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The California Home Equity Sales Contract Purchase Act

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Current economic conditions have resulted in the almost unprecedented, at least in recent times, situation in which it is possible – with a reasonable down payment – to invest in residential real property in California and to realize positive cash flow from such investment property. But the ability to do so does not come without the California legislature having attached statutory strings.

A recent EARLELAW NEWSLETTER titled *Potential Pitfalls of Purchasing Properties in Foreclosure* briefly discussed (among other things) one of those "statutory strings": the Home Equity Sales Contract Purchase Act (HESCPA), which is codified at California Civil Code § 1695 et. seq. and which imposes certain restrictions on the purchase of residential real property which is in foreclosure. In light of the recent California Court of Appeal decision in Spencer v. Marshall, 168 C.A.4th 783 (2008), which was published after the previous EARLELAW NEWSLETTER on this subject, this EARLELAW NEWSLETTER examines HESCA in more detail.

During 1998, Alanna Spencer, a first-time home buyer, purchased a condominium in Hayward, California. The lender, Option One Mortgage, filed a Notice of Default (NOD) several years later, during November 2002. At the time the NOD was filed, Spencer owed $170,000 on the loan to Option One. Spencer filed for Chapter 13 bankruptcy during January 2003, shortly after the NOD was filed.

At about the time Spencer filed for bankruptcy, Spencer's condominium was appraised for $290,000, some $120,000 more than Spencer owed on it.

During August 2004, and with the consent of the Bankruptcy Trustee, Spencer sold the condominium to Ryan Marshall "or assigns" for $200,000 – $30,000 more than Spencer owed on the property, but $90,000 less than the appraised value of the property. The purchase agreement provided that Spencer could (i) repurchase the condominium for $260,000, prior to September 2005 and (ii) leaseback the condominium for one year at a rate of $1,500 per month.

The purchase agreement was reviewed by Spencer's bankruptcy attorney. Spencer understood that the sale price for the condominium was less than its appraised value and that the repurchase price was higher than the sale price. Spencer also knew, at the time she signed the purchase agreement, that the bankruptcy court was about to lift the automatic stay, which in turn would allow Option One to proceed with its foreclosure action.

During August 2005, Spencer failed to qualify for a loan which would have allowed her to repurchase the condominium.

Spencer's option to repurchase the condominium expired during September 2005. Marshall offered to sell the condominium to Spencer for $315,000 (considering that Spencer was unable to repurchase the condominium only one month earlier at the repurchase price of $260,000, it is unclear how Spencer would have been able to purchase the condominium for $315,000). When Spencer failed to purchase the condominium, Marshall listed the property for sale at $370,000.

During December 2005, Spencer filed a lawsuit against Marshall, seeking to rescind the deed which transferred title of the condominium from Spencer to Marshall, to quite title to the condominium, and for compensatory and punitive damages. Marshall answered Spencer's lawsuit and also filed an unlawful detainer (eviction) lawsuit against Spencer.

The two lawsuits were consolidated. After a bench trial on Spencer's HESCPA claims, the trial court entered judgment in favor of Spencer and against Marshall, awarding Spencer $280,000, $70,000 of which represented actual damages and $210,000 of which represented punitive damages. Marshall appealed, asserting that he had not violated the HESCA.

The California Court of Appeal affirmed the trial court's decision.

Where did Marshall go wrong? Marshall purchased Spencer's condominium in foreclosure at a price which was $30,000 more than Spencer owed on the property, leased the condominium back to Spencer for a period of one year, and even granted Spencer an option to repurchase the condominium at a price which was then $30,000 less than the property's appraised value. Furthermore, Spencer's bankruptcy attorney reviewed the transaction and, presumably, found nothing objectionable in its terms.

The California legislature, when enacting the HESCPA, declared that "homeowners whose residences are in foreclosure have been subjected to fraud, deception, and unfair dealing by home equity purchasers." Civil Code § 1695(a). Rather than simply allowing homeowners who have been subjected to "fraud, deception, and unfair dealings" to use existing laws and remedies to redress such wrongful conduct, the HESCPA creates certain prophylactic procedural requirements intended to protect California homeowners in default who want to enter into contracts to sell their properties.

California homeowners in foreclosure may not waive the HESCPA protections. Thus, it is irrelevant that Marshall agreed to purchase Spencer's property for more than the amount of the loan, agreed to allow Spencer to repurchase the property for less than its appraised value, leased the property back to Spencer, or that Spencer's attorney reviewed the transaction.

Spencer, as the plaintiff, was required to make a prima facie showing that the transaction was subject to the HESCPA and that Marshall did not comply with the requirements of the HESCPA. Once Spencer met this burden, Marshall was required either to rebut Spencer's evidence or, alternatively, demonstrate that the transaction fell within at least one of the exceptions to the HESCPA.

Marshall admitted that the transaction with Spencer fell within the purview of HESCPA, but argued that HESCPA had not been violated because one of the statutory exceptions applied. Using standard rules of statutory construction, the court narrowly construed the exception upon which Marshall relied and upheld the trial court's judgment against Marshall.

The HESCPA applies to any transaction which involves a California residential property which is in foreclosure. The requirements of, and exceptions to, HESCPA might appear to be fairly straight-forward, but, as Spencer v. Marshall demonstrates, a disgruntled seller may call upon the courts to closely scrutinize a HESCPA transaction and order the investor/purchaser to pay over to the seller all profits from the transaction.

Please call EARLE LAW OFFICES today if you are a real estate investor who is actively seeking to purchase California residential property which is in foreclosure to request assistance in complying with HESCPA and other applicable laws.

EARLE LAW OFFICES provides litigation and non-litigation legal services in the areas of business law, family law, real estate law, tax law, and trusts and estates.

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