

# Client Alert

Latham & Watkins Finance Department

## Revisiting the One Action Rule for Secured Lenders: Forget About California Real Property at Your Peril!

With Governor Jerry Brown recently signing into law Senate Bill 2, which increases California's Renewable Portfolio Standard to 33 percent by 2020, the push to develop and finance renewable energy projects in California is likely to gain further momentum. Financing renewable energy projects in California, however, has re-exposed lenders, who are often not native to California, to the "one action rule." The one action rule places limits on the ability of lenders to enforce and collect debt that is secured by real property located in California.<sup>1</sup> While most states permit secured creditors to freely pursue the foreclosure of real property as well as the underlying debt simultaneously, California essentially requires creditors to exhaust the entirety of their real property security before suing on the underlying debt or before taking other action to collect against any of the debtor's unpledged assets.

Violation of the one action rule leaves lenders vulnerable to sanctions, including the potential loss of their lien on the real property. Certain conduct, including setoff against a debtor's unpledged accounts, may run afoul of the one action rule. Lenders who have extended credit secured by California real property should carefully plan their

enforcement and collection strategies in order to avoid violation of the one action rule.

This *Alert* is relevant to any entity extending credit secured by real property located in California.<sup>2</sup> This *Alert* briefly explains the one action rule and its ramifications and highlights general steps that can be taken to avoid violating the one action rule. It explains why non-judicial foreclosure, sometimes referred to as a trustee sale, is the most typical method for foreclosing on California real property. It also lays out the general steps necessary to complete a trustee sale. Finally, this *Alert* provides some practical tips to lenders on how to avoid breaching the one action rule.

### The One Action Rule and its Ramifications

Under California Code of Civil Procedure (CCP) § 726, a judicial foreclosure must take place in the same action as the cause of action to collect the debt. CCP § 726, which is commonly known as the one-action rule (One Action Rule), requires the creditor to foreclose on California real property and to exhaust all California real property security before obtaining a judgment on the debt.<sup>3</sup> A judicial action in any other

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state (or foreign country) may violate the One Action Rule.<sup>4</sup> A lender must therefore foreclose on California real property before obtaining a judgment on the debt secured by such real property. Failure to conclude a foreclosure in California before a judicial action is brought to judgment could result in the loss of the secured position in the California real property.<sup>5</sup>

California courts generally apply the One Action Rule whenever the real property securing the debt is located in California, regardless of whether the parties elected the law of another jurisdiction as the governing law. California courts have generally held explicit waivers of the One Action Rule to be unenforceable. In addition, California courts will generally void any clause viewed as an implicit waiver of the One Action Rule.<sup>6</sup>

### **What Constitutes Judicial Action and How to Avoid Tripping Over the One Action Rule**

A judicial action for purposes of the One Action Rule includes at a minimum a judgment in a lawsuit for recovery of the secured debt.<sup>7</sup> Nevertheless, a lender may initiate judicial foreclosure or other suit or proceeding in California or any other jurisdiction as long as a judgment is not entered prior to the completion of the foreclosure sale in California.<sup>8</sup>

In addition to lawsuits, California courts have held that other conduct, such as an improper prejudgment attachment of un-pledged assets<sup>9</sup> and setoff against an un-pledged bank account of a borrower,<sup>10</sup> also violates the One Action Rule. A threshold consideration (but not the only one) in determining whether given conduct that is not on its face “judicial action” may violate the One Action Rule is whether such conduct attempts to realize upon assets of a borrower that are not part of the collateral securing the debt.

A lender must therefore ensure that its enforcement conduct, even though on its face not a judicial action, is carefully tailored so that it does not violate the One Action Rule. The following conduct is not likely to breach the One Action Rule: (a) the appointment of a receiver at the lender’s behest, (b) sending notice to a bank pursuant to a control agreement to exercise control over accounts that have been pledged to secure the debt and (c) foreclosing non-judicially on stock, limited liability company interests or other personal property pledged as security for the debt. Until a foreclosure on the California real property is complete, a lender should not attempt to realize upon assets that have not been pledged to secure the debt.

### **Why Non-Judicial Foreclosure over Judicial Foreclosure?**

In California, a creditor may pursue either a judicial or a non-judicial foreclosure on real property. Judicial foreclosures, however, have significant limitations. In a judicial foreclosure on real property a deficiency cannot exceed the difference between the indebtedness and the fair value of the property as determined by the court after a hearing,<sup>11</sup> with consequent delays and other associated expenses. In addition, the borrower has a right of redemption for a one-year period after the judicial foreclosure sale is complete.<sup>12</sup> Furthermore, judicial foreclosures, like other lawsuits, can take many years to complete in California, simply by virtue of case back log, procedural requirements and the number of factual issues in the case.

Non-judicial foreclosures, by contrast, enjoy several advantages. First, a non-judicial foreclosure is not an action for purposes of the One Action Rule.<sup>13</sup> Second, with rare exceptions, determination of the fair value of the property is not required.<sup>14</sup> As long as a non-judicial foreclosure sale is

conducted properly, a disparity between the sale price and the value of the property is not grounds for setting aside the sale.<sup>15</sup> Third, the borrower has no right of redemption after a non-judicial foreclosure sale.<sup>16</sup> Although total recovery may ultimately be higher with a judicial foreclosure sale (and any applicable deficiency judgment), there is no post-sale risk of redemption with non-judicial foreclosures. Consequently, a creditor should be able to obtain a better total sales price in a non-judicial foreclosure because costs and expenses are lower and title to the property is immediately marketable. Finally, the entire non-judicial foreclosure process can be completed in as little as four months.

### **Preserving a Right to Judgment on the Debt**

One of the few disadvantages of a non-judicial foreclosure in California is that, pursuant to CCP § 580d, the creditor has no right to a deficiency judgment. As long as the parties have not selected California law to govern the loan documents, CCP § 580d does not bar a deficiency judgment outside of California following a non-judicial foreclosure.<sup>17</sup> So a lender could, if such an option is practical, seek a deficiency judgment outside of California following non-judicial foreclosure of real property located in California. Also, the One Action Rule and CCP § 580d generally do not apply to entities with a secondary obligation on the debt (guarantors, for example) unless the secondary obligation is also secured by California real property. Accordingly, assuming the guaranty includes appropriate waiver language, a lender would be able to enforce a guaranty claim without breaching the One Action Rule and without being limited by the restriction on deficiency judgments under CCP § 580d.

In light of the discussion above with respect to the limitations imposed by the One Action Rule and the anti-deficiency

statute of CCP § 580d, lenders typically foreclose on real property located in California by non-judicial foreclosure and preserve the right thereafter to obtain a judgment, if such an option is available, on the debt in a state other than California.

### **Completing Non-judicial Foreclosures in California**

A creditor may conduct a foreclosure sale without any judicial action if the deed of trust contains a "power of sale" clause (which they always should). This clause gives a creditor a right to dispose of the secured property upon default by the borrower.<sup>18</sup>

To begin the non-judicial sale process, a trustee records a notice of default in the county where the property is located and mails such notice to the borrower.<sup>19</sup> After three months have elapsed following the recordation and delivery of the notice of default, the trustee publishes and records a notice of sale no less than twenty days before the date for sale of the property.<sup>20</sup>

The borrower has the right to reinstate the loan at any time from the date of recording of the notice of default up to five business days before the date of sale by paying the amount stated in the notice of default plus costs and expenses, and curing other defaults as required under the deed of trust.<sup>21</sup> The borrower also has the right to avoid the foreclosure by paying the entire debt (not just the amount past due), plus interest and costs, at any time before the foreclosure sale date.<sup>22</sup>

The trustee sale must be conducted by public auction in the county where the property is located.<sup>23</sup> Anyone may bid at the sale and the foreclosing creditor may credit bid up to the amount of the indebtedness.<sup>24</sup> The sale is final when the trustee accepts the last and highest bid.<sup>25</sup> As mentioned above, the borrower has no right of redemption after the foreclosure sale is final.

## Some Practical Tips for Lenders

Lenders who extend credit secured by California real property may take certain steps to minimize their exposure to the One Action Rule and its potential sanctions. In syndicated loans, each member of the syndicate (including any non-lender secured party, such as hedge providers) should be aware of the possible application of the One Action Rule even if it is not acting as the agent for the syndicate. It is possible that a syndicate member could act, such as through the enforcement of equitable rights against a debtor's unencumbered assets, in a way that would violate the One Action Rule. Second, lenders should consult California counsel before commencing any enforcement action when California real property is part of the collateral. Thinking through which steps are appropriate will help avoid running afoul of the One Action Rule. And third, when there is more than one lender (either as part of a syndicate or due to a partial assignment of the original loan), the underlying loan documentation should specify that all enforcement action must be taken only through a single agent or member. Such precautionary language may help avoid acts by individual syndicate members that could trigger a violation of the One Action Rule; such language may also provide some contractual protection to the syndicate against any syndicate party that takes unauthorized action that violates the One Action Rule.

Once a decision is made to proceed with a foreclosure on the collateral, lenders typically foreclose on real property located in California by trustee sale. After all relevant trustee sales are complete, a lender may then obtain a judgment on the debt in any other jurisdiction. Subject to restrictions existing in other jurisdictions, a lender may pursue foreclosures in such other jurisdictions before or simultaneously with the non-judicial foreclosure process

in California, but only as long as the lender does not obtain a judgment as part of any of those foreclosures before completion of the trustee sale in California. If a judgment is obtained in another jurisdiction before all trustee sales are complete in California, the lender would risk losing its lien on the California real property securing the debt.

## Final Remarks

California real property is often part of a lender's security. This is true for many types of financings, including renewable energy, power and other project financings. The loss of a secured position in the real property could be devastating to a lender's ability to realize upon the value of a renewable energy or other project after a borrower defaults. Yet loss of the real property security is possible if lenders who extend credit secured by real property in California do not pay attention to the One Action Rule. Certain conduct, including setoff against a debtor's unpledged accounts, may violate the One Action Rule and leave the secured lenders vulnerable to a complete forfeiture of their real property security. Lenders extending credit secured by California real property should always pay attention to the possible application of the One Action Rule and work with counsel to carefully plan their enforcement and collection strategies in order to avoid violating the One Action Rule.

## Endnotes

- <sup>1</sup> A blanket security interest in all assets of a borrower may include a security interest in a California real property lease, which would inadvertently implicate the one action rule.
- <sup>2</sup> The one action rule and California's laws restricting deficiency judgments form a complex regulatory scheme which has many exceptions and variations. This *Alert* is general in nature and does not discuss all exceptions. There can also be no assurance that the rules discussed in this *Alert* are still applicable at a future date.

Consequently, entities extending credit secured by real property located in California are advised to consult with counsel, particularly before enforcing any remedies against a defaulting borrower.

<sup>3</sup> See *Prestige Ltd. Pshp. v. East Bay Car Wash Partners (In re Prestige Partnership)*, 234 F.3d 1108 (9th Cir. 2000).

<sup>4</sup> See *Ould v. Stoddard*, 54 Cal. 613 (1880).

<sup>5</sup> See supra note 1.

<sup>6</sup> A waiver may, however, be enforceable in connection with certain loan modifications.

<sup>7</sup> See, e.g., *Kirkpatrick v. Westamerica Bank*, 65 Cal.App.4th 982 (1998).

<sup>8</sup> See *Madigan v. Potrans Int'l, Inc.* (In re Madigan), 122 B.R. 103, 106 (9th Cir. 1991).

<sup>9</sup> See, e.g., *Shin v. Superior Court*, 26 Cal.App.4th 542 (1994).

<sup>10</sup> See *Security Pacific Nat'l Bank v. Wozab*, 51 Cal.3d 991 (1990).

<sup>11</sup> See *San Paolo U.S. Holding Co. v. 816 S. Figueroa Co.*, 62 Cal.App.4th 1010 (1998).

<sup>12</sup> Under CCP § 729.030(b), the one-year period applies if the proceeds are not sufficient to satisfy the indebtedness, plus interest and costs. Pursuant to CCP § 729.030(a), if the proceeds of the foreclosure sale are sufficient to satisfy the secured indebtedness with interest, costs and expenses, the redemption period is then limited to only three months after the date of the judicial foreclosure sale.

<sup>13</sup> See *Hatch v. Security First Nat'l Bank*, 19 Cal.2d 254, 257-8 (1942).

<sup>14</sup> See *Dreyfuss v. Union Bank of Cal.*, 24 Cal.4th 400 (2000).

<sup>15</sup> *Id.*

<sup>16</sup> CCC §§ 2903, 2931. CCP § 729.010, which governs post-sale redemption rights, does not apply to trustee sales.

<sup>17</sup> See *United Bank of Denver v. K and W Trucking Company, Inc.*, 147 Cal.App.3d 217 (1983) (rejecting the debtors' position that CCP § 580d, which prohibits deficiency judgments under certain circumstances, prevented California from recognizing a Colorado judgment based on a deficiency following a trustee sale of property located in California).

<sup>18</sup> See *McDonald v. Smoke Creek Live Stock Co.*, 209 Cal. 231 (1930).

<sup>19</sup> Cal. Civ. Code §§ 2924b(b)(1).

<sup>20</sup> CCC §§ 2924b(b)(2), 2924f(b)(1). CCC § 2924f sets forth the deadlines and other requirements for serving, publishing and recording a notice of sale.

<sup>21</sup> CCC § 2924c.

<sup>22</sup> CCC §§ 2903-2906.

<sup>23</sup> CCC § 2924g(a).

<sup>24</sup> CCC § 2924h.

<sup>25</sup> CCC § 2924h(c).

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