

# REAL ESTATE

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## Proceed With Caution: Enforcing A Defaulted Loan Within The Framework Of California's One Action Rule

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In enforcing its remedies against a defaulting borrower or any guarantors, a real property secured creditor, despite any language to the contrary in the loan documents, must be careful to ensure that its remedies are carried out in a way which does not violate California's anti-deficiency laws. This is especially important in the current market given the precarious situation of many borrowers of real property secured loans. Thus, an understanding of California's anti-deficiency laws is important both in the loan documentation process and in the enforcement of the remedies available to a real property secured creditor. The following provides a general overview of the protections and pitfalls of California's anti-deficiency laws.

### ONE ACTION RULE

Section §726(a) of the California Code of Civil Procedure (CCP), commonly referred to as the one action rule, encompasses three aspects regarding the enforcement of a real property secured obligation: (i) the security first rule, which prevents a real property secured creditor from ignoring its security and suing on the underlying note or debt;<sup>1</sup> (ii) the one action principle, which requires a real property secured creditor to enforce all of its security in a single action;<sup>2</sup> and (iii) the one form of action rule, which provides that there is

only one form of action by which a real property secured creditor can seek to enforce a debt, and that action is by judicial foreclosure.<sup>3</sup>

The security first rule requires a real property secured creditor to first look to the security before it can seek a personal judgment from the debtor.<sup>4</sup> The security first rule can be raised by a debtor at any time during trial, and when a debtor does so, the creditor is required to amend its complaint to include all of the security which secures the debt into one action.<sup>5</sup> Note that a creditors' exercise of its rights pursuant to a statutory banker's lien<sup>6</sup> and a set-off against a bank account<sup>7</sup> violate the security first rule; however, neither the exercise of a creditor's rights under §2938 of the California Civil Code (CC) (e.g., appointment of a receiver and collection and application of rents),<sup>8</sup> nor the presentment, receipt of payment or demand for payment under a letter of credit constitute an action for purposes of the one action rule.<sup>9</sup> The second aspect of the one action rule provides that a real property secured creditor must enforce its security in a single "action," which is generally defined as a judicial proceeding prosecuted to judgment<sup>10</sup> or the judicial or non-judicial appropriation of the debtor's non-collateral assets. Examples of non-judicial appropriation which violate the one action rule include: prejudgment attachment of non-collateral assets of the debtor;<sup>11</sup>

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and prejudgment attachment on a bank account.<sup>12</sup> For purposes of the one action rule, neither non-judicial foreclosure<sup>13</sup> nor the *commencement* of judicial foreclosure<sup>14</sup> are considered an “action” within the meaning of CCP §§22 or 726(a), since neither have been reduced to a judgment. In a loan secured by both real property and personal property, creditors are permitted to foreclose on any personal property secured by the creditor pursuant to Section 9604 of the California Commercial Code without violating the one action rule.<sup>15</sup> Note that since non-judicial foreclosure is not an action within the meaning of the one action rule, a creditor can conduct separate, piecemeal non-judicial foreclosure proceedings if the creditor did not originally include all of the security in the original non-judicial foreclosure or where multiple security is used for a single note.<sup>16</sup> The final aspect of the one action rule provides that judicial foreclosure is the sole action by which a real property secured creditor can enforce its security.<sup>17</sup> Once the creditor has completed judicial foreclosure proceedings, the creditor is deemed to have made an election of remedies and waived any security for the loan that was not included in the action.<sup>18</sup>

### **VIOLATIONS OF THE ONE ACTION RULE**

Violations of the one action rule typically occur when a creditor (i) proceeds directly on the note before foreclosing on the security and obtains a judgment, (ii) fails to include all of the security in a judicial foreclosure action and following a judgment attempts to enforce the remainder of the security, or (iii) exercises self-help remedies after a debtor’s default (e.g., set-off against a bank account, exercise of banker’s lien or appropriation of unpledged assets). As noted above, a debtor can raise the security first rule as a defense and require a creditor to amend its complaint to include all of the security before proceeding directly on the note. However, even if a debtor fails to timely raise the security first rule as a defense, the one action rule will still operate as a sanction. Historically, courts held that both the underlying debt and the security would be waived for violation of the one action rule. However, absent certain conduct by the creditor (e.g., the creditor’s refusal to restore funds offset by the creditor after the debtor’s demand), the more recent trend has been to waive only the security and to keep the debtor obligated on the underlying debt.<sup>19</sup>

The one action rule is inapplicable in certain situations, entitling a creditor to enforce its security without first instituting foreclosure proceedings. Exceptions to the one action rule include: (i) CCP §726.5, which allows a creditor to waive its lien for environmentally impaired real property and instead

sue the borrower directly on the note (as if the lender were an unsecured creditor) provided that (a) the borrower knows of or caused the impairment, (b) notice of default has been given, (c) a court has confirmed that the real property is environmentally impaired, (d) the creditor has foreclosed on all other security held by the creditor, and (e) the property is commercial property or over 15 residential units;<sup>20</sup> (ii) legally worthless security (e.g., real property that does not exist,<sup>21</sup> cannot be mortgaged,<sup>22</sup> is not owned by the trustor,<sup>23</sup> or cannot be encumbered by the debtor<sup>24</sup>); (iii) sold-out junior creditors (e.g., a junior creditor who has had its security extinguished when a senior creditor forecloses on the senior lien is not subject to the one action rule and may proceed directly against the borrower on the note, subject to any applicable anti-deficiency rules);<sup>25</sup> and (iv) rent skimming (e.g., the lender can come after the borrower to the extent of misappropriated rents upon the borrower’s default).<sup>26</sup>

### **WHEN A LENDER CAN BRING AN ACTION FOR MONEY DAMAGES FOR BREACH OF CONTRACT AGAINST A BORROWER**

In addition to the foregoing exceptions to the one action rule, CCP §736 allows a lender to bring an action for money damages for breach of contract against the borrower if the borrower has violated any environmental provision in the loan documents, notwithstanding CCP §726.<sup>27</sup> The requirements of bringing an action under CCP §736 are similar to the requirements noted above under CCP §726.5, except that to bring to an action under CCP §736 (i) the original loan amount must have been greater than \$200,000.00 and (ii) the creditor is not required to sue first and prove the impairment or foreclose first on other security held by the creditor.<sup>28</sup> Amounts recoverable under CCP §736 include (a) all amounts reasonably expended in connection with the cleanup costs if ordered by a governmental agency, or if not ordered by a governmental agency, amounts which are reasonable and made in good faith, (b) indemnification against all third parties provided that the creditor is not responsible for the impairment of the property, and (c) attorneys fees and costs incurred by the creditor relating to the breach.<sup>29</sup>

### **JUDICIAL FORECLOSURE VERSUS NON-JUDICIAL FORECLOSURE**

Typically, judicial foreclosure and non-judicial foreclosure are commenced simultaneously, with the creditor dismissing

one of the two foreclosure proceedings once the creditor has weighed the advantages and disadvantages of each process. Another reason for instituting both proceedings simultaneously is that a creditor can apply for the court to appoint a receiver in a judicial foreclosure action, but may not do so in a non-judicial foreclosure proceeding because such proceeding is conducted outside of the court.<sup>30</sup> The primary advantage of instituting a judicial foreclosure action is that, except for purchase money loans, a deficiency judgment is permitted after a judicial foreclosure to the extent the borrower is liable for a deficiency under the terms of the loan documents.<sup>31</sup> If the creditor is entitled to a deficiency judgment, the creditor must apply for the deficiency amount within three months following the foreclosure sale.<sup>32</sup> However, under the fair value limitations set forth in CCP §726(b), a deficiency judgment is limited to the outstanding amount of the debt (plus interest and costs) less the greater of (a) the “fair value” of the property as determined by the court or (b) the foreclosure sale price.<sup>33</sup> Theoretically, if the action is uncontested, a judicial foreclosure action may be completed in as little as three months. However, as a result of delays for calendaring in the local courts and the typical defenses raised by borrowers, the judicial foreclosure process usually takes up to a year or more.

Despite the prospect of obtaining a deficiency judgment, judicial foreclosure is rarely used by creditors in California primarily because (i) the debtor of judicially foreclosed property has a right to redeem the property until one year following the foreclosure if the proceeds from the foreclosure are insufficient to satisfy the indebtedness, plus interest and costs (or three months following foreclosure if the proceeds from the foreclosure are sufficient to satisfy the indebtedness, plus interest and costs); and during the applicable redemption period the debtor may continue to occupy the foreclosed property,<sup>34</sup> unless the lender has waived a deficiency judgment, in which case the borrower does not have a redemption period following judicial foreclosure;<sup>35</sup> (ii) a judicial foreclosure invariably takes longer and is more expensive than a non-judicial foreclosure; and (iii) a judicial foreclosure must be commenced within four years from the maturity date of the debt or if the maturity date is accelerated, within four years after the accelerated due date.<sup>36</sup>

### THE ADVANTAGES TO NON-JUDICIAL FORECLOSURE

The advantages to non-judicial foreclosure are: (i) it is less expensive since it does not involve courts and instead uses the power of sale clause in the deed of trust; (ii) it is a relatively quick process that can be completed within four months

(assuming the debtor does not contest); (iii) there is no statute of limitations within which the creditor must commence non-judicial foreclosure; and (iv) there is no redemption period following the sale of the property. The primary disadvantage to non-judicial foreclosure is that a deficiency judgment is prohibited against the borrower,<sup>37</sup> subject to a few limited exceptions.<sup>38</sup>

### GUARANTY

A true guaranty is one in which a party promises to pay for or pledges collateral for the debt of *another*.<sup>39</sup> While guarantors have the same protections that a surety is entitled to under CC §§2787 to 2855, the one action rule and the anti-deficiency laws are primarily for the benefit of debtors and are not applicable to guarantors. However, courts have found that in some instances, the anti-deficiency laws provide indirect protection to guarantors based on theories of estoppel<sup>40</sup> and certain other defenses provided in CC §§2787 to 2855.

Prior to the decision rendered in *Bank of S. Cal. v. Dombrow*,<sup>41</sup> it was long held that guarantors were not entitled to the benefits of the anti-deficiency laws. However, the *Dombrow* court held that under CCP §580a guarantors were entitled to a fair value hearing following a non-judicial foreclosure for purposes of determining the deficiency amount owed by the guarantors.<sup>42</sup> While acknowledging that this newly afforded protection to guarantors could be waived, the court found that no such waiver existed. Within a few months after it was decided, *Dombrow* was ordered depublished and not citable, but has not yet been overruled. With the depublishing of *Dombrow*, there is still no reported case in California which provides guarantors with the right to a fair value hearing following a non-judicial foreclosure; however, it would be prudent practice for a creditor to assume that guarantors are entitled to the protection of CCP §580a and in response obtain the requisite waivers discussed below. By obtaining the appropriate waivers, a guarantor would be liable for the entire deficiency amount following a non-judicial foreclosure.

### SHAM GUARANTY

A “sham guaranty” is a guaranty executed by a party who is already obligated on the guaranteed obligation. The most common situation in which a sham guaranty arises is when the guarantor is really the debtor in disguise. In determining whether a sham guaranty exists, courts generally look at whether the guaranty was executed by parties otherwise subject to unlimited liability and/or whether the guarantor is the alter ego of the borrower (e.g., where individual partners

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executed guarantees of a partnership debt,<sup>43</sup> or where a corporation was formed to borrow money and the corporation's debt is guaranteed by the sole or principal shareholders of the corporation which is the debtor).<sup>44</sup> Sham guarantees are unenforceable and, since the party executing the sham guaranty is considered a primary obligor of the debt, the "guarantor" of a sham guaranty is entitled to the same one action and anti-deficiency protections as a debtor.

Additional factors that courts have looked at in determining whether a true guaranty exists are: (i) whether the lender insisted on the creation of the entity in order to deprive the borrower of California's anti-deficiency protections; (ii) whether the lender reviewed only the financial information of the guarantor in making the loan and did not rely on the financial information of the borrower; and (iii) whether the guarantors, or some of them, are the alter egos of the thinly capitalized general partner of the borrower.<sup>45</sup>

While there are no reported California decisions considering the liability of a guarantor that is the sole member of a single member limited liability company borrower where anti-deficiency or one action principles are at issue, the case law is clear that courts will look at the purpose and effect of the transaction to determine whether the supposed guarantors are really the principal debtors under another name. If the structure of the transaction is designed to subvert the purpose of the anti-deficiency laws by relegating the true principal to the position of guarantor, courts are likely to find that a "true" guaranty does not exist and will afford the purported guarantor all the protections of the anti-deficiency laws.<sup>46</sup> To date though, courts have respected the typical structure of CMBS and other loans where the lender requires the borrower to be a single asset entity for securitization and bankruptcy remoteness purposes, but then also obtains certain guaranties and indemnities from one or more of the owners of that single asset entity.

### WAIVERS

CC §2856 states the suretyship defenses that a guarantor may waive under California law, which includes defenses resulting from the lender's election of remedies, any anti-deficiency and one action protections a guarantor may have under CCP §§580a (fair value limitation for non-judicial foreclosure), 580b (no deficiency judgment on any purchase money loan or loan secured by owner-occupied one to four family dwelling), 580d (no deficiency judgment after non-judicial foreclosure) and 726 (one action rule).<sup>47</sup> However, for many years lenders were uncertain about how to actually craft the language in their

loan documents to effectively waive such defenses. The holdings in two different cases in the mid-1990s further muddied the waters on this point. First, the court in *Cathay Bank v. Lee* held that the waiver must expressly state that (i) the destruction of subrogation rights creates a defense to a deficiency judgment and (ii) the guarantor is knowingly waiving that specific defense (i.e., the Gradsky defense).<sup>48</sup> Then the court in *Bank of S. Cal. v. Dombrow* held that guarantors were entitled to the fair market value protections of CCP §580a.<sup>49</sup> In response to these cases, many institutional lenders modified the waiver language in their guaranties to provide a lengthy explanation of every possible defense that the guarantor was waiving as well as a virtual treatise on the California case law dealing with such defenses.

In 1996 the California legislature stepped in and revised CC §2856 to include two "model waivers" [CC §§2856(c) and (d)] for a lender to include in a guaranty that are adequate to waive any rights a guarantor may have with respect to the following: (i) subrogation, reimbursement, indemnification and contribution; (ii) a creditor's election of remedies; and (iii) the protections of CCP §§580a, 580b, 580d and 726 (*see* the sidebar for the model waiver). While CC §§2856(c) and (d) are merely "model" waivers and CC §2856(a)(3) specifically states that no particular language is required to effectively waive the foregoing protections, use of the model waivers verbatim in a lender's loan documents is strongly advised. Still, even with the model waivers, many lenders use belts and suspenders in their waiver language by continuing to include lengthy "Gradsky" type waiver language in addition to the model waivers.

### EFFECT OF WAIVERS

A lender that includes the waivers set forth in CC §§2856(c) and (d) (or variations thereof) in a guaranty, may either (i) sue a guarantor first for the outstanding amount of the debt without looking to the collateral pledged by the debtor, or (ii) foreclose on the real property either judicially or non-judicially and afterwards collect from the guarantor the difference between the debt and the sale price of the real property. If the creditor sues first on the guaranty prior to foreclosure, the creditor still has its remedies of judicial or non-judicial foreclosure against the debtor if the suit against the guarantor has not satisfied the debt because (a) the one action rule is not applicable to a suit by a creditor against a guarantor,<sup>50</sup> and (b) CCP §580(d) only prohibits actions on a "note," rather than a guaranty.<sup>51</sup> If the creditor elects to judicially foreclose and seeks to collect any deficiency from the guarantor, the creditor

should add the guarantor as a party to the judicial foreclosure action.<sup>52</sup>

## CONCLUSION

The one action rule requires that a creditor must look to all of its security before it may sue the borrower on the underlying debt. In looking to the security, a creditor must be careful not to perform certain acts that would constitute an action for purposes of the one action rule since doing so might result in the loss of the security. In enforcing its security, a creditor is generally entitled to a deficiency judgment following a judicial foreclosure, but generally is not entitled to a deficiency judgment following a non-judicial foreclosure. Real property secured creditors who obtain guaranties must also be careful to structure the guaranty so that it is an enforceable guaranty, rather than a sham guaranty. While guarantors are

not directly entitled to the benefits of the one action rule or the anti-deficiency protections, it is nonetheless important that creditors obtain the appropriate waivers from a guarantor in light of the willingness of some courts to look past the plain language of CC §2856 and exonerate guarantors in certain circumstances.

## NOTES

1. *Walker v. Community Bank*, 10 Cal 3d 729, 733-34 (1974).
2. Cal. Civ. Proc. Code §726(a).
3. *Id.*
4. *Supra* note 1, at 733-34.
5. *Scalese v. Wong*, 84 Cal. App. 4th 863, 868 (2000).
6. *Krueger v. Wells Fargo Bank*, 11 Cal. 3d 352 (1974).
7. *Security Pacific National Bank v. Wozab*, 51 Cal. 3d 991, 998-999 (1990).
8. Cal. Civ. Code §2938(c)(4) and (e)(2).
9. Cal. Civ. Proc. Code §580.5.
10. *Id.*, §22.
11. *Shin v. Superior Court*, 26 Cal. App. 4th 542 (1994).
12. *Prestige Ltd. Partnership-Concord v. East Bay Car Wash Partners*, 205 BR 427 (ND Cal 1997). However, pursuant to CCP §483.010(b), creditors may attach non-collateral assets of the debtor if, through no fault of the creditor, the security becomes worthless or the security's value has decreased to less than the amount owed on the claim.
13. *Hatch v. Security-First National Bank*, 19 Cal. 2d 254, 258 (1942).
14. *Vlahovich v. Cruz*, 213 Cal. App. 3d 317, 322 (1989).
15. Cal. Comm. Code §9604(a). Our discussion of a creditor's remedies in connection with a mixed collateral foreclosure is only intended to provide a general overview of the subject and practitioners should carefully review the mixed collateral statute in Cal. Comm. Code §9604.
16. *Supra* note 13, at 257.
17. Cal. Civ. Proc. Code §726(a); note again that non-judicial foreclosure does not constitute an "action."
18. *Supra* note 1, at 733-34.
19. *Supra* note 7, at 1006.
20. Cal. Civ. Proc. Code §726.5.
21. *Dyer Law & Collection Co. v. Abbott*, 52 Cal. App. 545, 547 (1921).
22. *Republic Truck Sales Corp. v. Peak*, 194 Cal. 492, 515 (1924).
23. *Otto v. Long*, 127 Cal. 471, 477 (1900).
24. *Curtin v. Salmon River Hydraulic Gold Mining & Ditch Co.*, 141 Cal. 308, 312-13 (1903).
25. *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 39 (1963).
26. Cal. Civ. Code §891(g).
27. Cal. Civ. Proc. Code §736.
28. *Id.*, §736(c).
29. *Id.*, §736(b).
30. Cal. Civ. Code §2938(c).
31. Cal. Civ. Proc. Code §580(b).
32. *Id.*, §726(b).
33. *Id.*
34. *Id.*, §§729.010 et seq. Pursuant to CCP §729.060(b), the redemption price payable to the purchaser of the property is an amount equal to (i) the purchase price at the foreclosure sale, (ii) taxes, assessments, fire insurance and maintenance costs, (iii) amounts paid on a prior secured obligation to protect the purchaser's interest, (iv) interest on the amounts referenced in clauses (i)-(iii) above, and (v) the amount of any liens, plus interest, the purchaser has on the real property which are subordinate to the lien under which the real property was sold. Pursuant to CCP §729.060(c), rents and profits paid to the purchaser during the redemption period can be used to offset the amounts described in clauses (i)-(v) above.
35. Cal. Civ. Proc. Code §§726(e) and 729.010.
36. *Id.*, §337.
37. *Id.*, §580(d).
38. *Supra* note 25, sold-out junior creditor is not barred by CCP §580d; CCP §726(f), actions against the borrower for fraud are not barred by CCP §580d; CCP §726.5, creditor who waives its lien for environmentally impaired real property is not barred by any one action and anti-deficiency laws; and CCP §736, a lender may bring an action for money damages for breach of contract against borrower if borrower has violated any environmental provision in the loan documents, notwithstanding any one action or anti-deficiency laws.
39. Cal. Civ. Code §2787.
40. *Union Bank v. Gradsky*, 265 Cal. App. 2d 40, 44-47 (1968)
41. *Bank of Southern California v. Dombrow*, (ordered not published March 14, 1996; former opinion at 39 Cal. App. 4th 1457 (1995)).
42. *Id.*, at 1472.

### Model Waivers

*Model waiver set forth in CC §2856(c):* "The guarantor waives all rights and defenses that the guarantor may have because the debtor's debt is secured by real property. This means, among other things: (1) The creditor may collect from the guarantor without first foreclosing on any real or personal property collateral pledged by the debtor. (2) If the creditor forecloses on any real property collateral pledged by the debtor: (A) The amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price. (B) The creditor may collect from the guarantor even if the creditor, by foreclosing on the real property collateral, has destroyed any right the guarantor may have to collect from the debtor. This is an unconditional and irrevocable waiver of any rights and defenses the guarantor may have because the debtor's debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based upon Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure."<sup>53</sup>

*Model waiver set forth in CC §2856(d):* "The guarantor waives all rights and defenses arising out of an election of remedies by the creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guaranteed obligation, has destroyed the guarantor's rights of subrogation and reimbursement against the principal by the operation of Section 580d of the Code of Civil Procedure or otherwise."<sup>54</sup>

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43. *Riddle v. Lushing*, 203 Cal. App. 2d 831, 832-34 (1962).

44. *Valinda Builders, Inc. v. Bissner*, 230 Cal App. 2d 106, 109-11 (1964).

45. *River Bank America v. Diller*, 38 Cal. App. 4th 1400, 1419-25 (1995).

46. *Union Bank v. Brummel*, 269 Cal. App. 2d 836, 838 (1969).

47. Cal. Civ. Code §2856(a)(3).

48. *Cathay Bank v. Lee*, 14 Cal. App. 4th 1533 (1993).

49. *Supra* note 41.

50. *Supra* note 40, at 43.

51. *Supra* note 40, at 44.

52. *Titus v. Woods*, 45 Cal. App. 541, 546 (1920).

53. Cal. Civ. Code §2856(c).

54. *Id.*, §2856(d).

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