cobbs did not allege, and there was no evidence to suggest, that the two notes in that case arose from intentional loan splitting; they were executed in separate transactions more than two years apart. The bare assertion by the Cobbs that Black Sky's purchase of the property for \$7.5 million at a public auction in October 2014 was substantially less than the appraised value of the Subject Property as of August 1, 2013 — with no evidence of irregularity at the public auction or price stability between the appraisal and auction — is not enough to suggest that \$7.5 million was a lowball bid designed to effect an excessive recovery by obtaining a deficiency judgment on the junior lien.

Where, as in *Black Sky*, there is no allegation of evasive loan splitting or recovery in excess of what any junior lienholder would be able to recover, the Supreme Court saw no reason to depart from a straightforward reading of section 580d. Because no sale occurred under the deed of trust securing the junior note in the case, section 580d did not bar a deficiency judgment on the junior note.

#### LESSONS:

1. Remain aware of Code of Civil Procedure section 580d as its prohibition on deficiency judgments on certain loans is a powerful defense.
2. Having two liens on the same property may allow a deficiency judgment on the junior lien after a foreclosure on the senior lien, unless there is gamesmanship by the lender of evasive loan splitting or recovery in excess of what any junior lienholder would be able to recover.

3. If a deficiency judgment is desired, a judicial foreclosure resulting from a filed legal action is necessary, instead of a nonjudicial foreclosure.