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Foreclosures: California's One Action Rule

by Robert O. Barton, Esq., DLA Piper

With interest rates on adjustable mortgages on the way up, the pundits suggest we are headed for another round of foreclosure activity the likes of which we have not seen since the S&L crises in the 1980s. That makes now a good time to review the laws relating to foreclosure and deficiency judgments – and recent changes that have occurred in that area.

The Legislature enacted the One Form of Action rule – often simply called the One Action Rule – to eliminate multiple actions when a creditor elects to sue after a debtor's real property has gone into default. It specifically provides: "There can be but one form of action for the recovery of any debt, or the enforcement of any right secured by mortgage upon real property." (Cal. Code of Civ. Proc. § 726(a).)

The One Action Rule…give[s] a borrower leverage againt a creditor who wants the freedom to choose between either enforcing a security interest via a foreclosure proceeding, or circumventing the antideficiency statutes…

In jurisdictions without such a rule, property owners can be forced to simultaneously defend against both a personal action on the debt and a foreclosure action on the security, making it difficult, if not impossible, for the debtor to avoid a deficiency judgment. Not only is this unfair to property owners who reasonably relied on the value of the security for protection from personal liability, but it further strains limited judicial resources.

California's deficiency-judgment statues were intended to work in tandem with the One Action Rule to avoid such problems. Because the One Action Rule has the effect of inducing most creditors to foreclose on their security interests before seeking a personal judgment, these statutes protect debtors from a deficiency judgment if the property subject to foreclosure is a dwelling intended to be occupied by four or fewer families – one of which includes the purchaser – and if the loan secured by the deed of trust or mortgage was used to pay all or part of the purchase price of the property being foreclosed. (Cal. Code of Civ. Proc. Code § 580b.)

The purposes behind the One Action Rule and the deficiency-judgment statutes are to prevent multiple actions, compel exhaustion of all security before a deficiency judgment is entered, and ensure that debtors are credited with the fair market value of the secured property before they are subjected to personal liability. (See *In re: Prestige Ltd. Partnership-Concord v. East Bay Car Wash Partners, 234 F.3d 1108, 1115 (9th Cir. 2000).*)

DEFICIENCY-JUDGMENT PROTECTION

In the years leading up to the S&L crisis, many lenders had substantially relaxed their appraisal standards. Profits were high and the focus was on making loans, not on ensuring that the underlying security was adequate. When properties began to go into default at unprecedented rates, it became obvious that thousands of appraisals were inflated, and countless borrowers were unnecessarily exposed to debt far in excess of the value of their secured real property. In short order, this vicious cycle flooded the pool of Real Estate Owned (REO) properties in lender inventories and ultimately brought down a major industry

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A primary purpose of the antideficiency statutes is to place the risk of such overvaluation and inadequate security on the lenders who stand to profit directly from the loans they make. Taken together, sections 726, 580a, 580b, and 580d of the California Code of Civil Procedure constitute a comprehensive statutory scheme that specifically protects defaulting borrowers from being taken advantage of by overly aggressive lenders who may care more about making loans than protecting borrowers *(See Clayton Dev. Co. v. Falvey, 206 Cal. App. 3d 438, 445 (1988).)*

Under this scheme, if the proceeds from the sale of the real property are insufficient to cover the debt, the lender's right to a deficiency judgment may be limited or barred under one or more of these statutes. *(See Prestige, 234 F:3d at 1115.)* Thus, the One Action Rule works in concert with California's deficiency-judgment statutes to give a borrower leverage against a creditor who wants the freedom to choose between either enforcing a security interest via a foreclosure proceeding, or circumventing the antideficiency statutes and suing on the underlying note – whichever better suits its needs. *(See Clayton Dev. Co., 206 Cal. App. 3d at 445.)*

EXCEPTIONS TO THE RULES

The antideficiency provisions, which primarily aim to protect against overvaluation by lenders, apply automatically only to standard purchase-money transactions. *(See Roseleaf Corp. v. Chierighino,* 59 Cal. 2d 35, 41 (1963) and *Sprangler v. Memel,* 7 Cal. 3d 603, 610 and 612 (1972).) Thus, for example, section 580b does not apply when the purchaser intends to proceed with a different use of the property, such as commercial development, because the purchaser controls the success of the venture and should bear the risk of failure.

Section 580b also does not apply when the borrower has refinanced the real property, often to take out additional equity or obtain financing at better terms. (*See Union Bank v. Wendland*, 54 Cal. App. 3d 393, 400 (1976).) Conversely, when the borrower has never refinanced and the real property is still encumbered by the original purchase-money trust deed, the borrower retains the protection of the antideficiency judgment statutes. (*See Foothill Village Homeowners Ass'n v. Bishop*, 68 Cal. App. 4th 1364, 1367 n.1 (1999).)

THE DUAL ROLE

For a borrower in default, the One Action Rule offers two important benefits. It may be used upfront as an affirmative defense, or it may be invoked later as a sanction.

If the borrower successfully asserts the One Action Rule as an affirmative defense, the lender will be forced to foreclose its security interest before pursuing a money judgment against the debtor for any deficiency – if that is even possible given the protections available to the borrower under the antideficiency statutes. (*See Security Pacific Nat'l Bank v. Wozah*, 51 Cal. 3d 991, 997 (1990).)

A borrower who wishes to rely on the antideficiency-judgment statutes to avoid the personal liability must raise the One Action Rule as an affirmative defense in the answer or, at the latest, by the start of the trial – that is, when the lender would still have a chance to comply with the rule – or he or she is "simply too late." (*See Scalese v. Wong*, 84 Cal. App. 4th 863, 868 (2000) and *Spector v. National Pictures Corp.*, 201 Cal. App. 2d 217, 225-26 (1962).)

However, a borrower who fails to assert the One Action Rule as affirmative defense may still invoke it as a sanction against the lender, because by not foreclosing on its security interest in the action brought to enforce the debt, the lender has made an election of remedies and waived any right to subsequently foreclose on the security or sell the security under a power of sale. (*See Security Pacific Nat'l Bank v. Wozab*, 51 Cal. 3d 991 at 997 (1990) and *Prestige Ltd. Partnership-Concord v. East Bay Car Wash Partners*, 234 F.3d 1108 at 1114 (2000).)

Beginning in 1990, the law changed in two important ways. First, the California Supreme Court held that a creditor cannot be subject to the double sanction of losing both the security interest and the underlying debt. Second, a court of appeal held that a creditor could not enforce an agreement with the debtor to waive application of the One Action Rule as a sanction.

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These decisions have significant ramifications for borrowers and lenders alike.

NO DOUBLE SANCTIONS

The landmark case of *Security Pacific Nat'l Bank v. Wozab* places limits on using the One Action Rule as a sanction. In Wozab the California Supreme Court held that it would be inequitable to subject a lender to the double sanction of losing both the security and the underlying debt. Indeed, the court held that allowing the Wozabs to evade their debt almost in its entirety would be both a gross injustice to the bank and a corresponding windfall to the Wozabs, allowing them the benefit of their bargain without incurring the burden. (51 Cal. 3d at 1005-06.)

Later decisions by the Ninth Circuit Court of Appeals continue to apply the precendent set in *Wozab*.

In *DiSalvo v. DiSalvo*, the Bankruptcy Appellate Panel of the Ninth Circuit reversed, in part, a decision that double-sanctioned a creditor's efforts to collect first on the debt, in violation of section 726, by extinguishing both the security interest in the real property and, indeed, the $100,000 debt itself. (22 B.R. 769, 775 (9th Cir. 1998), overruled in part as to other issues by In re *DiSalvo v. DiSalvo*, 219 F.3d 1035 (9th Cir. 2000).) Although, as the bankruptcy court observed, the creditor's actions in attempting to collrect the $100,000 debt netted only $83, the creditor controlled the security-first aspect of the One Action Rule and could have invoked it at any time to bar the collection efforts.

Because a bankruptcy court can provide sufficient protection for a debtor whose business is threatened by the actions of a creditor without requiring that the creditor forfeit both the security and the debt, the appellate court held that the bankruptcy court's sanction of extinguishing the debt was an abuse of discretion "so severe as to be punitive and would result in a windfall to debtor." (219 F.3d at 1037.)

In *Prestige Ltd. Partnership-Concord v. East Bay Car Wash Partners*, decided later the same year, the Ninth Circuit was asked to address the issue again in a case in which the debtor sought to bar a creditor's unsecured claim against his bankruptcy estate. (234 F3d at 1111 (2000).)

Prestige, the debtor, purchased a car wash business from East Bay, the creditor, giving East Bay a promissory note secured by a deed of trust that included the personal guarantee of one of Prestige's partners, Jerry Brassfield. After Prestige defaulted on the note, East Bay filed an action on the guaranty rather than foreclosing on its security interest in the car wash. Although Brassfield asserted the One Action Rule as affirmative defense, East Bay obtained a writ of attachment against $75,000 in Brassfield's personal bank accounts.

Shortly thereafter, Prestige filed a petition for bankruptcy. The bankruptcy court held that Brassfield was a primary obligor on the note, " 'such that the purported guaranty added no additional liability,' and that East Bay had taken its action under § 726(a), resulting in waiver of its security interest in the real property." (2345 F.3d at 1112.) As a result, the superior court dissolved the writs, and East Bay released its attachment.

Unable to collect against the guaranty and having lost its security interest in the car wash, East Bay filed proof of its now unsecured claim in the bankruptcy action. The bankruptcy court decided in the creditor's favor, holding that East Bay "lost its security only, not its debt, and was not subject to the provisions of § 580b." The Ninth Circuit affirmed, citing *Wozab and DiSalvo*. In reaching its decision, the appellate court noted that Prestige had taken advantage of its right to invoke the sanction aspect of section 726 in the bankruptcy court, resulting in East Bay's loss of its security interest.

Moreover, just as in *Wozab* – where the court observed that the debtors had accepted the bank's reconveyance of the deed and thus acquiesced in, indeed demanded, the bank's decision not to foreclose – Prestige was the one who sought to have East Bay's security interest waived. Thus, under the holdings of both *Wozab* and *DiSalvo*, it would be inequitable to impose a double sanction that would deny East Bay both its security interest in the car wash and the underlying debt. (234 F.3d at 1115.)

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The law is clear: violating the One Action Rule extinguishes the creditor's security interest, but not the debtor's underlying obligations. Thus, after Wozab and its progeny, debtors who are protected by the deficiency-judgment statutes should take care not to waive the One Action Rule lest they lose its protection, yet remain liable "in total" for their debts.

NO WAIVER OF SANCTION

In *O'Neil v. General Security Corp.*, the court held that a borrower's agreement with his lender to waive application of the One Action Rule as a sanction and allow the lender, who had already brought a personal action against the borrower, to proceed with a foreclosure against the secured property is not enforceable. (4 Cal. App. 4th 587, 598 (1992).)

First the court held that the sanction aspect of the One Action Rule operates for the benefit of both the primary borrower and third parties claiming an interest in the property, whether as successors-in-interest, or as third-party lienholders. As such, the court concluded that the security and priority rights in the secured property held by a third party have independent status, are entitled to independent protections, and cannot be defeated by unilateral waivers by the borrower in favor of the lender. Indeed, the court questioned whether such a waiver agreement would even be enforceable against the borrower who made it.

Second, the court held that all of the lender's remedies, including foreclosure of the security, merge into and are extinguished by the judgment, limiting the lender's subsequent remedies to those remedies available to it as a judgment creditor.

Third, the court held that if a borrower's waiver agreement were enforceable, many of the policies and protections of the statutory scheme would be undermined.

Although the *O'Neil* decision might trap an unwary lender who pursues a personal judgment first in reliance on the borrower's agreement to waive the sanction aspect of the One Action Rule, this is not its greatest danger. A bigger problem could arise if a lender secures a single promissory note with deeds of trust on properties located in multiple jurisdictions, one of which is California. If the note goes into default, the lender might want to commence foreclosure actions against its security interests in all jurisdictions simultaneously. However, under California's One Action Rule, filing a foreclosure action an another jurisdiction before foreclosing the lender's security in this state could result in the lender losing its security interest in the California property.

In addition, under the holding in *O'Neil*, an agreement with the borrower to waive the sanction aspect of the One Action Rule, following a default would be of no help. Thus, before proceeding with such an arrangement, a prudent lender should carefully consider its exit strategy in the event that the loan goes into default.

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