

## Strategic Default in Anti-Deficiency States

By Mariana E. Gomez<sup>1</sup>

Mortgage lenders coping with rising foreclosure rates have a growing problem on their hands: underwater borrowers are walking away from their homes in increasing numbers.<sup>2</sup> These borrowers can afford their mortgage payments but choose to “strategically default” because the amount owing on their mortgage exceeds the value of the home. As many as one in four defaults may be strategic.

“Strategic default” is fast replacing traditionally accepted mores surrounding debt and repayment.<sup>3</sup> Consumer advocates are encouraging underwater borrowers to divorce themselves from their mortgages and start over.<sup>4</sup> Borrowers who walk away from their loans often blame lenders for not offering a significant reduction in the principle.<sup>5</sup> But lenders may be disinclined to offer principle reductions to borrowers who refinanced purchase-money loans or took equity out of their

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<sup>2</sup> See J. Hagerty & N. Timiraos, *Debtor’s Dilemma: Pay the Mortgage or Walk Away*, WALL STREET JOURNAL, Dec. 17, 2009 at A22 (citing Northwestern University study estimating that 1 in 4 defaults are strategic).

<sup>3</sup> David Streitfeld, *With No Help in Sight, More Homeowners Walk Away*, NY TIMES, Feb. 3, 2010 at A1.

<sup>4</sup> See Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis*, Ariz. L. Studies Discussion Paper No. 09-35 (Oct. 29, 2009) (encouraging borrowers to ignore social mores surrounding foreclosure and default).

<sup>5</sup> Id.

homes to finance luxury vehicles, vacations, investment properties, weddings, and other consumer goods and services.<sup>6</sup>

Strategic defaults are a particular concern for lenders operating in states that limit lender recourse after mortgage defaults. Under the common law, a borrower is personally liable for mortgage defaults if the foreclosure sale does not satisfy the full amount of the lien encumbering the property. The common law also allows lenders to file multiple actions related to the same mortgage default; lenders can foreclose on the collateral and sue directly on the dishonored note. Defaulting homeowners in common law states faced the loss of their home and personal liability for the balance of the debt not satisfied by the foreclosure judgment. The double threat of foreclosure and a "deficiency" judgment are formidable disincentives against voluntary default.

The number of states that allowed common law foreclosures and deficiency judgments decreased after the Great Depression. States enacted a variety of "anti-deficiency" laws to mitigate the effects of strict foreclosure and personal liability. Anti-deficiency statutes take a variety of forms: they may limit the election of remedies with "one-action" and "foreclosure first"

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<sup>6</sup>See Streitfeld, With No Help in Sight More Homeowners Walk Away, *supra* note 3.

rules<sup>7</sup> or cap deficiency judgments based on "fair value appraisals" instead of relying on the sale proceeds to determine the value of the collateral.<sup>8</sup> Some states go further and limit purchase-money security interest (PMSI) lenders<sup>9</sup> and bar deficiency judgments after non-judicial foreclosures.<sup>10</sup>

Not surprisingly, the rate of strategic defaults is higher in such states. This article explores the various options lenders can utilize to maximize recovery against borrowers who opt to "strategically default."

Residential PMSI mortgages and deficiency laws:

Borrowers in states with nonrecourse PMSI mortgages may be especially tempted to walk away from their homes. In contrast to states like Illinois, that explicitly allow deficiency judgments without any fair value limitation,<sup>11</sup> strategic defaulters in

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<sup>7</sup> See e.g., Cal. Civ. Proc. Code § 726; Idaho Code § 6-101; N.J. Stat. § 2A:50-2; Nev. Rev. Stat. § 40.430; Or. Rev. Stat. § 86.735(4); Utah Code § 78-37-1.

<sup>8</sup> See e.g., Ark. Stat. § 18-49-105; Ariz. Rev. Stat. § 729; Cal. Code Civ. Proc. § 580a; Conn. Stat. § 49-9, 49-25, 49-38; Id. Code § 6-108 (see e.g. *Thompson v. Kirsch*, 677 P.2d 490 (Id. Ct. App. 1984) (restricting senior lenders to "fair value" of property but applying "reasonable value" for sold-out junior lienors)); Oh. Rev. Code § 2329; S.D. §§ 21-47-15, 16, §§ 21-48-13, 14; Tx. Prop. Code § 51.005 (West 2010). The following states apply special scrutiny to lender purchases at judicial and/or private sales: AZ, CA, ID, FL, MI, NE, NC, and SD.

<sup>9</sup> See e.g., Ariz. Rev. Stat. §§ 33-722, 729(A), 814 (West 2010); Cal. Civ. Proc. § 580b (2010); Fla. § 702.06(2), as amended by Fla. H.B. 35 (2010), effective July, 1, 2010; MT 71-1-232 (West 2010); NC § 45-21.38 (West 2010); N.D. Cent. Code § 32-19-03 (2009); Or. Stat. §§ 88.040, 070 (West 2010). New Mexico prohibits the recovery of deficiency judgments against "low-income" households. See NM Stat. § 48-10-17(E-G) (barring personal liability and defining low income as below 80 percent of the local median income).

<sup>10</sup> The following states forbid deficiency judgments after nonjudicial foreclosures: AZ, CA, CO, KY, LA, ME, MD, ME, MT, OK, PA.

<sup>11</sup> Ill. Comp. Stat. §5/15-1508.

Arizona California, Florida,<sup>12</sup> Montana, Nevada<sup>13</sup>, North Carolina, and North Dakota<sup>14</sup> may be emboldened by laws that grant PMSI mortgages on residential property non-recourse status. Oregon also restricts recourse on borrower-occupied dwellings secured with PMSI mortgages but with an important limitation: PMSI lenders can waive their lien on the collateral and sue directly on the note.<sup>15</sup>

Other states bar personal liability on PMSI mortgages if lenders conduct nonjudicial or trustee foreclosure sales; Colorado, Louisiana, Maine, Massachusetts, Montana, Kentucky, Oklahoma, and Pennsylvania allow lenders to sue for a personal judgments after a judicial foreclosure against a residential PMSI mortgage, but not after a private sale.

In the past, laws authorizing deficiency judgments only after judicial foreclosures had the practical effect of making PMSI mortgages non-recourse because lenders often forgo deficiency judgments in favor of nonjudicial foreclosures, despite the availability of deficiency judgments after judicial

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<sup>12</sup> Florida's PMSI anti-deficiency law becomes effective on July 1, 2010. See Fla. H.B. 35 (2010) (barring deficiency judgments after default on mortgages securing homestead property).

<sup>13</sup> Nevada bars deficiency judgments on residential PMSI loans made on or after Oct. 1, 2009. See Nev. Rev. Stat. § 40.455, as amended by Nev. A.B. 471 (2009) (barring deficiency judgments against mortgages or trusts securing purchaser-occupied dwellings).

<sup>14</sup> See *supra* notes 10, 15.

<sup>15</sup> See *Beckhusen v. Frank*, 775 P.2d 923, 924-25 (Or. App. 1989) (allowing holder of residential trust deed to foreclose on property and waive right to deficiency or waive right to foreclose and sue directly on the note) (citing *Ward v. Beem Corp.*, 437 P.2d 483 (Or. 1968)).

foreclosures. Lenders prefer nonjudicial foreclosures because private sales are faster, and importantly, eliminate the debtor's statutory right to redeem the property. Eliminating the right to redeem protects the value of collateral because however unlikely it is that a debtor will exercise the right to redeem, the threat of redemption lowers the market value of the collateral.<sup>16</sup>

The increasing phenomena of strategic default may prompt lenders to rethink their foreclosure strategies. Unlike involuntary defaulters, strategic defaulters are more likely to have a reliable stream of income and own other assets. Strategic defaulters are probably more likely to purchase new property after default than an involuntary debtor. In these situations, a senior PMSI lender may weigh the hardships of judicial foreclosure with the benefits of deficiency judgment against the debtor. Where the debtor has assets subject to levy, the lender may be more inclined to pursue a course of action that permits personal liability.<sup>17</sup>

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<sup>16</sup> The threat of redemption, particularly when combined with the inability of bidders at foreclosure sales to inspect the property before auction, lowers the amount bidders will pay for foreclosed property. See Michael Shill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 493 (April 1991) (noting chilling effect redemption right and lack of pre-auction inspection causes on bidding at foreclosure sales).

<sup>17</sup> The role mortgage insurers do or do not play in lenders decisions to seek deficiency judgments is beyond the scope of this article. However, mortgage insurers tend to aggressively pursue deficiencies to maximize recovery and possibly to deter others from defaulting. See John Mixon, Ira Shepard, *Antideficiency Relief for Foreclosed Homeowners: ULSIA Section 511(b)*, 27 WAKE

If a lender obtains a personal judgment against the debtor, the judgment and lien on the debtor's non-exempt assets survives between five and twenty years.<sup>18</sup> During the life of the judgment creditors may levy on non-exempt property and where allowed, can garnish the debtor's wages.

More States are Passing PMSI Mortgage Anti-Deficiency Laws

In response to the housing crisis and poor economic outlook, more states are enacting anti-deficiency laws to protect PMSI mortgagors. Florida will begin enforcing an anti-deficiency law that absolves borrowers of legal liability for PMSI mortgages on July 1, 2010.<sup>19</sup> In March of 2009 Nevada enacted a law barring deficiency judgments on residential PMSI mortgages made on or after October 1, 2009.<sup>20</sup> In 2009, Iowa passed special legislation law that forbids nonjudicial foreclosures on residential PMSI mortgages, shortens the enforceability of deficiency judgments to two years, and allows courts to invalidate junior liens if the junior lender refuses to grant a mortgage modification that reduces at least ten

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FOREST L. REV. 455, 469 (1992) (noting that since the late 1970's and early 1980's, mortgage insurers and lenders routinely pursue deficiency judgments).

<sup>18</sup> Colorado judgments survive for six years; Colo. Rev. Stat. § 13-52-102. Delaware, Indiana, and Missouri have ten a year statute of limitations on judgments; Del. Code title 10, § 4711; Ind. Code § 34-1-45-2; Mo. Stat. § 511.370. Virginia's statute of limitations is 20-years. Va. Code Ann. § 8.01-251 (West 2010).

<sup>19</sup> Deficiency judgments in Florida used to be "the rule, not the exception." Florida H.B. No. 35 amended section 702.06(2) to prohibit deficiency judgments resulting from mortgage foreclosures on homestead property. Florida is a "homestead" state that allows unlimited exemptions for homestead properties during bankruptcy proceedings.

<sup>20</sup> See *supra* note 16.

percent of the net present value owing on the junior mortgage.<sup>21</sup> Maryland's recent emergency legislation does not forbid deficiency judgments but creates obstacles to deficiency judgments by significantly lengthening the time it takes to conduct a nonjudicial foreclosure on residential PMSI mortgages.<sup>22</sup>

However, borrowers should be aware that the presence of a residential PMSI deficiency law does not mean a lender can never obtain a money judgment on a residential PMSI mortgage or trust deed. Strategic defaulters relying on laws prohibiting deficiency judgments on standard PMSI-mortgages should know that both the PMSI transaction and the property securing the mortgage must meet specific criteria before an anti-deficiency law applies. For example, although the PMSI-mortgage laws are facially similar in California and Arizona, Arizona rejected California's interpretation of the statute.

In California, PMSI protection is limited to purchaser-occupied residential dwellings for not more than four families.<sup>25</sup> It does not apply to investment properties, vacation homes, reverse mortgages, refinancing transactions, home equity

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<sup>21</sup> Iowa Senate File 364, enacted on April 27, 2009, effective June 1, 2009. Iowa's new mortgagor protection law passed the Senate with a 50-0 vote. The Iowa legislation will expire in 2011 unless it is renewed.

<sup>22</sup> See 2010 Md. Senate Bill No. 276, Md. 427th (Jan. 22, 2010) (extending foreclosure proceedings from an average of fifteen days to 135 days), temporarily amending Md. Real Prop. § 1-705.1, Md. Rules of Proc. § 14-205.

<sup>25</sup> Cal. Civ. Proc. § 580b.

withdrawals, and non-standard PMSI's.<sup>23</sup> In contrast, the PMSI-mortgage protection privileges in Arizona are broader than California law allows. For example, Arizona deems refinanced PMSI loans and loan workouts to be PMSI mortgages protected by their PMSI anti-deficiency law; Arizona also shields PMSI mortgages on investment properties from deficiency judgments.<sup>24</sup>

#### Non-PMSI Mortgages and Deficiencies.

PMSI and non-PMSI lenders alike must contend with (1) foreclosure first laws; (2) one-action laws; and (3) bars against personal judgments after nonjudicial foreclosures. However, in most states, these laws will not apply to a non-PMSI mortgagee that is subordinate to a senior lien.<sup>25</sup> A non-PMSI mortgagee with senior priority is subject to laws limiting a lender's election of remedies, but loans that are considered "non-PMSI" (home equity loans, home improvement loans, loans to

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<sup>26</sup> See e.g., *Allstate Savings & Loan Assn. v. Murphy*, 159 Cal. Rptr. 663, 664 (2d Dist. 1979) (noting section 580b did not bar deficiency judgment when loan proceeds used to construct a swimming pool); *Roseleaf v. Chierighino* 378 P.2d 97, 99-101 (ruling that loan paying for the balance owing on a purchase-money mortgage is not protected under 580b because it is a "standard" PMSI); *Union Bank v. Wendlend*, 126 Cal. Rptr. 549, 552 (App. Ct. 1976) (second loan to pay off balance of residential PMSI mortgage was not a PMSI note entitled to protection under 580b).

<sup>27</sup> See *Bank One v. Beauvais*, 934 P.2d 809, 814-15 (Ariz. App. 1997) (rejecting *Wendlend*, and holding that refinanced PMSI's and workout agreements are PMSI mortgages under Arizona law). The protection of investment properties under Arizona's anti-deficiency law is the subject of ongoing litigation. Arizona Sen. Bill 1271 (2009) narrowed anti-deficiency protection under 33-722, 33-729 and 33-814 to dwellings occupied by obligors for at least six months prior to foreclosure. SB 1271 was effective Sept. 30, 2009 but it was repealed by the Governor in the fall of 2009. The Arizona Bankers' Association is challenging the validity of the repeal in court.

<sup>25</sup> *Wendlend*, 126 Cal. Rptr. at 552 (one-action rule and foreclosure first rule does not apply to subordinate junior lien holders), cf. with *Bank One v. Beauvais*, at 814-15 (rejecting *Wendlend* and holding that junior lenders are subject to foreclosure first rules and one-action laws).



purchase other property, etc.) are frequently second or third in priority. For example, during the go-go credit days, a debtor with some equity in their home could usually secure a second, non-PMSI loan. The long-term of traditional purchase money mortgages (thirty years) also increases the likelihood that a non-PMSI loan secured by the borrowers home will be second to a senior PMSI mortgage.

Borrowers who walk away from their homes may be walking away from both first and second mortgages. A subordinate non-PMSI loan can avoid election of remedies laws and laws forbidding judgments after nonjudicial foreclosures by exercising forbearance.<sup>26</sup> With the exception of Arizona, actions filed or undertaken by senior mortgagees are not attributed to junior lenders.<sup>27</sup> The result is the inapplicability of anti-deficiency laws to non-PMSI, subordinate lienors.

In strategic default cases, the junior position can be advantageous for a variety of reasons:

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<sup>26</sup> See *Heller v. Bloxham*, 221 Cal. Rptr. 425, 427 (App. 1985) (holding Cal. Civ. Proc. § 580d does not bar purchasing junior from obtaining deficiency judgment when senior creditor elects to foreclose by nonjudicial sale, because purchasing junior did not elect private sale and it would be unfair to eliminate junior's right to deficiency even though junior ended up with nonredeemable title); cf. with *Evans v. Cal. Trailer Ct.*, 33 Cal. Rptr.2d 646 (App. 1994) (barring junior action for money judgment on junior note after junior purchased senior note and foreclosed on the senior note because juniors own actions led to foreclosure that extinguished junior's interest in collateral), *rehearing denied, review denied*.

<sup>27</sup> See *supra*, 27. The *Beauvais* court refused to allow a sold-out junior to sue for a personal judgment after the junior purchased the collateral at the senior's sale.

- Juniors are positioned to get two bites of the apple: they can purchase the collateral at the senior's foreclosure sale (which extinguishes the right of redemption) *and* sue on the note for a personal judgment.
- Borrowers who are planning to walk away from their homes may continue to make payments on their non-PMSI obligations even if they stopped making payments on the first mortgages. The rationale is that borrowers, particularly strategic defaulters who can afford to make payments on the second mortgages, make payments on their home equity credit lines to preserve an important source of cash.
- The financial resources and future income stream of strategic defaulters are probably greater than an involuntary debtor; thus the value of a money judgment may be worth more to a junior lender than a money judgment against a bankrupt debtor.
- Where debtors have a degree of financial stability and the value of the collateral has decreased dramatically, a money judgment may be attractive. A money judgment avoids the practical difficulties posed by taking possession of thousands of foreclosed homes. In a depressed housing market and poor economic climate the

home may remain on the market for months before it sells. A money judgment can be promptly sold to a credit collection company.

*The Long-Term Consequences of Strategic Default*

Inevitably, some borrowers without second or third mortgages will avoid personal liability after they walk away from their mortgages. However, borrowers should not confuse legal liability with the debt itself. Anti-deficiency laws can extinguish the lien, but the underlying debt continues to exist. Lenders can and do pursue borrowers for "voluntary" repayment of their obligation.

A debtor's credit report will take a heavy hit and make it more difficult for a borrower to obtain quality-credit products in the future. Defaults are reported to credit reporting agencies and may remain on the report seven years. Defaulting borrowers will also face additional hurdles the next time they apply for a mortgage; debtors must wait at least five years after a default before they can apply for a government-secured loan, and there is no guarantee that a prudent lender will extend credit to a borrower who walked away from their last mortgage.

Despite the long-term economic consequences caused by strategic default, these problems are not going away any time

soon. As long as anti-deficiency laws transform purchase-money mortgages into non-recourse debt, rational borrowers will take advantage of the laws as an easy way to shed debt. Unless anti-deficiency laws are curtailed - which is unlikely in the current political climate - or until there is a sea-change in market values, lenders can continue to expect waves of "jingle mail" to flood their offices.<sup>28</sup>

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<sup>28</sup> Jingle mail is a short-hand term that expresses the sound envelopes make when borrowers send their lender the keys to their home because the borrower has "walked away" from the home.