

TO: Banking and Financial Services Industry

FROM: Grant K. Riley

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RE: Overview and Comparison of California and Nevada Deficiency Law

A. Overview of California Law.

Although subject to significant nuance depending on the facts, California law pertaining to the collection of a deficiency judgment prior to or following the judicial or non-judicial foreclosure of a deed of trust encumbering real property is fairly straight forward:

1. A creditor whose debt is secured by real property must file either a judicial or non-judicial foreclosure to comply with California's "one form of action" rule. In the event a creditor attempts to enforce payment on a note without first foreclosing on the real property collateral, the debtor can raise the shield of Code of Civil Procedure, Section 726 and force the foreclosure of the property. Should the creditor be foolish enough to deliberately violate the "one form of action" rule by exercising a perceived right of set off against a borrower's deposit account in an attempt to reduce the amount due on a secured obligation, the creditor may, in extreme cases, suffer the loss of its collateral.

2. Should the creditor file a judicial foreclosure, which consists of a court action, the creditor can name the borrower and guarantor as defendants, obtain a judgment and

cause the sale of the property by the Sheriff of the county in which the property is located. To obtain a deficiency against the borrower or a guarantor of the subject promissory note, the creditor must file a motion within three months of the Sheriff's sale to establish the amount of the deficiency. In general, to qualify for a deficiency judgment, the creditor must be the holder and beneficiary of a recourse obligation that does not secure a purchase money obligation as that term is defined in Code of Civil Procedure, Section 580b.

3. Per Code of Civil Procedure, Section 726, the deficiency available to a creditor that has filed a judicial foreclosure action is limited to the difference between the total secured debt less the fair market value of the collateral or the successful bid at the Sheriff's sale, whichever is greater. As further described in Section 726(e), the maker of the note is provided with a statutory right of redemption which allows the borrower/guarantor to effectively repurchase the property within 12 months of the Sheriff's sale (in the event of a deficiency) upon payment of the purchase price at the foreclosure sale, amounts expended to insure the property post sale, payments on any senior lien and interest on the above amounts less any income derived from the ownership of the property.

4. Should the creditor conduct a non-judicial (trustee's sale) foreclosure of the deed of trust, the anti-deficiency rule articulated in Code of Civil Procedure, Section 580d bars any deficiency against the borrower. Likewise, the trustee's sale cuts off the borrower's right of redemption. The most important exception to Section 580d pertains to creditors whose obligation is secured by a junior deed of trust. "Sold out" junior lien holders whose deed of trust has been wiped out by the foreclosure of a senior deed of trust can generally sue on the note.

5. Subject to a guarantor's suretyship defenses or, more fittingly, a proper waiver of those defenses, California law does allow the filing of an action against a guarantor for either all sums due under the subject note (without first having to foreclose on the subject collateral) or a post-foreclosure sale deficiency claim. However, the right to proceed directly against the guarantor without first conducting a judicial or non-judicial foreclosure requires the execution by the guarantor of a guarantee that satisfies and complies with the requirements of Civil Code, Section 2856. This statute attempts to clarify the confusion surrounding and codify the holding of the "Gradsky decision" articulated in *Union Bank v. Gradsky* (1968) 265 Cal.App.2d 40 and *Cathay Bank v. Lee* (1993) 14 Cal.App.4th 1533.

6. Upon waiver of the guarantor's suretyship and subrogation rights in compliance with Section 2856, the creditor may sue the guarantor for all sums due on the note without first attempting to foreclose or for a deficiency following a non-judicial foreclosure. Although most form bank guarantees (including LaserPro) contain the requisite waivers, confirming the scope and extent of the guarantors Section 2856 waivers is a critical task that must be completed prior to funding.

B. Overview of Nevada Law.

1. In general, Nevada law is far more creditor friendly than California law and permits a creditor to enforce its deficiency rights against both a borrower and a guarantor uninhibited by anti-deficiency rules similar to those which arise from the application of Code of Civil Procedure, Section 580d.

2. Although the Nevada "one form of action" rule set forth in NRS 40.430 is strikingly similar to the California version of the rule in that it is the public policy of the State of

Nevada to force creditors to realize on their collateral before suing a debtor for a deficiency, there is one notable difference. Specifically, the Nevada rule permits a creditor to exercise a right to set off in a deposit account. Should a Nevada creditor initiate an action which violates NRS 40.430, the statute allows the Court to dismiss the action without prejudice and/or to allow the creditor to amend its complaint so as to comply with the statute.

3. Whereas California law bars a deficiency claim against a borrower following a non-judicial foreclosure per the application of Section 580d, Nevada allows a creditor to sue the borrower for a deficiency per NRS 40.455. It is the absence of an anti-deficiency statute that makes Nevada law unique. To pursue a deficiency, a creditor must file a motion in a pending or newly filed action within 6 months of the foreclosure sale. Like California, the amount of the deficiency is the difference between the total of the secured debt and the amount realized from the sale or the fair value of the property whichever is greater.

4. A guarantor of an obligation secured by property in Nevada can waive Nevada's version of the "one from of action" rule. In such event, "an action for the enforcement of that person's obligation to pay, satisfy or purchase all or part of any indebtedness or obligation secured by a mortgage or lien upon real property may be maintained separately and independently from: (a) an action on the debt; (b) the exercise of any power of sale; (c) any action to foreclose or otherwise enforce a mortgage . . .". Importantly, Nevada guarantors may not waive NRS 40.30 in the event that the principal balance of the subject loan was never greater than \$500,000 or is the subject of a purchase money note. Likewise, guarantors of notes secured by agricultural land and personal residences are exempt from a direct action on the guarantee. Guarantors who are not provided with notice of a trustee's sale are released from liability.

5. As in California, the beneficiary of a Nevada deed of trust is provided with broad discretion to file an action for the appointment of a receiver to protect the subject collateral and/or prevent a defaulting borrower from "cherry-picking" the rents from income producing property. Nevada receivers can also be given broad discretion to complete busted construction projects when appropriate.

Note: The foregoing is intended only as a brief overview of a comparison between basic concepts of California and Nevada law as they pertain to the enforcement of a creditor's rights in connection with a loan secured by real property. Each legal matter is different. As a result, this memo should not be relied on in making legal decisions. Riley & Associates CA/NV has offices in Los Angeles and Las Vegas and is available to assist secured creditors with deficiency claims in both California and Nevada. For further information regarding the firm, please contact Grant Riley at griley@rileylawca-nv.com or visit the firm's website at www.rileylawca-nv.com.