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## Fair-Value Limitations Applied to the Deficiency Judgments of Sold-Out Junior Lienholders: A Critical Analysis of the Courts' Application of California Code of Civil Procedure Sections 580a

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**FAIR-VALUE LIMITATIONS APPLIED TO THE  
DEFICIENCY JUDGMENTS OF SOLD-OUT  
JUNIOR LIENHOLDERS: A CRITICAL  
ANALYSIS OF THE COURTS'  
APPLICATION OF CALIFORNIA CODE OF CIVIL  
PROCEDURE SECTION 580a**

I. INTRODUCTION

California Code of Civil Procedure Section 580a<sup>1</sup> was once considered the dormant antideficiency statute.<sup>2</sup> Born of the Great Depression, section 580a was virtually obsolete from 1939 until 1981.<sup>3</sup> Revitalized, however, this statute has become a formidable weapon in the hands of

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1. CAL. CIV. PROC. CODE § 580a (West Supp. 1989). Section 580a provides in pertinent part:

Whenever a money judgment is sought for the balance due upon an obligation for the payment of which a deed of trust or mortgage with power of sale upon real property or any interest therein was given as security, following the exercise of the power of sale in such deed of trust or mortgage, the plaintiff shall set forth in his or her complaint the entire amount of the indebtedness which was secured by the deed of trust or mortgage at the time of sale, the amount for which the real property or interest therein was sold and the fair market value thereof at the date of sale and the date of that sale. . . . Before rendering any judgment the court shall find the fair market value of the real property, or interest therein sold, at the time of sale. The court may render judgment for not more than the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value of the real property or interest therein sold at the time of sale with interest thereon from the date of the sale; provided, however, that in no event shall the amount of the judgment, exclusive of interest after the date of sale, exceed the difference between the amount for which the property was sold and the entire amount of the indebtedness secured by the deed of trust or mortgage. Any such action must be brought within three months of the time of sale under the deed of trust or mortgage. No judgment shall be rendered in any such action until the real property or interest therein has first been sold pursuant to the terms of the deed of trust or mortgage, unless the real property or interest therein has become valueless.

*Id.*

2. One commentator notes that "[t]he author has found no reported California decisions applying section 580a as the Legislature intended." Mertens, *California's Foreclosure Statutes: Some Proposals for Reform*, 26 SANTA CLARA L. REV. 533, 542 (1986); see also Arnold, *Anti-Deficiency in the Eighties: The "Sanction Aspect," Fair Value and Where the Action Is (And Isn't)*, 5 CAL. REAL PROP. J., Spring 1987, 1, 18 ("However, since the 1939 passage of CCP § 580d . . . Section 580a has been generally irrelevant.").

3. See Leipziger, *Deficiency Judgments in California: The Supreme Court Tries Again*, 22 UCLA L. REV. 753, n.1 (1975); Mertens, *supra* note 2, at 534 & n.10; see also R. BERNHARDT, CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE § 4.18 (1979 & Supp. 1988); J. HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS § 6.1 (1970).

debtors.<sup>4</sup> This Comment analyzes the recent application of section 580a to limit the deficiency judgments of sold-out junior lienholders (SOJLs) who purchase the real property forming their security at non-judicial foreclosure sales.<sup>5</sup>

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4. This Comment discusses the ways that debtors use and attempt to use section 580a, and the courts' willingness to see debtors' perspectives.

5. The reader who is not versed in the language of real estate secured transactions may find it difficult to consider the provisions of section 580a without first being familiar with some of the terminology used in this technical area of law. The following hypothetical illustrates some basic concepts:

Assume debtor (D) purchases commercial property for \$100,000. D pays \$25,000 in cash as a down payment, and gives the seller (S) a promissory note for \$75,000, putting up the property as collateral for the loan. S takes back a thirty-year promissory note, and a first trust deed on the property that evidences S's security interest. (Since S is the first lienholder to record its security interest on the property, it becomes the "senior lienholder.")

Having purchased the property, D needs to develop the land for business uses. Since D put all available capital into the down payment, D takes out a construction loan in the amount of \$25,000 from 1st Hypothetical Bank. In exchange for this loan, 1st Hypothetical Bank takes back a note and a second trust deed (thus, becoming a "junior lienholder" (J)). Soon after construction is completed, D defaults on the note held by S. Pursuant to the note, S "accelerates" D's obligation (calls the entire debt due immediately), but D is unable to pay.

In order to recover its \$75,000 debt, S must foreclose on the property. *See* *Western Fuel Co. v. Sanford G. Lewald Co.*, 190 Cal. 25, 210 P. 419 (1922); *Barbieri v. Ramelli*, 84 Cal. 154, 156, 23 P. 1086, 1087 (1890); CAL. CIV. PROC. CODE § 726 (West Supp. 1989). However, the lienholder has the option of foreclosing "judicially," CAL. CIV. PROC. CODE § 726, or "non-judicially" under the "power of sale" clause contained in the trust deed. CAL. CIV. PROC. CODE § 2924 (West Supp. 1989) (lienholder's right to foreclose non-judicially under power of sale and procedures for non-judicial foreclosure). In a judicial foreclosure, S can recover a deficiency judgment against D if the property is sold for less than the amount due on S's note. CAL. CIV. PROC. CODE § 726 (West Supp. 1989). However, real property sold pursuant to a judicial foreclosure is subject to the debtor's statutory right of redemption (in other words, debtor can buy property back from purchaser at foreclosure sale for certain period of time following sale). CAL. CIV. PROC. CODE § 729.010-729.080 (West Supp. 1989) (debtor's post-sale statutory right of redemption). After a non-judicial foreclosure sale, there is no statutory right of redemption, but the selling lienholder cannot sue the debtor for a deficiency if the property sells for less than the amount due on the note. CAL. CIV. PROC. CODE § 580d (West 1976).

Further assume that S forecloses non-judicially, selling the property to J at the foreclosure sale for \$75,000 (the amount of J's debt). Since the property is sold for less than the amount needed to fully compensate J, J is a "sold-out" junior lienholder (SOJL) (J's lien, being junior to S's, is extinguished by the foreclosure sale). *See infra* note 12 and accompanying text. However, since J is not the *selling* lienholder, it may sue D for a deficiency judgment. *See infra* note 15 and accompanying text. The issue in this Comment is whether D may defend such an action by arguing that the real property was sold for less than its fair market value, thereby limiting the deficiency that D will have to pay to J. *See Spangler v. Memel*, 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr. 807 (1972), for a similar fact pattern. The primary difference between the facts in *Spangler* and the above hypothetical is that the seller in *Spangler* "subordinated" (contractually waived her priority) to the construction lender. *Id.* at 606, 498 P.2d at 1056, 102 Cal. Rptr. at 808.

A. *The Operation and Effect of Section 580a*

Section 580a<sup>6</sup> is an antideficiency statute. When debtors<sup>7</sup> default on their obligations to pay lienholders, the lienholders have the option of several remedies, including foreclosure of the mortgage or trust deed.<sup>8</sup> After a foreclosure sale, which may be effected judicially or non-judicially,<sup>9</sup> one of three situations may exist. First, the amount bid on the property at the foreclosure sale may be exactly the amount necessary to extinguish all lienholders' liens. Second, the amount bid may be greater than the amount necessary to extinguish the lienholders' liens. This is called a "surplus."<sup>10</sup> Finally, the amount bid may be less than the amount necessary to extinguish the lienholders' liens. This is called a "deficiency."

Either the selling lienholder<sup>11</sup> or a junior lienholder may have a deficiency. The selling lienholder's deficiency results from a bid amount that is less than the amount of its debt. The junior lienholder's deficiency results from a bid amount that is not great enough to extinguish the debts of both the selling lienholder and the junior. Thus, after the foreclosure sale, the junior lienholder's entire debt may remain, or a part of that debt. However, the foreclosure sale extinguishes all junior liens.<sup>12</sup> The result is that the junior lienholder is "sold-out" by the selling lienholder's foreclosure, and the property no longer secures the debt of the "sold-out" junior lienholder (SOJL).

A lienholder who has a deficiency after a judicial foreclosure sale

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6. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

7. In this Comment, "debtor" will be used synonymously with "mortgagor" and the trustee on a trust deed. "Lienholder" will be used synonymously with "mortgagee" and the beneficiary of a trust deed.

8. CAL. CIV. PROC. CODE § 726 (West Supp. 1989); *see* *Passanisi v. Merit-McBride Realtors*, 190 Cal. App. 3d 1496, 1505-06, 236 Cal. Rptr. 59, 62 (1987). Other options include negotiating a deed in lieu of foreclosure, suing a guarantor on the guarantee or effecting a "workout." However, under section 726 of the California Code of Civil Procedure, a creditor whose debt is secured by real property cannot sue a debtor directly on the note until after a foreclosure. CAL. CIV. PROC. CODE § 726 (West Supp. 1989).

9. A non-judicial foreclosure sale is often referred to as a foreclosure under the lienholder's "power of sale." "Power of sale" is the terminology used in section 580a. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

10. For the purposes of this Comment, "surplus" refers to any proceeds received for the property at the foreclosure sale in excess of the amount of the foreclosing lienholder's lien. Surplus proceeds are distributed first to junior secured creditors and then, if a surplus remains, to the debtor. *See* 1 H. MILLER & M. STARR, *CURRENT LAW OF CALIFORNIA REAL ESTATE* § 3:120 (1975).

11. The terms "selling lienholder" and "foreclosing lienholder" are synonymous for the purposes of this Comment.

12. CAL. CIV. CODE § 1214 (West 1982); *see also* *Rheem Mfg. Co. v. United States*, 57 Cal. 2d 621, 371 P.2d 578, 21 Cal. Rptr. 802 (1962).

can sue the debtor directly on the note.<sup>13</sup> Prior to 1939,<sup>14</sup> the selling lienholder and SOJL could sue the debtor for deficiencies on the notes after a non-judicial foreclosure sale as well.<sup>15</sup> Section 580a required the selling lienholder to sue the debtor for a deficiency judgment within three months after the foreclosure sale.<sup>16</sup> Moreover, section 580a provided that the selling lienholder's deficiency would be limited by the "fair market value" of the real property sold at the foreclosure sale.<sup>17</sup> Thus, section 580a operated as an affirmative defense to the selling lienholder's action for a deficiency judgment on the note.

Section 580a was considered inapplicable to SOJLs.<sup>18</sup> The plain language of the statute indicates that it applies solely to the selling lienholder.<sup>19</sup> The statute goes into effect "following the exercise of the power of sale in *such* deed of trust or mortgage. . . ."<sup>20</sup> Only selling lienholders exercise their powers of sale; the SOJL's lien is extinguished by the selling lienholder's foreclosure.<sup>21</sup> Thus, since SOJLs cannot exercise their powers of sale, the express language of the statute supports the contention that section 580a was intended only to apply to selling lienholders after a non-judicial foreclosure.<sup>22</sup> If the California Legislature had intended this section to limit the deficiency judgments of SOJLs, it easily could have substituted the language "any deed of trust or mortgage" for "such deed of trust or mortgage." Then, arguably, section 580a could limit a deficiency by any lienholder after the selling lienholder's non-judicial foreclosure.

Thus, prior to 1939, a debtor could assert section 580a as an affirma-

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13. CAL. CIV. PROC. CODE § 726 (West Supp. 1989). The lienholder could sue a guarantor on the guarantee if one exists. *See, e.g.,* Everts v. Matteson, 21 Cal. 2d 437, 132 P.2d 476 (1943); R. BERNHARDT, *supra* note 3, § 4.44. However, the lienholder may not be able to recover from the guarantor if the guarantor ultimately is liable as a debtor as well. This generally results when a lienholder takes a guarantee from the general partners of a debtor partnership. *See* Union Bank v. Dorn, 254 Cal. App. 2d 157, 159, 61 Cal. Rptr. 893, 894 (1967); Riddle v. Lushing, 203 Cal. App. 2d 831, 836, 21 Cal. Rptr. 902, 904-05 (1962).

14. In 1939, the California Legislature enacted section 580d of the Code of Civil Procedure. 1939 Cal. Stat. 1991 (codified as amended at CAL. CIV. PROC. CODE § 580d (West 1976)). This section prohibited selling lienholders from seeking a deficiency judgment after non-judicial foreclosures. *See infra* notes 61-65 and accompanying text for a discussion of section 580d.

15. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

16. *Id.*

17. *Id.*

18. *See* Roseleaf Corp. v. Chierighino, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

19. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

20. *Id.* (emphasis added).

21. *See supra* note 12 and accompanying text.

22. *See* Arnold, *supra* note 2, at 19.

tive defense against a selling lienholder's action for a deficiency judgment, but not against an SOJL. Between 1939 and 1981, section 580a was essentially dormant.<sup>23</sup> The controversy addressed in this Comment, however, began in 1981 when the Ninth Circuit Court of Appeals applied the fair-value limitation of section 580a to an SOJL who purchased the secured property at a non-judicial foreclosure sale (purchasing SOJL).<sup>24</sup>

*B. The Controversy over the Application of Section 580a to Purchasing Sold-Out Junior Lienholders: Cases and Policies*

Originally, the California Supreme Court held that section 580a was not applicable to SOJLs. In *Roseleaf Corp. v. Chierighino*,<sup>25</sup> the California Supreme Court stated that section 580a was intended to apply only to selling lienholders.<sup>26</sup> Moreover, the court found that SOJLs are more like debtors than selling lienholders because both the SOJLs and the debtors must invest additional funds to purchase the property at the foreclosure sale.<sup>27</sup> In contrast, selling lienholders could purchase the property by "credit-bidding" against their debts.<sup>28</sup> Thus, California law permitted any SOJL to purchase the property and subsequently sue the debtor for a deficiency that would not be limited by the fair-value provision of section 580a.<sup>29</sup>

A subsequent California Court of Appeal case expanded on *Roseleaf*

23. See Arnold, *supra* note 2, at 18 ("[S]ince the 1939 passage of CCP § 580d . . . Section 580a has been generally irrelevant, especially with regard to a defaulting trustor who executed a note secured by real property."); Mertens, *supra* note 2, at 534 ("In 1939, however, section 580d was enacted barring all deficiency judgments after a nonjudicial foreclosure, thereby rendering section 580a obsolete."); see also R. BERNHARDT, *supra* note 3, § 4.18 ("[T]he enactment of § 580d created a complete bar to any deficiency judgment after a private sale, preempting § 580a in most, if not all, situations.").

24. *Bank of Hemet v. United States*, 643 F.2d 661 (1981). See *infra* notes 144-70 and accompanying text for a detailed analysis of *Bank of Hemet*.

25. 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

26. *Id.* at 40, 378 P.2d at 99, 27 Cal. Rptr. at 875 ("The purpose of the fair-value limitations in sections 580a and 726 does not extend to sold-out junior lienors. . . . Fair-value provisions are designed to prevent creditors from buying in at *their own* sales at deflated prices and realizing double recoveries by holding debtors for large deficiencies.") (emphasis added).

27. *Id.* at 39, 378 P.2d at 99, 27 Cal. Rptr. at 875 ("The fair-value limitations of sections 580a and 726 likewise do not apply to a junior lienor . . . whose security has been rendered valueless by a senior sale.").

28. "Credit-bid" refers to foreclosing creditors' right to bid against their debts rather than pay cash to buy the property at the foreclosure sale. See R. BERNHARDT, *supra* note 3, § 6.23. Non-selling lienholders are not permitted to credit-bid; rather, they must pay cash. *Nomellini Constr. Co. v. Modesto Sav. & Loan Ass'n*, 275 Cal. App. 2d 114, 115, 79 Cal. Rptr. 717, 719 (1969); *Investcal Realty Corp. v. Edgar H. Mueller Constr. Co.*, 247 Cal. App. 2d 190, 197, 55 Cal. Rptr. 475, 480 (1966).

29. *Roseleaf*, 59 Cal. 2d at 39, 378 P.2d at 99, 27 Cal. Rptr. at 875.

by refusing to apply section 580a to a purchasing SOJL who sought a deficiency by foreclosing on additional security. In *Dickey v. Williams*,<sup>30</sup> the court refused to limit a purchasing SOJL's deficiency even though the property was purchased at a price well below the fair-market value. The court reasoned that the purchasing SOJL was taking advantage of an opportunity which was equally available to any "stranger" at the foreclosure sale.<sup>31</sup>

However, beginning in 1981, the courts perceived a distinction between a purchasing SOJL and a non-purchasing SOJL.<sup>32</sup> The basis of this distinction seems to be that, unlike the non-purchasing SOJL, the purchasing SOJL may resell the property later to recover the debt.<sup>33</sup> Thus, these courts argued that purchasing SOJLs should be precluded from recovering the difference between the fair value and the amount of the senior lienholder's debt that the SOJL paid at the sale.<sup>34</sup> Based upon this policy, the Ninth Circuit Court of Appeals applied the fair-value limitation of section 580a to a purchasing SOJL in *Bank of Hemet v. United States*.<sup>35</sup> Although some question exists as to the legitimacy of the Ninth Circuit's decision in light of *Roseleaf*,<sup>36</sup> the California Court of Appeal ratified the policies enunciated by the Ninth Circuit's *Bank of Hemet* decision in *Walter E. Heller Western, Inc. v. Bloxham*.<sup>37</sup>

*Heller Western* is the sole California case to apply section 580a to purchasing SOJLs. Nonetheless, *Heller Western* has had a considerable effect on California real estate secured transactions law.<sup>38</sup> The *Heller Western* court relied on the Ninth Circuit's reasoning and thereby validated *Bank of Hemet* as a proper interpretation of California law.<sup>39</sup>

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30. 240 Cal. App. 2d 270, 49 Cal. Rptr. 529 (1966).

31. *Id.* at 272, 49 Cal. Rptr. at 531.

32. See *Bank of Hemet v. United States*, 643 F.2d 661, 668-69 (1981); *Walter E. Heller Western, Inc. v. Bloxham*, 176 Cal. App. 3d 266, 272-74, 221 Cal. Rptr. 425, 428-29 (1985); see also *infra* notes 136-38 and accompanying text.

33. *Bank of Hemet*, 643 F.2d at 669.

34. See, e.g., *Bank of Hemet*, 643 F.2d at 669; *Heller Western*, 176 Cal. App. 3d at 273-74, 221 Cal. Rptr. at 429-30.

35. 643 F.2d 661 (9th Cir. 1981).

36. See *infra* notes 165-70 and accompanying text.

37. 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

38. See *Arnold*, *supra* note 2, at 18 ("Despite the holding of *Roseleaf*, Section 580a has since been deemed to apply on two occasions to a sold-out junior lienor in what might be colloquially described as the judicial equivalent of resurrection."); see also R. BERNHARDT, *supra* note 3, § 4.31 ("[The *Bank of Hemet v. United States*] approach was then adopted in California in *Walter E. Heller Western, Inc. v. Bloxham* . . .").

39. *Heller Western*, 176 Cal. App. 3d at 274, 221 Cal. Rptr. at 429 ("To so limit the deficiency judgment right is consistent with the general purpose of section 580a . . .") (citing *Bank of Hemet v. United States*, 643 F.2d 661, 669 (9th Cir. 1981)).

Although *Heller Western* was a marked departure from earlier state court decisions interpreting California secured transactions law,<sup>40</sup> the California Supreme Court did not review this decision.

The California Supreme Court's failure to settle this matter invited disagreement in the court of appeal. Just two years after *Heller Western*, a court of appeal decided *Pacific Loan Management v. Superior Court*.<sup>41</sup> *Pacific Loan Management* involved an SOJL who overbid on the property at the foreclosure sale and sought to have the debt satisfied out of the surplus proceeds.<sup>42</sup> The court disagreed with some of the policies enunciated by *Heller Western*.<sup>43</sup> Nonetheless, the *Pacific Loan Management* court also appeared to adopt *Heller Western* in dicta.<sup>44</sup> Thus, *Heller Western* is still the most current statement of California law on the application of section 580a to purchasing SOJLs who seek deficiency judgments.

Currently, *Heller Western*'s application of section 580a limits purchasing SOJLs' *out-of-pocket* deficiency judgments after non-judicial foreclosure sales.<sup>45</sup> However, *Pacific Loan Management* permits the purchasing SOJL to circumvent this problem by either (1) taking security interests in multiple parcels, thereby giving the purchasing SOJL flexibility of action;<sup>46</sup> or (2) being over-secured,<sup>47</sup> thereby increasing the likeli-

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40. See, e.g., *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963); *Investcal Realty Corp. v. Edgar H. Mueller Constr. Co.*, 247 Cal. App. 2d 190, 55 Cal. Rptr. 475 (1966); *Dickey v. Williams*, 240 Cal. App. 2d 270, 49 Cal. Rptr. 529 (1966).

41. 196 Cal. App. 3d 1485, 242 Cal. Rptr. 547 (1987).

42. *Id.* at 1488, 242 Cal. Rptr. at 548. Surplus proceeds result when the property is sold for more than the amount of the selling lienholder's lien. See *supra* note 10 and accompanying text.

43. 196 Cal. App. 3d at 1494, 242 Cal. Rptr. at 552-53.

44. *Id.* at 1495 & n.3; 242 Cal. Rptr. at 553 & n.3.

45. As used in this Comment, an "out-of-pocket" deficiency is one which the debtor must pay directly to the creditor (such as a judgment) as distinguished from a recovery out of funds which the debtor already has made available to the creditor (such as additional collateral) or which come from the creditor himself (such as when the creditor overbids on the property). Thus, despite *Heller Western* and *Bank of Hemet*, a purchasing SOJL may foreclose on additional security or recover the surplus proceeds from the sale. See *Investcal*, 247 Cal. App. 2d at 198-99, 55 Cal. Rptr. at 481; *Dickey*, 240 Cal. App. 2d at 271-72, 49 Cal. Rptr. at 530-31.

46. See *Dickey*, 240 Cal. App. 2d at 271-72, 49 Cal. Rptr. at 530-31. The SOJL can purchase the first parcel for less than the fair value and subsequently foreclose on the additional security. *Id.* If their debts are not satisfied out of the proceeds of the sale, SOJLs can get a deficiency judgment under the following circumstances: (1) they do not purchase the second parcel; or (2) they pay the fair value for the second parcel. See, e.g., *Investcal*, 247 Cal. App. 2d at 198-99, 55 Cal. Rptr. at 481; *Dickey*, 240 Cal. App. 2d at 271-72, 49 Cal. Rptr. at 530-31.

47. Creditors may be over-secured in one of two ways: (1) they may take a security interest in one parcel of property having an unencumbered value which is greater than the amount of the debt; or (2) they may take a security interest in multiple parcels of property which have



hood that the security will be sufficient to satisfy the SOJL's debt.<sup>48</sup>

This Comment suggests that *Bank of Hemet* and *Heller Western* are based on conclusionary reasoning and result in consequences that harm the interests of both debtors and lienholders. The Author therefore proposes that section 580a be repealed and, consequently, both purchasing and non-purchasing SOJLs be permitted to recover full deficiency judgments.<sup>49</sup>

Part II examines section 580a's context and purpose in the scheme of California antideficiency legislation. Part III then analyzes the case law in light of the purpose of the statute and the policies guiding the decisions of the respective courts. Finally, Part IV raises new policy concerns over the current state of the law in this area.

## II. SECTION 580A IN THE SCHEME OF CALIFORNIA ANTIDEFICIENCY LEGISLATION

California antideficiency legislation currently consists of four statutes: Code of Civil Procedure sections 580a,<sup>50</sup> 580b,<sup>51</sup> 580d<sup>52</sup> and 726.<sup>53</sup> Section 726,<sup>54</sup> enacted in 1872,<sup>55</sup> is considered to be the "linchpin" of the

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a combined unencumbered value greater than the amount of the debt. *See, e.g., Investcal*, 247 Cal. App. 2d at 198-99, 55 Cal. Rptr. at 481; *Dickey*, 240 Cal. App. 2d at 271-72, 49 Cal. Rptr. at 530-31.

48. *See Hatch v. Security First Nat'l Bank*, 19 Cal. 2d 254, 120 P.2d 869 (1942). The court stated that "[b]y its express terms, [section 580a] is concerned only with actions to recover deficiency judgments after the security is exhausted . . ." *Id.* at 261, 120 P.2d at 873. The court held that "since the defendant has at no time attempted to secure a deficiency judgment against anyone . . . section 580a is not applicable. It imposes no requirement which would invalidate the [sale of the additional security]." *Id.* at 262, 120 P.2d at 874. Of course, if all of the SOJL's real property collateral has been exhausted by selling lienholder foreclosures, then the SOJL can sue for a deficiency judgment. *See Roseleaf*, 59 Cal. 2d at 38, 378 P.2d at 98, 27 Cal. Rptr. at 874; *see also Savings Bank v. Central Mkt. Co.*, 122 Cal. 28, 63 P. 165 (1898).

The purchasing SOJL may be able to protect himself in other ways as well. Currently, section 580a does not protect guarantors. *See Everts v. Matteson*, 21 Cal. 2d 437, 132 P.2d 476 (1942); *Bank of Am. v. Hunter*, 8 Cal. 2d 592, 67 P.2d 99 (1937); *Mariners Sav. & Loan Ass'n v. Neil*, 22 Cal. App. 3d 232, 99 Cal. Rptr. 238 (1971); *Security-First Nat'l Bank v. Chapman*, 41 Cal. App. 2d 219, 106 P.2d 431 (1940). However, this rule came under attack in *Union Bank v. Gradsky*, 265 Cal. App. 2d 40, 71 Cal. Rptr. 64 (1968). *See also Mertens, supra* note 2, at 561-69.

49. Section 580b would still create an exception for applicable purchase-money residential property. CAL. CIV. PROC. CODE § 580b (West 1976).

50. *Id.* § 580a (West Supp. 1989).

51. *Id.* § 580b (West 1976).

52. *Id.* § 580d (West 1976).

53. *Id.* § 726 (West Supp. 1989).

54. *Id.*

55. CAL. CIV. PROC. CODE § 726. It should be noted that section 726's fair-value limitation was not added until 1933. 1933 Cal. Stat. 2118.

entire scheme.<sup>56</sup> Section 726 contains two primary subsections. Subsection 726(a)<sup>57</sup> is called the "one-action statute" because it requires creditors who are secured by mortgages or deeds of trust to extinguish their security<sup>58</sup> prior to suing the debtor on the note.<sup>59</sup> Subsection 726(b),<sup>60</sup> which goes into effect following a judicial foreclosure, contains a fair-value limitation<sup>61</sup> and a time limitation for filing an action against the debtor for a deficiency judgment.<sup>62</sup>

In 1933, the California Legislature enacted sections 580a<sup>63</sup> and 580b<sup>64</sup> as a direct result of the financial hardship of the Great Depression.<sup>65</sup> The economic realities of the period pushed many debtors into

56. Hetland & Hansen, *The "Mixed Collateral" Amendments to California's Commercial Code—Covert Repeal of California's Real Property Foreclosure and Antideficiency Provisions or Exercise in Futility?*, 75 CALIF. L. REV. 185, 195 (1987). In response to this article, see Hirsch, Arnold, Rabin & Sigman, *The U.C.C. Mixed Collateral Statute—Has Paradise Really Been Lost?*, 36 UCLA L. REV. 1 (1988).

57. CAL. CIV. PROC. CODE § 726(a) (West Supp. 1989).

58. When a senior lienholder forecloses on property, the junior liens are "extinguished." See *Rheem Mfg. Co. v. United States*, 57 Cal. 2d 621, 371 P.2d 578, 21 Cal. Rptr. 802 (1962). Thus, the purchaser at a foreclosure sale only takes "subject to" liens senior to the selling lienholder's. See CAL. CIV. PROC. CODE § 1214 (West 1982).

59. *Barbieri v. Ramelli*, 84 Cal. 154, 156, 23 P. 1086, 1087 (1890).

60. CAL. CIV. PROC. CODE § 726(b) (West Supp. 1989). Subsection 726(b) was enacted in 1933. 1933 Cal. Stat. 2118.

61. Under California case law, fair value is defined as "intrinsic value." *Rainer Mortgage v. Silverwood, Ltd.*, 163 Cal. App. 3d 359, 366, 209 Cal. Rptr. 294, 298 (1985) ("The 'fair value' of foreclosed property is thus its intrinsic value. Under normal conditions this intrinsic value will often coincide with its fair market value; the value a willing purchaser will pay to a willing seller in an open market.").

62. CAL. CIV. PROC. CODE § 726(b) (West Supp. 1989). Section 580a and subsection 726(b) both contain a fair-value limitation and a time limitation for filing an action against the debtor for a deficiency judgment. *Id.* §§ 580a, 726(b) (West Supp. 1989). The primary difference between the corresponding provisions of section 580a and subsection 726(b) is that section 580a applies to non-judicial foreclosures (those which are held under the lienholder's power of sale), and subsection 726(b) applies to judicial foreclosures (those which are supervised by the court). Thus, cases often discuss these code sections together and analogies between the two sections are easily drawn. See, e.g., *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 39, 378 P.2d 97, 99, 27 Cal. Rptr. 873, 875 (1963).

63. 1933 Cal. Stat. 1669, 1672 (codified as amended at CAL. CIV. PROC. CODE § 580a (West Supp. 1989)). This section is similar to subsection 726(b) in that it contains a fair-value limitation and a time limitation within which a secured creditor must sue on the note for a deficiency judgment. *Id.*; see also *supra* note 62.

64. 1933 Cal. Stat. 1669, 1673 (codified as amended at CAL. CIV. PROC. CODE § 580b (West 1976)). See *infra* notes 77-84 and accompanying text for a discussion of section 580b.

65. *Hatch v. Security First Nat'l Bank of Los Angeles*, 19 Cal. 2d 254, 259, 120 P.2d 869, 873 (1942) ("The evil which led to the enactment of this legislation became pronounced during the recent period of economic depression . . ."). See also *Arnold, supra* note 2, at 1 ("Section 580b and the 'fair value' limitations on deficiency judgments imposed by CCP Sections 580a and 726 were both added in 1933 as a response to the economic chaos of the Depression era.");

default and caused a general decline in real property values.<sup>66</sup> Selling lienholders could sell property at non-judicial foreclosure sales and "credit-bid"<sup>67</sup> against their debts for the lowest amount necessary to purchase the property.<sup>68</sup> Consequently, the selling lienholder would own the property, usually buying it for much less than the debtor owed on the note.<sup>69</sup> The lienholder could then sue the debtor for a deficiency judgment.<sup>70</sup> As a result, the debtor would lose the property and still owe the selling lienholder a substantial amount of money.<sup>71</sup> Sections 580a and 580b were enacted to prevent or mitigate the effect of this practice.<sup>72</sup>

By limiting the purchasing lienholder's deficiency judgment to the difference between the amount owed on the note and the fair value of the property, section 580a<sup>73</sup> created an incentive for selling lienholders to sell property for a price reasonably close to the amount of their security interests.<sup>74</sup> Selling lienholders who credit-bid for less than the full amount of their security interests at the non-judicial foreclosure sales had their deficiency judgments limited to the difference between the amount of the security interest and the fair value of the property, not the amount bid at the sale.<sup>75</sup> Thus, where a credit-bid was less than the fair value of the property, section 580a created the legal fiction that the bid was for the fair value of the property—regardless of the actual bid.<sup>76</sup>

Section 580b<sup>77</sup> attacked the problem more directly.<sup>78</sup> It prohibits

Mertens, *supra* note 2, at 533; Note, *California Fair Value Limitations Applied to Non-Foreclosing Junior Lienholder*, 12 GOLDEN GATE U.L. REV. 317, 319 (1982).

66. See Hetland, *Deficiency Judgment Limitations in California—A New Judicial Approach*, 51 CALIF. L. REV. 1, 2-3 (1963); Hetland & Hansen, *supra* note 56, at 187-88; Mertens, *supra* note 2, at 541. See also R. BERNHARDT, *supra* note 3, § 4.16.

67. See *supra* note 28 for a definition of "credit-bid."

68. See R. BERNHARDT, *supra* note 3, §§ 4.16, 6.23.

69. See Hetland, *Deficiency Judgment Limitations in California—A New Judicial Approach*, 51 CALIF. L. REV. 1, 2-3 (1963); Hetland & Hansen, *supra* note 56, at 187-88; Mertens, *supra* note 2, at 541. See also R. BERNHARDT, *supra* note 3, at § 4.16.

70. Mertens, *supra* note 2, at 541.

71. *Id.*

72. *Roseleaf*, 59 Cal. 2d at 40, 378 P.2d at 99, 27 Cal. Rptr. at 875; *Hatch*, 19 Cal. 2d at 259, 120 P.2d at 872.

73. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

74. Section 580a was designed to "prevent creditors from buying in at their own sales at deflated prices and realizing double recoveries by holding debtors for large deficiencies." *Roseleaf*, 59 Cal. 2d at 40, 378 P.2d at 99, 27 Cal. Rptr. at 875. Once a selling lienholder credit-bids the amount of the debt, the debt is extinguished and no action for a deficiency will lie against the debtor. See R. BERNHARDT, *supra* note 3, §§ 5.24, 6.26.

75. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

76. *Id.*

77. CAL. CIV. PROC. CODE § 580b (West 1976).

78. Section 580b provides in pertinent part:

any deficiency judgment after a foreclosure of a "purchase money"<sup>79</sup> mortgage or deed of trust (1) consisting of vendor financing or (2) on owner-occupied residential property for four families or less.<sup>80</sup> The practical effect of this rule is to prevent "down on their luck" homeowners from being displaced and disabled by large deficiency judgments.<sup>81</sup> These purchase-money debtors will lose the property, but they will not be burdened by the remaining debt. Thus, section 580b protects residential homeowners from deficiency judgments.<sup>82</sup>

The purpose of section 580b is to prevent vendors of residential property from overvaluing real property security.<sup>83</sup> In the standard residential transactions, where potential homeowners borrow purchase-money from institutional lenders, accurate valuation is accomplished indirectly by placing the risk of inadequate security on the lenders.<sup>84</sup> Theoretically, since these purchase-money lienholders cannot seek deficiency judgments, they may refuse to lend potential vendors more than the lienholders expect to recover from the property, resulting in a cap on the property's value. The vendor could still overvalue the property by requiring the vendee to pay more than the standard down payment; how-

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No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale, or under a deed of trust, or mortgage, given to the vendor to secure payment of the balance of the purchase price of real property . . . on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of such dwelling occupied, entirely or in part, by the purchaser.

CAL. CIV. PROC. CODE § 580b (West 1976).

79. "Purchase money" transactions are those in which the loan proceeds are applied towards the purchase price of the property on which the lender has taken a security interest. R. BERNHARDT, *supra* note 3, § 1.1. There are two kinds of purchase money liens: vendors' liens and third-party liens. Vendors' liens result when the seller of the property finances some or all of the purchase price of the property. *Id.* § 4.26. Third-party liens result when a third-party lender finances the purchase of property. *Id.*

80. CAL. CIV. PROC. CODE § 580b (West 1976).

81. Professor Hetland notes:

"The real property [foreclosure] system bears the indelible stamp of cases involving security interests in both residential and business property where foreclosure can result not only in a dramatic forfeiture of most or all of the mortgagor's personal worth but also may result in a deprivation of such basic necessities as shelter and the means of earning a livelihood."

Hetland & Hansen, *supra* note 56, at 188.

82. *Id.* Section 580b is indirectly relevant to the focus of this Comment. Since section 580b protects the residential homeowner from deficiency judgments, the courts' application of section 580a to purchasing SOJLs primarily impacts commercial transactions. *See, e.g.*, R. BERNHARDT, *supra* note 3, § 4.26. Thus, the policies of the courts discussed below must be considered in light of the parties that the courts are protecting.

83. Spangler v. Memel, 7 Cal. 3d 603, 612, 498 P.2d 1055, 1060-61, 102 Cal. Rptr. 807, 812-13 (1972); *Roseleaf*, 59 Cal. 2d at 42, 378 P.2d at 101, 27 Cal. Rptr. at 877.

84. *Spangler*, 7 Cal. 3d at 612, 498 P.2d at 1060-61, 102 Cal. Rptr. at 812-13; *Roseleaf*, 59 Cal. 2d at 42, 378 P.2d at 101, 27 Cal. Rptr. at 877.

ever, the lienholder's appraisal amount and refusal to lend at a standard loan-to-value ratio would still warn the vendee that the vendor has overvalued the property.

Enacted in 1939,<sup>85</sup> section 580d<sup>86</sup> was the California Legislature's last antideficiency statute.<sup>87</sup> Section 580d prohibits *any* deficiency judgment by a selling lienholder after a non-judicial foreclosure.<sup>88</sup> Thus, this provision implicitly appears to repeal section 580a. Lienholders cannot be limited by the fair value of the property under section 580a if they are prohibited by section 580d from recovering any deficiency judgment at all. Unfortunately, the California Legislature did not repeal or amend section 580a. This section remained dormant on the books—an outdated law without any clear purpose.<sup>89</sup> More than forty years later, however, a purpose would be found: section 580a would limit the deficiency judgments of purchasing SOJLs.<sup>90</sup>

### III. SECTION 580A AND THE COURTS: A CRITICAL ANALYSIS

#### A. 1933-1979: *The California Courts Clearly Establish that Section 580a Does Not Apply to Purchasing Sold-Out Junior Lienholders*

The major California case considering the application of section 580a<sup>91</sup> to a sold-out junior lienholder (SOJL) was *Roseleaf Corp. v. Chierighino*.<sup>92</sup> Roseleaf Corporation (Roseleaf) sold a hotel to Chierighino who, in return, gave Roseleaf a note secured by a first trust deed on the hotel and three notes secured by second trust deeds on unrelated real

85. 1939 Cal. Stat. 1991 (codified as amended at CAL. CIV. PROC. CODE § 580d (West 1976)).

86. CAL. CIV. PROC. CODE § 580d (West 1976). Section 580d provides in pertinent part:

No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property . . . in any case in which the real property has been sold by the mortgagee or trustee under power of sale contained in such mortgage or deed of trust.

*Id.*

87. See R. BERNHARDT, *supra* note 3, § 4.12.

88. CAL. CIV. PROC. CODE § 580d (West 1976). Section 580d differs from section 580b in that section 580b protects debtors who borrow purchase-money, and section 580d protects all debtors whose property is sold after a non-judicial foreclosure. *Id.* §§ 580b, 580d (West 1976). The purpose in limiting deficiency judgments after non-judicial foreclosures is to discourage overvaluing the security. *Union Bank v. Wendland*, 54 Cal. App. 3d 393, 406, 126 Cal. Rptr. 549, 559 (1976). This is accomplished by placing the risk of overvaluation on the mortgagee. *Id.*

89. See R. BERNHARDT, *supra* note 3, § 4.18.

90. See *Bank of Hemet v. United States*, 643 F.2d 661 (9th Cir. 1981); *Walter E. Heller Western, Inc. v. Bloxham*, 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

91. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

92. 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

property owned by Chierighino and his relatives.<sup>93</sup> After the holders of the first trust deeds on the three parcels foreclosed, thereby extinguishing Roseleaf's security interest in those parcels, Roseleaf sued Chierighino for the full amounts unpaid on his three notes.<sup>94</sup> Chierighino contended that the fair-value limitation of section 580a limited Roseleaf's deficiency judgment.<sup>95</sup>

The court, in an opinion by Justice Traynor, refused to apply section 580a to an SOJL.<sup>96</sup> Justice Traynor argued that the express language of section 580a limited its application to the selling lienholder.<sup>97</sup> Furthermore, Justice Traynor reasoned that fair-value limitations would serve no purpose with respect to an SOJL because these provisions were "designed to prevent creditors from buying in at *their own* sales at deflated prices and realizing double recoveries by holding debtors for large deficiencies."<sup>98</sup> Justice Traynor recognized that the position of the SOJL is fundamentally different from the position of the selling lienholder:

The position of a junior lienor whose security is lost through a senior sale is different from that of a selling senior lienor. A selling senior can make certain that the security brings an amount equal to his claim against the debtor or the fair market value, whichever is less, simply by bidding in for that amount. . . . The junior lienor, however, is in no better position to protect himself than is the debtor. Either would have to invest additional funds to redeem or buy in at the sale.<sup>99</sup>

In *Roseleaf*, Justice Traynor did not have the opportunity to consider whether a distinction exists between the purchasing SOJL and the non-purchasing SOJL. However, the policies discussed in *Roseleaf* are equally applicable to both SOJLs.<sup>100</sup> Neither SOJL can "credit-bid" at the foreclosure sale.<sup>101</sup> And, since neither SOJL can exercise a power of sale,<sup>102</sup> the language of section 580a is equally inapplicable.

In 1966, the California Court of Appeal decided *Dickey v. Wil-*

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93. *Id.* at 38, 378 P.2d at 98, 27 Cal. Rptr. at 874.

94. *Id.*

95. *Id.*

96. *Id.* at 40-41, 378 P.2d at 99-100, 27 Cal. Rptr. at 875-76.

97. *Id.*

98. *Id.* at 40, 378 P.2d at 99, 27 Cal. Rptr. at 875 (emphasis added).

99. *Id.* at 41, 378 P.2d at 100, 27 Cal. Rptr. at 876.

100. *Id.* at 40-41, 378 P.2d at 99-100, 27 Cal. Rptr. at 875-76.

101. *Nomellini Constr. Co. v. Modesto Sav. & Loan Ass'n*, 275 Cal. App. 2d 114, 115, 79 Cal. Rptr. 717, 719 (1969); *Investcal*, 247 Cal. App. 2d at 197, 55 Cal. Rptr. at 480.

102. CAL. CIV. CODE § 1214 (West 1982); *see also Rheem Mfg. Co. v. United States*, 57 Cal. 2d 621, 371 P.2d 578, 21 Cal. Rptr. 802 (1962).

liams.<sup>103</sup> In that case, Williams loaned \$25,000 to Dickey.<sup>104</sup> As consideration for the loan, Williams received a note secured by a second trust deed on property in San Francisco and a third trust deed on property in Sonoma.<sup>105</sup> The holders of the first trust deeds on both parcels foreclosed under their powers of sale.<sup>106</sup> Williams purchased the Sonoma property at the non-judicial foreclosure sale.<sup>107</sup> The subsequent sale of the San Francisco parcel to a third party resulted in the full payment of the note secured by the first trust deed, and a surplus remained.<sup>108</sup> Thus, the issue was whether that surplus should be applied to Williams' note, or to four mechanic's lien claimants.<sup>109</sup>

Fishing for any antideficiency statute that would fit the facts of the case, Dickey directed the court's attention to sections 580a, 580b,<sup>110</sup> 580d,<sup>111</sup> 725a<sup>112</sup> and 726.<sup>113</sup> The court, citing *Roseleaf*, stated that only section 580b potentially could apply to this situation.<sup>114</sup> Williams, who was an SOJL by virtue of the foreclosure of the San Francisco parcel under the first trust deed, did not have his right to a deficiency out of the surplus proceeds from the non-judicial foreclosure sale limited by section 580a. Thus, the court's silence with regard to section 580a constituted an implicit acknowledgement that section 580a would not be applied to surplus proceeds resulting from multiple or excess security.<sup>115</sup>

Williams sought to recover the surplus proceeds from the non-judicial foreclosure sale, not a deficiency judgment.<sup>116</sup> Consequently, *Dickey* does not directly address the issue of whether a purchasing SOJL's deficiency judgment should be limited by the fair-value provision of section 580a. However, the reasoning in *Dickey* is applicable to the deficiency judgment situation.<sup>117</sup>

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103. 240 Cal. App. 2d 270, 40 Cal. Rptr. 529 (1966).

104. *Id.* at 271, 49 Cal. Rptr. at 530. In fact, Dickey represented the actual borrower's estate. *Id.*

105. *Id.*

106. *Id.* at 272, 49 Cal. Rptr. at 530.

107. *Id.*

108. *Id.*

109. *Id.*

110. CAL. CIV. PROC. CODE § 580b (West 1976).

111. *Id.* § 580d (West 1976).

112. *Id.* § 725a (West 1980 & Supp. 1989).

113. *Id.* § 726 (West Supp. 1989).

114. *Dickey*, 240 Cal. App. 2d at 272, 49 Cal. Rptr. at 530.

115. *Id.*; see Note, *supra* note 65, at 321-22 n.23.

116. 240 Cal. App. 2d at 272, 49 Cal. Rptr. at 530.

117. If Williams' debt had not been satisfied out of the surplus proceeds from the foreclosure sale, and Williams had sued Dickey for a deficiency on the note, Williams would have had the same recovery: (1) the Sonoma property; and (2) the funds necessary to satisfy the debt.

Dickey argued that Williams would get an excess recovery if Williams were permitted to purchase the Sonoma property at significantly less than the fair value in addition to the receipt of the surplus proceeds.<sup>118</sup> The court responded that *any* purchaser at the foreclosure sale is in a position to make a profit on the property:

[Dickey] suffered no greater detriment than if a complete stranger had purchased at the senior's sale, and [Williams] had no advantage unavailable to a stranger. . . . The fact that [Williams] bought the [Sonoma] property for cash at a public sale in no way distinguishes him from the sold out junior lienholder in *Roseleaf*.<sup>119</sup>

Analogously, SOJLs are not receiving a windfall or excess recovery when they purchase the property for less than the fair value and then sue the debtor for a deficiency judgment on the note. Any third party could purchase the property at the foreclosure sale and resell it for a profit equivalent to that made by the SOJL<sup>120</sup> because property tends to sell for less at foreclosure sales than on the open market.<sup>121</sup>

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*Roseleaf*, 59 Cal. 2d at 39-40, 378 P.2d at 99-100, 27 Cal. Rptr. at 875-76 (holding that section 580a does not apply to "non-selling junior lienors"). Thus, the only difference between a recovery from surplus proceeds and a deficiency on the note is the source of the funds recovered. In the former situation, the funds are available from the liquidation of the property, but in the latter situation, the debtor must pay the judgment out-of-pocket.

118. *Dickey*, 240 Cal. App. 2d at 272, 49 Cal. Rptr. at 530.

119. *Id.*, 49 Cal. Rptr. at 531.

120. Consider the following calculations: Assume that a parcel being sold at a foreclosure sale has a value of \$100,000. The amount unpaid on the SOJL's note is \$30,000. A third party who purchases the property for \$70,000 will make a profit of \$30,000. On the other hand, an SOJL who purchases the property for \$70,000 will just break even because the SOJL has already invested \$30,000 in the property. Thus, a \$30,000 deficiency judgment against the debtor will result in the SOJL realizing the same profit as a third party.

In fact, even the selling lienholder will make a profit by purchasing the property. In the above hypothetical, assume that the selling lienholder has an outstanding debt of \$70,000. The selling lienholder can purchase the property by credit-bidding the amount of the selling lienholder's debt rather than paying cash. The selling lienholder cannot recover a deficiency, yet will make a \$30,000 profit from the property itself. Thus, section 580a's application to purchasing SOJLs results in the purchasing SOJL being the only bidder at the foreclosure sale who is not likely to make a profit by purchasing the property.

121. See Washburn, *The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales*, 53 S. CAL. L. REV. 843 (1980). See also Johnson & Hoffman, *Inadequacy of Sales Price at Judicially Ordered Sales of Real Property*, 12 COLO. LAW. 1435 (1983). Both articles specifically deal with the inadequacy of the sales price of property at foreclosure sales *when the sale is supervised by the court*. Undoubtedly, non-judicial foreclosure sales are as likely as judicial foreclosures to result in inadequate prices. R. BERNHARDT, *supra* note 3, § 4.14. Thus, the California Legislature enacted section 580d, which prohibits any deficiency by selling lienholders after non-judicial foreclosure sales. 1939 Cal. Stat. 1991 (codified as amended at CAL. CIV. PROC. CODE § 580d (West 1976)).



*Investcal Realty Corp. v. Edgar H. Mueller Constr. Co.*,<sup>122</sup> decided by the court of appeal the same year as *Dickey*, implicitly applied *Roseleaf's* holding<sup>123</sup> to a purchasing SOJL who sued the debtor for a deficiency judgment on the note.<sup>124</sup> Investcal loaned \$15,000 to Mueller's partnership.<sup>125</sup> The loan was secured by junior trust deeds on two parcels of real property (parcel 1 and parcel 2).<sup>126</sup> Investcal purchased parcel 1 at the selling lienholder's foreclosure sale for \$26,281.21, and subsequently resold that parcel for \$60,000.<sup>127</sup> Next, Investcal judicially foreclosed on parcel 2 and, in addition, sought a deficiency judgment against the debtors.<sup>128</sup>

The court first determined that Investcal was not precluded from foreclosing on parcel 2, even though it had purchased parcel 1 at the foreclosure sale.<sup>129</sup> The court then considered section 726,<sup>130</sup> but did not find it necessary to discuss the fair-value limitation.<sup>131</sup> Just as in *Dickey*, the *Investcal Realty* court's silence with regard to the application of fair-value limitations to the deficiencies of purchasing SOJLs implied that the issue had been decided by *Roseleaf*.<sup>132</sup> Thus, in 1966, *Roseleaf's* discussion of section 580a appeared fully ingrained into California law.

This state of affairs, however, would not last. Although appearing to be settled law, *Roseleaf's* refusal to apply section 580a to sold-out junior lienholders would come under attack from the courts in the 1980s.

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122. 247 Cal. App. 2d 190, 55 Cal. Rptr. 475 (1966).

123. *Roseleaf* held that section 580a is inapplicable to "nonselling" junior lienholders. *Roseleaf*, 59 Cal. 2d at 40-41, 378 P.2d at 99-100, 27 Cal. Rptr. at 875-76.

124. See Note, *supra* note 65, at 321-22 n.23.

125. *Investcal*, 247 Cal. App. 2d at 193, 55 Cal. Rptr. at 477-78.

126. *Id.*, 55 Cal. Rptr. at 478.

127. *Id.* at 194, 55 Cal. Rptr. at 478. The court did not indicate that any question was raised as to the fairness of the foreclosure sale. On the contrary, the facts indicated that Investcal's subsequent sale of the parcel may have been at an inflated price because, prior to the closing of escrow, the purchaser obtained a zoning change from agricultural to commercial. *Id.*

128. *Id.* at 194-95, 55 Cal. Rptr. at 478. Section 580a was not applicable since the foreclosure sale was "judicial." Instead, Mueller raised the fair-value limitation of section 726 which, as previously noted, is essentially the same as the fair-value limitation of section 580a. *Id.*; see also *supra* note 62.

129. *Investcal*, 247 Cal. App. 2d at 196-99, 55 Cal. Rptr. at 480-81. The court stated that "[i]f a junior lienholder . . . fortuitously has secured the deed of trust by a lien on other property . . . we cannot hold [that the junior lienholder] waived its secured interest as to the other lien if the junior lienholder purchases the property at the senior lienholder's trustee sale." *Id.* at 197-98, 55 Cal. Rptr. at 480. In the absence of the partnership's waiver of the "one-action" rule of section 726, Investcal's only recourse was to foreclose on parcel 2. *Id.* at 196, 55 Cal. Rptr. at 480.

130. CAL. CIV. PROC. CODE § 726 (West Supp. 1989).

131. *Investcal*, 247 Cal. App. 2d at 197, 55 Cal. Rptr. at 480.

132. See Note, *supra* note 65, at 321-22 n.23.

*B. 1981-1989: The Application of Section 580a to the Purchasing Sold-Out Junior Lienholder*

The basic policy behind *Roseleaf Corp. v. Chierighino's*<sup>133</sup> refusal to apply section 580a<sup>134</sup> to SOJLs is that, as between the SOJL and the debtor, the latter should bear the loss of the SOJL's deficiency created by the debtor's default and the selling lienholder's foreclosure of the senior trust deed.<sup>135</sup> However, in 1981, the courts' view of section 580a changed due to a perceived distinction between a purchasing SOJL and a non-purchasing SOJL.<sup>136</sup> A purchasing SOJL who purchases the property at the non-judicial foreclosure sale for less than the fair value can subsequently resell that property at the fair value. The 1980s courts contend that allowing the purchasing SOJL to recover both the property and a judgment against the debtor for the full amount of the deficiency would result in a windfall or excess recovery.<sup>137</sup> From this perspective, the dilemma is not whether the purchasing SOJL or the debtor should bear the loss of the deficiency, but whether the purchasing SOJL should be permitted to make a profit while the debtor is saddled with a large deficiency judgment.<sup>138</sup>

At first, the courts' policy of protecting debtors from excess recoveries by lienholders appears to be justified. The SOJL should not get a windfall at the expense of the debtor. However, this argument begs the question in the context of purchasing SOJLs. The analysis assumes that

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133. 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

134. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

135. *Roseleaf*, 59 Cal. 2d at 41, 378 P.2d at 100, 27 Cal. Rptr. at 876 ("Equitable considerations favor placing this burden on the debtor not only because it is his default that provokes the senior sale, but also because he has the benefit of his bargain with the junior lienor who, unlike the selling senior, might otherwise end up with nothing."). The debtor is the cheapest cost avoider. *Roseleaf*, 59 Cal. 2d at 41, 378 P.2d at 100, 27 Cal. Rptr. at 876. The SOJL has no control over the debtor's default and, thus, cannot prevent the loss occasioned by the default and foreclosure.

136. See, e.g., *Bank of Hemet v. United States*, 643 F.2d 661 (9th Cir. 1981); *Walter E. Heller Western, Inc. v. Bloxham*, 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

137. *Bank of Hemet*, 643 F.2d at 669; *Heller Western*, 176 Cal. App. 3d at 273-74, 221 Cal. Rptr. at 429-30; see also Arnold, *supra* note 2, at 19 ("The principal factor in [these] decisions was the belief that application of Section 580a was essential to prevention of an excess recovery by the purchasing junior lienor.")

138. See *Bank of Hemet*, 643 F.2d at 669.

the profit made by the purchasing SOJL is a windfall or an excess recovery.<sup>139</sup> In fact, such a characterization is inaccurate.<sup>140</sup>

The remainder of this section analyzes the three major cases of the 1980s and identifies their erroneous underlying assumptions: (1) *Bank of Hemet v. United States*,<sup>141</sup> which first applied section 580a to a purchasing SOJL; (2) *Walter E. Heller Western, Inc. v. Bloxham*,<sup>142</sup> which incorporated the *Bank of Hemet* rule into California law; and (3) *Pacific Loan Management v. Superior Court*,<sup>143</sup> where the court questioned the first two cases in dicta, but indicated that it might follow the *Heller Western* rule in a case directly on point.

1. *Bank of Hemet v. United States*: an illegitimate case makes bad law

In *Bank of Hemet*, Bank of Hemet (Bank) held a non-purchase-money second trust deed on real property, and the United States held tax liens junior to the Bank's trust deed.<sup>144</sup> Both the Bank and the United States became SOJLs after a senior lienholder foreclosed on the first trust deed.<sup>145</sup> The Bank purchased the real property at the foreclosure sale for two dollars more than the amount owed on the first trust deed.<sup>146</sup> Approximately four months later, the United States sought to exercise its federal post-sale statutory right of redemption.<sup>147</sup> The United States tendered the amount that the Bank paid for the property, plus interest at the statutory rate, to the Bank.<sup>148</sup> The Bank accepted the tender under protest and sued the United States, alleging that the amount tendered to the

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139. *Id.* See also Note, *supra* note 65, at 323 ("The *Bank of Hemet* court correctly perceived that fair-value provisions such as section 580a are intended to prevent any creditor from reaping a windfall at the debtor's expense by combining a deficiency judgment with a bargain purchase of the property.").

140. See *infra* notes 246-66 and accompanying text for a discussion of how the purchasing SOJL's profit should be characterized.

141. 643 F.2d 661 (9th Cir. 1981).

142. 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

143. 196 Cal. App. 3d 1485, 242 Cal. Rptr. 547 (1987).

144. *Bank of Hemet*, 643 F.2d at 663.

145. *Id.*

146. *Id.*

147. *Id.* "Post-sale statutory right of redemption" refers to a statutory right to buy back property which already has been sold at a foreclosure sale to another party. See R. BERNHARDT, *supra* note 3, § 5.72. In California, a statutory right of redemption exists in favor of the debtor after a judicial foreclosure sale if a creditor seeks a deficiency judgment. CAL. CIV. PROC. CODE § 729.010 (West Supp. 1989). However, as discussed in this case, the federal government has a statutory right of redemption where it holds tax liens against real property. See 26 U.S.C. § 7425(d) (1982); 28 U.S.C. § 2410 (1982).

148. *Bank of Hemet*, 643 F.2d at 663.

Bank by the United States was improper.<sup>149</sup> The trial court granted the United States' motion for summary judgment.<sup>150</sup>

In order to calculate the United States' redemption price, the Ninth Circuit Court of Appeals had to determine to what extent the Bank's junior lien was discharged by its purchase of the property at the non-judicial foreclosure sale.<sup>151</sup> Both parties agreed that California law determined whether the Bank was entitled to a deficiency judgment against the debtor.<sup>152</sup> The court first held that section 580d of the California Code of Civil Procedure<sup>153</sup> was inapplicable to an SOJL; therefore, the Bank could obtain a deficiency judgment.<sup>154</sup> The court then discussed whether the Bank's deficiency judgment would be limited by section 580a.<sup>155</sup> The court stated that "[t]he *Roseleaf* Court did not treat [section 580a] as superceded [sic] by section 580d and also held it to be inapplicable to 'nonselling junior lienors.'"<sup>156</sup> Thus, had the court followed *Roseleaf*, the non-selling SOJL's (the Bank's) right to a full-deficiency judgment would not be impaired by the fair-value provision of section 580a.<sup>157</sup> However, to apply section 580a, the court seized upon the Bank's purchase of the real property at the selling lienholder's foreclosure sale as a key factor that distinguished this case from *Roseleaf*:

This case is, however, distinguishable from *Roseleaf* in that here the junior lienholder did bid on and purchase the property which, strong evidence suggests, at the time had a fair value substantially in excess of the amount of the senior lienholder's debt. In brief, the Bank was not a sold-out junior lienholder as was the case in *Roseleaf*.<sup>158</sup>

This distinction was based upon the "general purpose of section 580a,"

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149. *Id.* The Bank felt that the tender was improper because the Bank was not paid the value of its investment in the property. *Id.* The government redeemed the property for the amount that the Bank had paid; however, the Bank had also invested the amount of its unpaid debt in the property. *Id.*

The other theory relied upon by the Bank was that the government's redemption constituted a taking without just compensation in violation of the Fifth Amendment to the United States Constitution. *Id.*

150. *Id.*

151. *Id.* at 667.

152. *Id.*

153. CAL. CIV. PROC. CODE § 580d (West 1976). Recall that section 580d precludes a foreclosing lienholder from seeking any deficiency judgment after a non-judicial foreclosure. *Id.*; see also *supra* note 88 and accompanying text.

154. *Bank of Hemet*, 643 F.2d at 667-68.

155. *Id.* at 668-70.

156. *Id.* at 668 (emphasis added).

157. *Id.* at 669.

158. *Id.*

which is preventing lienholders from buying the property at a deflated price, obtaining a deficiency judgment and reselling the property at a profit.<sup>159</sup> The court did not, however, attempt to prove that the Legislature intended section 580a to prevent *all* lienholders from buying the property at the foreclosure sale and recovering a deficiency judgment free of the fair-value limitations of section 580a. In fact, the court recognized that its holding required "the imposition of a gloss [on section 580a], that a deficiency judgment could only be allowed to the extent that the combined debt of the senior and junior lienholders exceeded the property's fair market value."<sup>160</sup>

The court's attempted justification for its "gloss" was not compelling. Being a federal court, the Ninth Circuit knew that the *Bank of Hemet* opinion would be charged as an improper creation of state law.<sup>161</sup> Thus, in an effort to support its interpretation of section 580a and dispell federalism concerns, the court sweepingly concluded that "[t]he unmistakable policy of California is to prevent excess recoveries by secured creditors."<sup>162</sup> Remarkably, the court did not cite any authority for this proposition.

The court's statement was irrelevant in this context. The court begged the question of *why* this was an "excess" recovery. Rather, the decision to label the profit made by a purchasing SOJL an "excess recovery" was dispositive.<sup>163</sup> Although lienholders should not be allowed to use their status to take unfair advantage of debtors, a purchasing SOJL who purchases the property at the non-judicial foreclosure sale for a bargain price reaps a benefit that is available to any third-party purchaser.<sup>164</sup> Thus, while the court spoke of "excess recovery," the effect of this decision was to penalize junior lienholders for having a subordinate security interest.

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159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.* This is a tautology since "excess" is defined as "the fact of exceeding specified limits in amount." THE RANDOM HOUSE DICTIONARY 311 (1978).

163. *Bank of Hemet*, 643 F.2d at 669.

164. See *Dickey v. Williams*, 240 Cal. App. 2d 270, 272, 49 Cal. Rptr. 529, 531 (1966). Assume that the SOJL purchases the property for the amount of the selling lienholder's debt (\$70,000). The SOJL still has not recovered the amount of his debt (\$30,000). The fair value is equivalent to the amounts of both the senior and junior debts (\$100,000). If section 580a applies, then the purchasing SOJL will have the property with just enough equity to recover the combined debts, but cannot sue the debtor for a deficiency. On the other hand, a third party could purchase the property for the same price (\$70,000) and resell the property at the fair value (\$100,000). Thus, the SOJL only recovers potential losses, but the third party makes a profit of \$30,000.

At least one commentator believed *Bank of Hemet* contradicted *Roseleaf*, yet believed that *Bank of Hemet* was decided correctly.<sup>165</sup> The commentator argued that the Ninth Circuit was the first court to perceive the true California law on antideficiency limitations.<sup>166</sup> This view is founded upon the commentator's perception that the California antideficiency limitations were intended by the Legislature only to be a framework that was to be completed by the courts.<sup>167</sup> However, even if this perspective were correct, the commentator does not explain how this position justifies a federal court overturning California law. The principles of comity and federalism require that state courts be the ultimate interpreters of state laws.<sup>168</sup> California's highest court had settled this matter in *Roseleaf*.<sup>169</sup> Thus, the Ninth Circuit Court of Appeals overstepped its constitutional bounds by *creating* California law.<sup>170</sup>

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165. See Note, *supra* note 65, at 322-24. The author stated that "due largely to the [*Roseleaf*] court's authoritative treatment of section[ ] 580a . . . in connection with sold-out juniors, no subsequent California case has questioned *Roseleaf*." *Id.* at 321. This commentator further stated that "[c]ontrary to the rather clear holding in *Roseleaf*, the *Bank of Hemet* court perceived a real difference between a sold-out junior lienor who purchases at the senior's sale and one who does not." *Id.* at 322.

166. *Id.* at 317. The commentator is referring to the Ninth Circuit's "superior understanding of the purpose of California's debtor protection laws." *Id.*

167. *Id.* at 322 ("California's anti-deficiency rules . . . are best viewed, not as a completed system of regulation, but only as a framework for that system."). However, Professor Hetland has referred to this system as "California's elaborate and interrelated set of antideficiency and foreclosure statutes." Hetland & Hansen, *supra* note 56, at 185.

168. See *McKenna v. Ortho Pharmaceutical Corp.*, 622 F.2d 657, 661 (3d Cir.), *cert. denied*, 449 U.S. 976 (1980).

169. *Roseleaf*, 59 Cal. 2d at 39, 378 P.2d at 99, 27 Cal. Rptr. at 875. In fact, the *Bank of Hemet* court recognized that its opinion was inconsistent with *Roseleaf*. The court stated:

To refuse to apply this policy, together with its implications and refinements, to the facts of this case because such facts fit section 580a's language somewhat awkwardly and because of the result reached by the California court in *Roseleaf* would amount to a rejection of the spirit of California's law in favor of its letter. We decline to do this.

*Bank of Hemet*, 643 F.2d at 669.

170. See *McKenna*, 622 F.2d at 661 (federal courts must look to the body of state law and attempt to predict how a state's highest court would decide the issue).

Note that *Bank of Hemet* was not a conventional antideficiency case. *Bank of Hemet* was not an action for a deficiency, and the debtor was not a party. *Bank of Hemet*, 643 F.2d at 663. The action was between a purchasing SOJL and the United States arising from the latter's statutory redemption under a junior tax lien. *Id.*

Moreover, the court's desire to change California law resulted in legal gymnastics. The court's strained application of section 580a precluded the Bank from recovering a deficiency because the Bank had failed to file its action to recover a deficiency within the three month statute of limitations provided in section 580a. *Id.* at 669. However, the court interpreted the federal statutory redemption law to compensate the Bank for the equivalent of its deficiency. *Id.* at 666-70. See 28 U.S.C. § 2410(d) (1976) and Treas. Reg. § 301.7425-4(b)(2)(ii) (1988) for the redemption formula used by the court.

## 2. *Walter E. Heller Western, Inc. v. Bloxham*

In *Heller Western*, the California Court of Appeal ratified the Ninth Circuit's holding in *Bank of Hemet*.<sup>171</sup> *Heller Western* had funded a series of loans to Bloxham that were consolidated into one note, secured by trust deeds on lots owned by Bloxham.<sup>172</sup> The trust deeds were then subordinated to a loan made by Newport Equity Fund Trust 291.<sup>173</sup> After Bloxham's default, Newport Equity exercised its power of sale under the first trust deed.<sup>174</sup> *Heller Western* purchased the property at the non-judicial foreclosure sale and sought a deficiency judgment against Bloxham for the full unpaid value of the note plus interest.<sup>175</sup> On appeal, Bloxham contended that the property was purchased at less than the fair value and, thus, *Heller Western's* deficiency judgment should be limited by section 580a.<sup>176</sup>

Whereas Justice Traynor held in *Roseleaf* that section 580a did not apply to any SOJL,<sup>177</sup> the *Bank of Hemet* court held that section 580a did apply to purchasing SOJLs.<sup>178</sup> The *Heller Western* court, agreeing with *Bank of Hemet*, distinguished between a purchasing SOJL and a non-purchasing SOJL.<sup>179</sup> The reason for this distinction was that the application of section 580a to non-purchasing SOJLs would be to limit their deficiencies based upon "someone else's bid."<sup>180</sup> On the other hand, if SOJLs purchase the property, then their deficiencies are limited by their own bids.<sup>181</sup> Thus, the court's adoption of the *Bank of Hemet* position was based largely upon the issue of control of the purchase price.<sup>182</sup> The court concluded by echoing *Bank of Hemet's* incantation: "the unmistakable policy of California is to prevent excess recoveries by secured creditors."<sup>183</sup>

The *Heller Western* court's analysis is based upon an illusory dis-

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171. *Heller Western*, 76 Cal. App. 3d at 272-74, 221 Cal. Rptr. at 428-30.

172. *Id.* at 269, 221 Cal. Rptr. at 426.

173. *Id.*

174. *Id.*, 221 Cal. Rptr. at 426-27.

175. *Id.* at 269-70, 221 Cal. Rptr. at 427. The property later was conveyed to *Heller Western*. *Id.* at 270, 221 Cal. Rptr. at 427.

176. *Id.*

177. *Roseleaf*, 59 Cal. 2d at 40, 378 P.2d at 99, 27 Cal. Rptr. at 875.

178. *Bank of Hemet*, 643 F.2d at 669.

179. *Heller Western*, 176 Cal. App. 3d at 273-74, 221 Cal. Rptr. at 429.

180. *Id.* at 273, 221 Cal. Rptr. at 429.

181. *Id.* at 273-74, 221 Cal. Rptr. at 429.

182. See Mertens, *supra* note 2, at 542.

183. *Heller Western*, 176 Cal. App. 3d at 274, 221 Cal. Rptr. at 430 (quoting *Bank of Hemet v. United States*, 643 F.2d 661, 669 (9th Cir. 1981)). The court reasoned that the purchasing SOJL would be able to compensate for the lost deficiency by being a purchaser of the property at a bargain price. *Id.*, 221 Cal. Rptr. at 429.

inction. The court contended that the purchasing SOJL controls the purchase price.<sup>184</sup> However, this premise is illogical. The SOJL shows up at a senior lienholder's foreclosure sale. The SOJL has no more control over the selling price of the property than any other non-selling bidder at the sale. In fact, the SOJL and debtor have common incentives: to make sure that the sale is fair, and that a reasonable price is received for the property.<sup>185</sup> Bidding is in the SOJL's self-interest when a reasonable price will not be received for the property.<sup>186</sup>

Generally, the SOJL is motivated to protect himself by bidding an amount just less than the unpaid amounts on both the senior and junior security interests.<sup>187</sup> If a third party purchases the property for more than this amount, the surplus<sup>188</sup> would be distributed by the trustee<sup>189</sup> either to another SOJL<sup>190</sup> or, in the absence of another secured party, to the debtor.<sup>191</sup> Thus, while purchasing SOJLs are in control of how much they bid, they are not in control of the point at which the bidding stops.<sup>192</sup> Logically, the junior lienholder would bid no more than neces-

184. *Id.* at 273-74, 221 Cal. Rptr. at 429.

185. *Roseleaf*, 59 Cal. 2d at 41, 378 P.2d at 100, 59 Cal. Rptr. at 876. The debtor's incentive is based upon a desire to avoid a deficiency judgment. *Id.* Similarly, SOJLs desire to recover as much of the debt as possible from the foreclosure of the security to avoid the costs of suing the debtor for a deficiency. *Id.* In contrast, selling lienholders are motivated either to sell the property for a price high enough to cover their own debts, or to buy the property at a bargain price and reap the profit. *Id.*

Ironically, the selling lienholder will make the profit which *Heller Western* and *Bank of Hemet* seek to deny the purchasing SOJL. See *Hetland*, *supra* note 69, at 29. A selling lienholder who credit-bids the full amount of the senior debt, thereby purchasing the property, may recover a parcel that has a fair value in excess of the debt. *Id.* Thus, the selling lienholder can usually make a profit without seeking a deficiency judgment. *Id.* The purchasing SOJL will not make a profit unless the property value is greater than the combined total of the senior and junior debts and the purchasing SOJL's additional cash outlay to buy the property.

186. R. BERNHARDT, *supra* note 3, § 4.14 ("If the property is worth more than the debt . . . the bid will be less than the market value of the property . . . and there will be no surplus for the debtor or junior lienholders.").

187. No purpose is served by the SOJL bidding more than necessary to purchase the property.

188. The surplus is the amount of the sale proceeds which exceeds the amount of the foreclosing lienholder's lien.

189. G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW*, § 1.6 (2d ed. 1985).

190. For example, there might be a third trust deed.

191. Surplus proceeds are distributed first to junior secured creditors and then, if a surplus remains, to the debtor. See 1 H. MILLER & M. STARR, *supra* note 10, § 3:120.

192. As recognized in *Roseleaf*, the foreclosing creditor has created the environment of the sale and, in the absence of antideficiency protections, might intentionally hold down the price of the property to reap a double recovery. *Roseleaf*, 59 Cal. 2d at 40, 378 P.2d at 99, 27 Cal. Rptr. at 875; *Hatch v. Security First Nat'l Bank of Los Angeles*, 19 Cal. 2d 254, 259, 120 P.2d 869, 872 (1942) ("The evil which led to the enactment of this legislation became pronounced during the recent period of economic depression when creditors were frequently able to bid in the debtor's real property at a nominal figure and also to hold the debtor personally liable for a



sary to purchase the property. However, under the *Bank of Hemet* and *Heller Western* applications of section 580a, the junior's bid is imputed by law to be a bid at the fair value of the property up to the amount of the junior and selling lienholders' combined debts.<sup>193</sup>

A hypothetical will help to illustrate this point. A selling lienholder (S) holds a foreclosure sale which is attended by a junior lienholder (J). J had taken no part in the arrangements for the sale and the turnout is small. The property being sold has a fair value of \$100,000. The amount of S's lien is \$70,000, and J's lien is for \$30,000. The bidding stops at \$70,000. J now has two alternatives: allow the property to be sold to a third party for \$70,000, and then sue the debtor (D) on the note for a \$30,000 deficiency,<sup>194</sup> or bid up the price and purchase the property. In this latter case, however, section 580a will make J's bid legally equivalent to \$100,000,<sup>195</sup> thereby satisfying both S's and J's debts.<sup>196</sup>

### 3. *Pacific Loan Management v. Superior Court*

In *Pacific Loan Management*, the California Court of Appeal struggled with both the 1960s and 1980s lines of cases.<sup>197</sup> *Pacific Loan Management Corp.* (Pacific) acted as the trustee on behalf of the selling lienholder in a non-judicial foreclosure of certain property.<sup>198</sup> The property was purchased by the junior lienholder, the United States Small Business Administration (SBA).<sup>199</sup> After the selling lienholder was paid, both the SBA and the debtor claimed the surplus proceeds remaining

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large proportion of the original debt." Holding down the bidding at foreclosure sales can be done in various ways. For example, the trustee, who is often an agent of the selling lienholder, could hold the foreclosure sale in a warehouse in the worst part of town on a rainy day. See CAL. CIV. CODE § 2924g (West 1989) for foreclosure sale time and place requirements. When sale conditions are poor, a large turnout of potential purchasers is unlikely. See, e.g., Washburn, *supra* note 121, at 848-49.

Another tactic designed to keep bidding down might be to advertise the foreclosure sale in a newspaper with a small circulation. See, e.g., *id.* at 848. In any event, non-selling SOJLs do not control foreclosure sales.

193. *Bank of Hemet*, 643 F.2d at 669; *Heller Western*, 176 Cal. App. 3d at 273, 221 Cal. Rptr. at 429.

194. J would be entitled to a deficiency judgment in this situation even under *Heller Western* as a non-purchasing SOJL. *Heller Western*, 176 Cal. App. 3d at 273, 221 Cal. Rptr. at 429. Of course, J risks that D will become insolvent.

195. The purchasing SOJL's bid is imputed to be the fair value of the property. See CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

196. \$100,000 is the combined total of the debts.

197. See *supra* notes 91-132 for a discussion of these cases.

198. *Pacific Loan Management*, 196 Cal. App. 3d at 1488, 242 Cal. Rptr. at 548.

199. *Id.*

from the foreclosure sale.<sup>200</sup> Pacific filed an action in interpleader and requested to be discharged, arguing that it was merely a stakeholder of unclaimed funds.<sup>201</sup> The trial court denied this request.<sup>202</sup> The court of appeal held that the trial court should have granted the interpleader, and that the SBA did not lose its right to the surplus proceeds by purchasing the property.<sup>203</sup> The opinion questioned the reasoning supporting the *Heller Western* holding.<sup>204</sup>

The court argued that this case was not distinguishable from *Dickey v. Williams*.<sup>205</sup> If *Dickey* could recover a deficiency out of the surplus proceeds from the foreclosure of a different parcel,<sup>206</sup> it follows that an SOJL should be able to recover a deficiency out of the surplus proceeds from the foreclosed parcel.<sup>207</sup> Furthermore, the court was not concerned about the potential profit to be made by the SBA:

[The debtor] argues that SBA now has the property, may sell it at a profit, and will not have to account to [the debtor] for that profit. Therefore it is not equitably entitled to the surplus. This conclusion does not follow. SBA has no legal duty, as a general proposition, to account to [the debtor] for the profits of its investments. Nor do we perceive any unfairness in these facts such as would give rise to any equitable duty in SBA to account for such hypothetical profit. . . . Whether SBA, or [a third party], is the owner of the property makes no difference so far as [the debtor's] economic position is concerned.<sup>208</sup>

The court took issue with *Heller Western's* distinction between purchasing SOJLs and non-purchasing SOJLs.<sup>209</sup> The court noted that "no presumption of unfair advantage should result simply because the secured party purchases the collateral, when prescribed statutory safe-

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200. *Id.* In other words, the SBA claimed the surplus funds that it had paid out when it purchased the property.

201. *Id.*

202. *Id.*

203. *Id.* at 1495, 242 Cal. Rptr. at 553.

204. The *Pacific Loan Management* court observed:

The *Heller* decision rests on the tacit assumption that a foreclosure sale auction frequently results in a sale below the fair value of the property. We express no opinion on whether that is a justified assumption or whether such an assumption should legitimately control the decision to apply . . . section 580a to a junior lienor/purchaser.

*Id.* at 1494, 242 Cal. Rptr. at 552-53.

205. *Pacific Loan Management*, 196 Cal. App. 3d at 1493, 242 Cal. Rptr. at 552 (citing *Dickey v. Williams*, 240 Cal. App. 2d 270, 49 Cal. Rptr. 529 (1966)).

206. *Dickey*, 240 Cal. App. 2d at 272, 49 Cal. Rptr. at 530-31.

207. *Pacific Loan Management*, 196 Cal. App. 3d at 1493, 242 Cal. Rptr. at 552.

208. *Id.* at 1493-94, 242 Cal. Rptr. at 552.

209. *Id.* at 1494 n.2, 242 Cal. Rptr. at 553 n.2.

guards are met."<sup>210</sup>

Although the *Pacific Loan Management* court appeared to disapprove of *Heller Western's* holding, the court recognized that *Heller Western* was still good law.<sup>211</sup> Thus, the SBA was entitled to the surplus proceeds from the non-judicial foreclosure sale, but may not have been entitled to a deficiency judgment.<sup>212</sup>

The remaining question is what effect does *Pacific Loan Management* have on *Heller Western*? The answer is that it has no formal effect on *Heller Western* because the two cases are inapposite. *Pacific Loan Management* deals with the issue of whether the debtor or the purchasing SOJL has a prior right to the surplus proceeds from the foreclosure sale.<sup>213</sup> On the other hand, *Heller Western* deals with the issue of whether a purchasing SOJL is limited by the fair value of the property in an action for a deficiency judgment against the debtor.<sup>214</sup> Nothing in *Heller Western* prevents any SOJL from recovering the surplus proceeds from the foreclosure sale up to the amount of the SOJL's security interest. Thus, much of *Pacific Loan Management's* criticism of *Heller Western* was gratuitous.

This does not mean that *Pacific Loan Management* is completely irrelevant to the issue raised in *Heller Western*. By focusing on the debtor's economics rather than the purchasing SOJL's profit,<sup>215</sup> *Pacific Loan Management* has planted the seed for the California Supreme Court to overrule *Heller Western*. Adopting this "debtor-centered" orientation,<sup>216</sup> the Supreme Court could logically determine that the

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210. *Pacific Loan Management*, 196 Cal. App. 3d at 1494 n.2, 242 Cal. Rptr. at 553 n.2. See also CAL. CIV. CODE § 2924g (West 1989) (time and place of foreclosure sale safeguards).

211. *Id.* at 1495 n.3, 242 Cal. Rptr. at 553 n.3.

212. *Id.*

213. The court stated that "[h]ere, however, we are not yet measuring what deficiency judgment, if any, SBA may collect against [the debtor]. We deal instead with the surplus generated by SBA's own overbid, a fund actually provided with cash out of SBA's pocket." *Id.* at 1495, 242 Cal. Rptr. at 553.

214. *Heller Western*, 176 Cal. App. 3d at 270, 221 Cal. Rptr. at 427.

215. *Pacific Loan Management*, 196 Cal. App. 3d at 1493-94, 242 Cal. Rptr. at 552. This focus is essentially the same as the focus used by the *Dickey* court in holding that section 580a should not be applied in the context of a purchasing SOJL. *Dickey*, 240 Cal. App. 2d at 272, 49 Cal. Rptr. at 530. Why should the debtor's liability for a deficiency be based upon whether the property is purchased by the SOJL or by a third party? If section 580a were not applied to the purchasing SOJL in this situation, the debtor's economic position would be the same no matter who purchased the property. *Id.* Only the focus on the potential profit to be made by the purchasing SOJL concerned the *Bank of Hemet* and *Heller Western* courts. See *Bank of Hemet*, 643 F.2d at 669; *Heller Western*, 176 Cal. App. 3d at 273-74, 221 Cal. Rptr. at 429-30. As previously discussed, however, this potential profit is available to any stranger who purchases property at a foreclosure sale. See *supra* text accompanying notes 118-21.

216. In using a "debtor-centered" analysis, the supreme court would concentrate on the

purchasing SOJL's recovery of a full deficiency judgment is a legitimate recovery, not an excess recovery.<sup>217</sup> Even without the *Heller Western* rule, the debtor would be in a better position if the purchasing SOJL purchases the property than if a third party purchases it.<sup>218</sup> Thus, the purchasing SOJL's potential for a profit should not be restricted.

In the meantime, *Pacific Loan Management* provides ways around the application of section 580a to the purchasing SOJL. In its attempt to reconcile the cases, *Pacific Loan Management* verified that *Investcal's* refusal to apply section 580a in multiple security contexts is still good law.<sup>219</sup> Furthermore, *Pacific Loan Management*, following *Dickey*, established that section 580a should not be applied to limit a purchasing SOJL's recovery of surplus proceeds from a non-judicial foreclosure sale.<sup>220</sup> Thus, to avoid the consequences of section 580a, SOJLs now have a strong incentive to oversecure their debts, thereby insuring that a fund will exist for recovery of deficiencies.<sup>221</sup> However, while structuring transactions to avoid section 580a makes sense from a creditor's perspective, the proliferation of these transactions may have detrimental effects

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fact that the debtor is not any worse off if the SOJL purchases the property than if a third party purchases it.

217. This "debtor-centered" orientation finds support from the Alaska Supreme Court. *Adams v. Fedalaska Fed. Credit Union*, 757 P.2d 1040 (1988). In *Adams*, a purchasing SOJL sued the mortgagor for a deficiency on the note. *Id.* at 1041. The mortgagor cited *Heller Western* as persuasive authority for the proposition that the purchasing SOJL equitably should be limited by the fair value of the property. *Id.* at 1043. After determining that the requisite statutory foundation did not exist to create such a rule, the court flatly disagreed with *Heller Western*:

[T]here is a strong argument against the position of the California court. That is, if the Alaska law is strictly followed, the position of [the debtor] is no different whether [the purchasing SOJL] or a third party buys the property. In either case [the purchasing SOJL] would lose its security and [the debtor] would be personally liable on the note. Under the [California approach] [the debtor] fortuitously benefits by [the purchasing SOJL's] purchase.

*Id.* at 1043-44.

218. See Schechter, *Judicial Lien Creditors Versus Prior Unrecorded Transferees of Real Property: Rethinking the Goals of the Recording System and Their Consequences*, 62 S. CAL. L. REV. 105, 125-26 nn.64-67 (1988); Washburn, *supra* note 121, at 848-49; see also *infra* notes 230-45 and accompanying text for a discussion of the debtor's advantage from competitive bidding.

219. *Pacific Loan Management*, 196 Cal. App. 3d at 1492-95, 242 Cal. Rptr. at 551-53.

220. *Id.* at 1495, 242 Cal. Rptr. at 553. Creditors are more likely to compensate for the risks of being a junior lienholder by engaging in forms of "loss cushioning," including internalizing the potential costs into their interest rates. See Schechter, *supra* note 218, at 125-26 nn.64-67. This internalization spreads those costs to all debtors who give creditors junior security. *Id.* at 125 n.64 ("Secured creditors take collateral at the outset of a transaction as a means of assuring a source of collection in the event of a subsequent default. To the extent that collection is uncertain, interest rates will rise overall."). Thus, many debtors who have never missed a payment share the costs of default with the defaulting debtors.

221. See Schechter, *supra* note 218, at 132 n.89.

on the economy.<sup>222</sup>

#### IV. POLICY CONSIDERATIONS

In Part III, this Comment discussed analytical difficulties with the courts' reasoning in cases holding that the fair-value limitation of section 580a<sup>223</sup> should be applied to purchasing SOJLs.<sup>224</sup> Among these difficulties is the charge that the *Bank of Hemet v. United States*<sup>225</sup> court improperly created state law,<sup>226</sup> and the fallacy that the junior lienholder's profit is an "excess" recovery.<sup>227</sup> Additionally, the *Walter E. Heller Western, Inc. v. Bloxham*<sup>228</sup> court's contention that somehow the purchasing SOJL controls the amount of the selling price by bidding on the property at the foreclosure sale was shown to be erroneous.<sup>229</sup> Beyond these formal or doctrinal concerns, however, Part IV considers the broader social policies which militate against the application of section 580a to purchasing SOJLs.

##### A. *The Detrimental Effect on the Debtor*

The application of section 580a<sup>230</sup> to purchasing SOJLs may actually be adverse to the interests of the debtor. Before *Bank of Hemet v. United States*,<sup>231</sup> the SOJL would be motivated to purchase the property at the foreclosure sale because, in a worst case scenario, the SOJL would have the property to resell. The SOJL could then sue on the note for a deficiency judgment which would not be limited by section 580a.<sup>232</sup> Following *Bank of Hemet* and *Walter E. Heller Western, Inc. v. Bloxham*,<sup>233</sup>

222. If creditors routinely required excess security, then debtors would not be able to make efficient use of their equity since a significant amount of equity would be unnecessarily tied up. See generally Schechter, *supra* note 218, at 132 n.89 ("That marginal increase in the use of secured credit entails added and unnecessary costs; not only are the parties' transaction costs increased, but the encumbrance of debtors' assets will restrict the flow of credit."). This increase in the use of security has added transaction and social costs. *Id.*

223. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

224. See *supra* notes 133-222 and accompanying text.

225. 643 F.2d 661 (9th Cir. 1981).

226. See *supra* note 170 and accompanying text.

227. See *Bank of Hemet*, 643 F.2d at 669; see also *supra* notes 163-64, 183 and accompanying text.

228. 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

229. *Id.* at 273-74, 221 Cal. Rptr. at 429; see also *supra* notes 184-96 and accompanying text.

230. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

231. 643 F.2d 661 (9th Cir. 1981).

232. See *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963); see also *supra* notes 96-102 and accompanying text for a discussion of *Roseleaf's* refusal to apply section 580a to SOJLs.

233. 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

the SOJL has to make a choice. The SOJL can forego purchasing the property and sue the debtor for a full deficiency judgment,<sup>234</sup> or purchase the property and recover a deficiency judgment limited by the fair-value provision of section 580a.<sup>235</sup> Many SOJLs will opt for the first alternative in an effort to recover the entire unpaid amounts of their notes. SOJLs choosing the second alternative are limited by section 580a, and generally will recover less than the entire unpaid amounts.<sup>236</sup>

An SOJL who purchases property at a foreclosure sale must bear significant costs before realizing a recovery against the debt. First, the SOJL must sell the property. Thus, many SOJLs must absorb real estate agents' commissions. In addition, the SOJL either would have to insure the property or risk waste during the interim between the purchase and the sale of the property.<sup>237</sup> As the owner of the property, the SOJL would risk liability to third parties.<sup>238</sup> Furthermore, institutional lenders would absorb significant administrative costs in managing their inventory of properties. Courts do not consider any of these costs in determining the fair value of property purchased at a foreclosure sale.<sup>239</sup>

Assuming that *Bank of Hemet* and *Heller Western* have increased the likelihood that the SOJL will not bid on the property at the non-judicial foreclosure sale, at least one fewer interested bidder will attend the sale. This "chilling" effect most likely will lead to higher deficiency judgments by SOJLs against debtors.<sup>240</sup> For example, in the hypotheti-

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234. See *id.* at 273, 221 Cal. Rptr. at 429.

235. *Id.* at 273-74, 221 Cal. Rptr. at 429.

236. See Arnold, *supra* note 2, at 19.

237. Vacant property seems to invite waste. Generally, lienholders have no remedy at law for waste. See *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 542 P.2d 981, 125 Cal. Rptr. 557 (1975) (lienholder has action against debtor only for bad-faith waste).

238. See generally *Rowland v. Christian*, 69 Cal. 2d 108, 443 P.2d 561, 70 Cal. Rptr. 97 (1968). See also D. DOBBS, *TORTS AND COMPENSATION* 285-309 (1985) for a comprehensive discussion of landowner liability.

239. See *Rainer Mortgage v. Silverwood, Ltd.*, 163 Cal. App. 3d 359, 369-70, 209 Cal. Rptr. 294, 300 (1985) ("Construing the phrase 'fair value' . . . as taking into consideration all the disabilities attending a foreclosure sale would be unreasonable, because it would permit the lender the double recovery the statute was intended to prevent."). See Washburn, *supra* note 121, at 907-16, for a comprehensive discussion of "fair-market value" statutes.

240. Commentators have argued that "the presence of competitive bidding reduces the chance that the property will sell below its fair market value." Schechter, *supra* note 218, at 547 n.147. Since an SOJL is motivated under certain circumstances to bid on the property, "chilling" the SOJL's bid weakens the competition at the foreclosure sale, thereby resulting in harm to the debtor. *Id.*; Washburn, *supra* note 121, at 848-49; see also *Riley v. Martinelli*, 97 Cal. 575, 582, 32 P. 579, 580 (1893) ("The law of this state, with a view, no doubt, of benefiting the debtor, by causing his property to bring the best attainable price, permits and encourages the creditor, alike with others, to purchase at sales under execution . . . ."); Sternberger v.

cal discussed above,<sup>241</sup> if J does not bid at the sale, then the property is sold for \$70,000. Thus, J is entitled to sue D for a deficiency of \$30,000. However, under the holding of *Investcal Realty Corp. v. Edgar H. Mueller Constr. Co.*,<sup>242</sup> J could have purchased the property at the foreclosure sale for \$80,000<sup>243</sup> and still sued D for a deficiency of \$20,000.<sup>244</sup> Clearly, D is better off in the second scenario. If J does not purchase the

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Ragland, 57 Ohio St. 148, 160, 48 N.E. 811, 813 (1897) (“[E]very additional bid is necessarily an advantage to the [debtor].”).

At least one commentator has questioned whether *Bank of Hemet* and *Heller Western* will “chill” the SOJLs’ bids. See Arnold, *supra* note 2, at 19 (“*Bloxham* has been described as inconsistent with another goal of ‘fair value’ limits, namely promoting full bidding at foreclosure sales, since it can create a marked disincentive on the part of a junior lienor to bid at a senior foreclosure sale . . .”). However, Arnold contends that, in fact, the disincentive to the SOJL may succumb to expediency:

There are many settings in which a junior lienor will choose the potentially more expedient method of “bidding in” at a bargain price and reselling the property. This may be a far more attractive possibility than proceeding slowly through the courts to collect an unsecured obligation from a party who, if sufficiently creditworthy to justify pursuing, may possess the requisite resources to mount a protracted defense.

*Id.*

241. See *supra* notes 194-96 and accompanying text.

242. 247 Cal. App. 2d 190, 55 Cal. Rptr. 475 (1966); see also *supra* notes 122-32 and accompanying text for a discussion of *Investcal*.

243. This \$80,000 figure is used to simplify the hypothetical. In most cases, a reasonable SOJL will bid only one dollar more than the amount of the next highest bid. Thus, it may appear that the debtor comes out virtually the same whether the SOJL or a third party purchases the property (the debtor is one dollar worse off if the third party purchases it). However, this conclusion would be unjustified. The SOJL’s presence at the foreclosure sale as an interested bidder may result in significantly lower deficiency judgments against the debtor. See Schechter, *supra* note 218, at 158 n.147 (“The increased selling price resulting from more competitive bidding reduces *pro-tanto* the amount of the judgment remaining unsatisfied.”). Moreover, the SOJL’s bidding activity could have a catalytic effect. How high the bidding ultimately will go depends upon how much the “lively concourse of bidders” is willing to pay for the property. *Id.* (citing B. CLARK, THE LAW OF SECURED TRANSACTION UNDER THE UNIFORM COMMERCIAL CODE § 4.8[5][a] (1980)).

For example, in the above hypothetical, suppose that the bidding stops at \$70,000 (the amount of the senior debt). By not bidding, J can recover a \$30,000 deficiency judgment against D. However, J reasonably could bid as much as the fair value of the property (\$100,000) less J’s expenses of owning and selling the property. See *Rainer Mortgage v. Silverwood, Ltd.*, 163 Cal. App. 3d 359, 367, 209 Cal. Rptr. 294, 298 (1985) (holding that the costs incident to foreclosure sales are excluded from the “fair value” of the property). Thus, J might raise the bidding to \$70,001. The \$70,000 bidder might respond by raising the bid to \$72,000. J might respond by bidding \$72,001, and so on until J buys the property for \$80,000. Under *Roseleaf* and *Investcal*, J would own the property and recover only a \$20,000 deficiency, resulting in a benefit to D in the amount of \$10,000.

J may choose to sue the debtor for the \$30,000 deficiency rather than bid on the property because *Heller Western* and *Bank of Hemet* would eliminate J’s deficiency (the hypothetical property has a fair value which is equivalent to the amount of the combined senior and junior debts). Thus, by chilling J’s bid, *Heller Western* and *Bank of Hemet* may inflict a \$10,000 loss on D.

244. Under the *Investcal* rule, J would be entitled to a deficiency judgment against the

property, then a third party would realize the profit from purchasing the property at a bargain price, J would sue D for a full deficiency, and D would have to pay J \$10,000 more than if J had purchased the property. Thus, this application of section 580a actually costs debtors in the long run when it "chills" the SOJLs' bids.<sup>245</sup>

### B. *The Characterization of Additional Funds*

In *Roseleaf Corp. v. Chierighino*,<sup>246</sup> the California Supreme Court held that section 580a did not apply to SOJLs because SOJLs, like debtors, have to invest "additional funds" to purchase the property at the foreclosure sale.<sup>247</sup> This "additional funds" rationale applies equally to both the purchasing SOJL and the non-purchasing SOJL.<sup>248</sup> This section explains why the infusion of additional funds into the property justifies the profit made by the purchasing SOJL.

The primary policy consideration relied upon by *Bank of Hemet v. United States*<sup>249</sup> and *Walter E. Heller Western, Inc. v. Bloxham*<sup>250</sup> is that, equitably, purchasing SOJLs should recover no more than the unpaid amount of their notes from the sum of the property and a deficiency judgment.<sup>251</sup> This policy must be premised upon the overly-simplistic contention that purchasing SOJLs have received the benefit of their bargain when they recover their funds plus any accrued interest.<sup>252</sup> In fact, purchasing SOJLs have invested much more than their original cash outlay and, therefore, deserve more in return for their investments.

The lending and foreclosing process illustrates exactly how much the purchasing SOJL invests in the property. The purchasing SOJL loans cash to the debtor, who invests the cash in the real property. Subsequently, the debtor defaults. In order to protect this interest in the

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debtor even if J did purchase the property at the foreclosure sale. See *supra* notes 123-24 and accompanying text.

245. See Schechter, *supra* note 218, at 158 ("[A]ny enhancement of the collection process will result in increased creditor recoveries and thus decreased debtor deficiencies. The idea that enhancing the collection process favors debtors, although somewhat counterintuitive, is well established.").

246. 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

247. *Id.* at 41, 378 P.2d at 100, 27 Cal. Rptr. at 876.

248. *Id.* Note that only the selling lienholder can credit-bid, thereby purchasing the property without investing any additional funds. See *supra* note 28.

249. 643 F.2d 661 (9th Cir. 1981).

250. 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

251. *Bank of Hemet*, 643 F.2d at 668-69; *Heller Western*, 176 Cal. App. 3d at 272-74, 221 Cal. Rptr. at 427-29.

252. Note, *supra* note 65, at 323 ("[H]aving elected to purchase, all that is required to give the junior the 'benefit of his bargain' is to allow him to recoup that portion of his debt not satisfied from the subsequent sale of the property.").



property, the purchasing SOJL bids on and purchases the property at the non-judicial foreclosure sale. However, unlike the selling lienholder, the purchasing SOJL cannot "credit-bid."<sup>253</sup> Thus, the purchasing SOJL must invest additional cash to buy the property.

In the above hypothetical,<sup>254</sup> S's first trust deed is \$70,000 and J's second trust deed is \$30,000. Since S is motivated to "credit-bid" on the property for \$70,000,<sup>255</sup> J has to bid in for *at least* \$70,000 cash to buy the property.<sup>256</sup> Thus, J's total cash investment in the property is at least \$100,000, which is equivalent to the full value.<sup>257</sup>

This additional investment can be characterized in two ways. First, it can be characterized as a purchase of real property that is a separate transaction from the initial loan.<sup>258</sup> The SOJL is just as entitled to make a profit from its investments as any third-party bidder.<sup>259</sup> Other purchasers at foreclosure sales could realize profits from their investments in the properties.<sup>260</sup> Yet, under the *Heller Western* rule, purchasing SOJLs are denied any return whatsoever merely because they have junior security interests; they only are permitted to recoup most of their losses.<sup>261</sup>

Second, the purchasing SOJL's additional cash outlay could be characterized as an effort to protect the SOJL's original investment.<sup>262</sup> Even assuming that this characterization is consistent with the purchasing SOJL's primary motivation for bidding, this characterization does not exclude the investment characterization. Many factors may enter

253. See *supra* note 28 for a discussion of credit-bidding.

254. See *supra* notes 194-96 and accompanying text.

255. S will "credit-bid" for the full amount of the senior debt if necessary to buy the property because the selling, or foreclosing, lienholder cannot recover a deficiency judgment after a non-judicial foreclosure. CAL. CIV. PROC. CODE § 580d (West 1976). Thus, the selling lienholder must buy the property unless another participant bids more than the amount of the lienholder's debt if the selling lienholder wishes fully to recover the debt.

256. Note that this amount is two-and-one-third times the amount of J's initial cash outlay.

257. One hundred thousand dollars is the sum of the initial \$30,000 loan and the \$70,000 cash outlay.

258. This would be consistent with the perspective taken by the court in *Pacific Loan Management v. Superior Court*, 196 Cal. App. 3d 1485, 242 Cal. Rptr. 547 (1987). In *Pacific Loan Management*, the court referred to the SOJL's infusion of additional funds as an "investment[ ]". *Id.* at 1493-94, 242 Cal. Rptr. at 552.

259. *Id.*; see also *Dickey v. Williams*, 240 Cal. App. 2d 270, 272, 49 Cal. Rptr. 529, 531 (1966) ("[D]efendant had no advantage unavailable to a stranger . . .").

260. See *supra* note 185. This includes the selling lienholder who will make a profit without investing any additional funds.

261. This follows from the fact that purchasing SOJLs will have their deficiency judgments reduced by the difference between the purchase price of the property and the fair value. *Heller Western*, 176 Cal. App. 3d at 270, 221 Cal. Rptr. at 427.

262. Presumably, this is how the *Bank of Hemet* and *Heller Western* courts would characterize it. See *Bank of Hemet*, 643 F.2d at 668-69; *Heller Western*, 176 Cal. App. 3d at 272-74, 221 Cal. Rptr. at 428-30.

into an SOJL's decision to bid, or abstain from bidding, including alternative investment opportunities for the funds. Under the *Heller Western* rule, a purchasing SOJL cannot recover as much as a selling lienholder or a third party,<sup>263</sup> yet the purchasing SOJL must commit a substantial amount of cash which might otherwise be invested more efficiently. Thus, this characterization bears an unrecoverable opportunity cost to the purchasing SOJL and society.<sup>264</sup>

In light of the debtor's superior position to avoid the harm caused by default and foreclosure,<sup>265</sup> the purchasing SOJL's opportunity costs should be borne by the debtor. Thus, the investment characterization is more equitable. An SOJL who cannot or does not purchase the property can still recover the initial investment by seeking a deficiency judgment against the debtor.<sup>266</sup> An SOJL who does invest additional funds to purchase the property should be entitled to recover the debt and receive a reasonable return on its investment.

### C. The Uncertainty Problem

The major problem facing the practicing attorney is uncertainty. By applying section 580a<sup>267</sup> to the SOJL, the *Walter E. Heller Western, Inc. v. Bloxham*<sup>268</sup> and *Bank of Hemet v. United States*<sup>269</sup> courts have clearly construed this section beyond the plain wording of the statute and, according to most authority, beyond the intent of the California Legislature.<sup>270</sup>

Statutes should always be interpreted by reference to their statutory purposes.<sup>271</sup> However, once the statutory purpose appears settled, and parties have planned their affairs based upon prior courts' interpretations, social stability requires that future courts be limited by the doctrine of stare decisis:

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263. See *supra* note 185.

264. See Schechter, *supra* note 218, at 132 n.89. The amount of credit available to society in general is reduced by the funds tied up in property purchased by purchasing SOJL's at foreclosure sales. *Id.*

265. See *Investcal Realty Corp. v. Edgar H. Mueller Constr. Co.*, 247 Cal. App. 2d 190, 197, 55 Cal. Rptr. 475, 480 (1966) ("Investcal's security in Parcel No. 1 had been rendered valueless through no fault of Investcal.").

266. *Heller Western*, 176 Cal. App. 3d at 273, 221 Cal. Rptr. at 429. See *supra* notes 171-96 and accompanying text for a discussion of *Heller Western*.

267. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

268. 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

269. 643 F.2d 661 (9th Cir. 1981).

270. See *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 40, 378 P.2d 97, 99, 27 Cal. Rptr. 873, 875 (1963); see also *Hetland & Hansen*, *supra* note 56, at 213.

271. See L. CARTER, *REASON IN LAW* 118 (2d ed. 1985) ("Judges must satisfy themselves that their application of a statute to the case before them serves statutory purpose.").

When adherence to a prior interpretation or series of cases interpreting a statute promotes stability in law and this stability in turn allows citizens to plan their affairs on the basis of certain and stable law—in short, when stability promotes the paramount social goal of cooperation—courts should not abandon stare decisis.<sup>272</sup>

Thus, in light of *Heller Western's* belated abandonment of the rule in *Roseleaf Corp. v. Chierighino*,<sup>273</sup> *Heller Western's* dicta that section 580a should not be applied to a non-purchasing SOJL<sup>274</sup> can offer little comfort to the SOJL. Just nineteen years earlier, Justice Traynor held in *Roseleaf* that section 580a would not be applied to any “non-selling junior lienors.”<sup>275</sup>

In support of changing precedent, proponents may argue that fairness often outweighs certainty.<sup>276</sup> This contention ignores the fact that certainty is often a component of fairness.<sup>277</sup> Moreover, even assuming that the result in *Heller Western* is fair, certainty is at a premium in secured transactions.<sup>278</sup> Thus, courts should hesitate to change settled

272. *Id.* at 130.

273. 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

274. *Heller Western*, 176 Cal. App. 3d at 273, 221 Cal. Rptr. at 429.

275. *Roseleaf*, 59 Cal. 2d at 40, 378 P.2d at 100, 27 Cal. Rptr. at 876. Debtors probably will make the argument that section 580a should apply to all SOJLs. For example, debtors conceivably might argue that the non-purchasing SOJL “controls” the selling price of the property by choosing not to bid.

Furthermore, in *Pacific Loan Management v. Superior Court*, the debtor went so far as to argue that section 580a should preclude the purchasing SOJL from recovering the surplus from the foreclosure sale even though the surplus was the purchasing SOJL's money. 196 Cal. App. 3d 1485, 1488, 242 Cal. Rptr. 547, 548 (1987). The trial court, in direct contravention of the *Dickey* rule, agreed with the debtor: “The trial court denied the motion by an order which recites that SBA is not entitled to the proceeds because a junior purchasing at the senior's sale is not entitled to both the property and the satisfaction of his junior obligation.” *Id.* at 1489, 242 Cal. Rptr. at 549.

276. For example, this argument implicitly was made by the *Heller Western* court. 176 Cal. App. 3d at 273-74, 221 Cal. Rptr. at 429 (“[O]nce a junior chooses to purchase, it is equitable to apply the fair value limitations to him.”). Since *Heller Western* was the first California court to apply section 580a to a purchasing SOJL, the parties could not have contemplated this application of the statute at the time that the transaction occurred.

277. L. CARTER, *supra* note 271, at 130-31.

278. An analogy might be made to the creation of Article 9 of the Uniform Commercial Code (U.C.C.), which deals with secured transactions in personal property. U.C.C. art. 9 (1985). The Official Comment to section 9-101 states, in part:

The growing complexity of financing transactions forced legislatures to keep piling new statutory provisions on top of our inadequate and already sufficiently complicated . . . structure of security law. The results of this continuing development were increasing costs to both parties and increasing uncertainty as to their rights and the rights of third parties dealing with them.

The aim of this Article is to provide a simple and unified structure within which

secured transactions law except in the most extreme cases of inequity—especially when the law is statutorily created.<sup>279</sup> When the legislature amends a statute, the changes often are made effective prospectively—allowing contracting parties to internalize the costs of those changes.<sup>280</sup> However, when the courts change the law, the changes are retrospective with respect to the parties to the action and those similarly situated.<sup>281</sup>

Thus, the purchasing SOJL in *Heller Western* agreed to provide the debtor with junior financing under the good-faith belief that section 580a would not limit a deficiency judgment after a default and foreclosure. An SOJL who had known that the deficiency judgment would be limited might have taken additional security or financed at a higher interest rate to internalize the added risk.<sup>282</sup> This scenario affects all the SOJLs who had liens on real property at the time that *Heller Western* was decided. The inescapable result of a sudden and unexpected increase in lending risks is a general increase in the cost of credit.<sup>283</sup>

#### D. Application to Non-Purchasing Juniors: The Future-Expansion Problem

The next logical step in the evolution of section 580a<sup>284</sup> is its application to all SOJLs.<sup>285</sup> The potential application of this section to non-purchasing SOJLs could give the debtor the unbridled power to wipe out junior liens and still not be subject to deficiency judgments. This inequity

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the immense variety of present-day secured financing transactions can go forward with less cost and with greater efficiency.

U.C.C. § 9-101 comment (1985).

279. L. CARTER, *supra* note 271, at 130-31.

280. Prospective application of changes in the law provides parties with notice and an opportunity to adjust the way that they do business to compensate for those changes.

281. *See, e.g.,* *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 46 Cal. 3d 287, 758 P.2d 58, 250 Cal. Rptr. 116 (1988); *Evangelatos v. Superior Court*, 44 Cal. 3d 1188, 753 P.2d 585, 246 Cal. Rptr. 629 (1988). *Cf. Chevron Oil Co. v. Huson*, 404 U.S. 97, 100 (1971) ("We affirm the judgment . . . on the ground that *Rodrigue* should not be invoked to require application of the Louisiana time limitation retroactively to this case.").

282. *See Schechter, supra* note 218, at 125 n.64.

283. *Id.* It follows that a retroactive increase of risks to lenders requires the lenders to overcompensate in order to internalize these new costs being applied to prior transactions.

284. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

285. Those who scoff at the possibility of a blatant overruling of *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963), might be surprised to learn that this very proposal was made by Professor Leipziger. *See Leipziger, supra* note 3, at 767 n.40. Professor Leipziger proposed that section 580a be applied to all SOJLs in non-commercial transactions, regardless of whether the SOJLs purchased the property. *Id.* Professor Leipziger would not apply fair-value limitations to SOJLs in commercial transactions because "[the SOJLs] do not have an economically realistic alternative of reinstating the defaulted senior obligation." *Id.*

would result from section 580a's three-month statute of limitations on bringing actions for a deficiency judgment against the debtor.<sup>286</sup> Debtors who anticipate default could plan to default on the senior debts earlier than necessary, while continuing to pay the SOJLs for three months following the foreclosure. The SOJLs' right to seek foreclosure remedies is contingent upon a default by the debtor.<sup>287</sup> Thus, an SOJL's cause of action for a deficiency judgment might not be ripe within the statutory period, resulting in a loss of the SOJL's rights.<sup>288</sup>

## V. CONCLUSION

Section 580a<sup>289</sup> should be repealed. Applying section 580a to limit the deficiency judgments of purchasing SOJLs is detrimental to both SOJLs and debtors. Moreover, the application of section 580a to purchasing SOJLs may be a precursor to further expansion of fair-value limitations in the courts' ever-widening pursuit of antideficiency protection.

The cases arguing that section 580a should be applied to limit the deficiency judgment of purchasing SOJLs are plagued by analytical problems.<sup>290</sup> *Pacific Loan Management v. Superior Court*,<sup>291</sup> the first Court of Appeal case to consider this issue since *Walter E. Heller Western, Inc. v. Bloxham*<sup>292</sup> ingrained this application of section 580a into California law, was not clear in its support or disapproval of *Heller Western*.<sup>293</sup> While it appears that the *Pacific Loan Management* court disagreed with most of the *Heller Western* policies,<sup>294</sup> the court nonetheless cited *Heller Western* with approval.<sup>295</sup> Thus, purchasing SOJLs will have their deficiency judgments limited by the fair-value provision of section 580a.<sup>296</sup>

Section 580a should have been explicitly repealed by the California Legislature in 1939, when section 580d was enacted.<sup>297</sup> Now that section 580a has been expanded beyond its language, it has become a dangerous

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286. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

287. G. NELSON & D. WHITMAN, *supra* note 189, § 7.6.

288. See R. BERNHARDT, *supra* note 3, § 4.31. SOJLs can solve this problem by including "cross default" provisions in their loan agreements.

289. CAL. CIV. PROC. CODE § 580a (West Supp. 1989).

290. See *supra* notes 133-222 and accompanying text.

291. 196 Cal. App. 3d 1485, 242 Cal. Rptr. 547 (1987).

292. 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985).

293. *Pacific Loan Management*, 196 Cal. App. 3d at 1494-95, 242 Cal. Rptr. at 552-53.

294. *Id.*

295. *Id.* at 1495 n.3, 242 Cal. Rptr. at 553 n.3.

296. *Heller Western*, 176 Cal. App. 3d at 270, 221 Cal. Rptr. at 427.

297. CAL. CIV. PROC. CODE § 580d (West 1976).

instrumentality of "debtor-protectionism." Thus, in the absence of legislative action, the California Supreme Court should consider the statute's current application.

Until section 580a is repealed, SOJLs can structure their transactions so as to avoid its impact. Section 580a does not apply to additional or excess security.<sup>298</sup> Additionally, in multiple security contexts, section 580a does not prohibit a deficiency judgment when the SOJL either does not purchase one parcel, or pays the fair value for one parcel.<sup>299</sup>

Unfortunately, these remedies have their costs. Over-encumbering property prevents debtors from taking the full economic advantage of their equity and restricts the free use of credit.<sup>300</sup> Furthermore, these strategies are not certain to be successful. Given the courts' failure to adhere to the doctrine of stare decisis in the application of section 580a, and especially in light of the courts' misguided attempts at debtor protectionism, attorneys would be wise to tread warily in this area.<sup>301</sup>

*Jonathan F. Golding\**

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298. *Investcal Realty Corp. v. Edgar H. Mueller Constr. Co.*, 247 Cal. App. 2d 190, 197-98, 55 Cal. Rptr. 475, 480 (1966); *Dickey v. Williams*, 240 Cal. App. 2d 270, 272, 49 Cal. Rptr. 529, 530 (1966).

299. *Dickey*, 240 Cal. App. 2d at 272, 49 Cal. Rptr. at 530-31.

300. *See supra* note 222 and accompanying text.

301. One commentator has already proposed that section 580a be applied to multiple security contexts, and to limit deficiencies against guarantors. Mertens, *supra* note 2, at 561.

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