

**SIMPLIFIED OVERVIEW OF CALIFORNIA'S**

**ONE ACTION AND ANTI-DEFICIENCY LAWS**<sup>\*</sup>

- I. Overview. California's one action and anti-deficiency rules can be very complex in their application, but they all derive from three simple principles:
  - A. Once you have taken real estate collateral, you cannot ignore it and simply sue on the obligations secured. You must foreclose, either judicially or non-judicially.
  - B. If you judicially foreclose, the process of obtaining clear title is slower, but a deficiency judgment may be obtained, although it is limited by a court-determined valuation of the property.
  - C. Non-judicial foreclosure is faster and cheaper, but there is no right to a deficiency judgment on the secured obligation.
  
- II. Types of foreclosures.
  - A. Judicial Foreclosure (Slow, Relatively Expensive, Right of Redemption and Deficiency Judgment):
    1. Requires a court proceeding, and therefore is more expensive.
    2. Takes longer.
      - Requires court proceeding, which can take six to twelve months even in simple cases -- and can take longer if affirmative defenses or counterclaims are asserted against the lender that cannot be disposed of on summary judgment.
      - After you go to judgment and a sale is conducted, there is a right of redemption -- usually 1 year -- which will effectively cloud title until the redemption period has run.
    3. You must include all of your collateral in the action, and may or may not be required to sue the guarantors in the same action (but it is

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<sup>\*</sup> This outline is a brief and general review of some of the basic issues respecting California's one action and anti-deficiency laws. It is not intended as, and is not, a complete discussion of this area of the law, which is extremely complex. This brief summary is not intended as, and is not a substitute for, legal advice concerning California's one action and anti-deficiency laws and their application to any particular situation. Sheppard, Mullin, Richter & Hampton LLP does not undertake to update this outline as developments and changes in the law occur. If you have any questions concerning California's one action or anti-deficiency laws, or their application to specific situations, please contact us at the address indicated on the cover of these materials.

better practice to do so). This is discussed further in Section III below.

4. Deficiency judgment:

- You must move for entry of a deficiency judgment within 3 months after the foreclosure sale.
- The deficiency is limited by a so-called "fair value" limitation, meaning the deficiency is limited to the difference between the secured debt and the greater of the amount bid at the sale or the value of the property.
- The property value is determined by the court, usually based upon appraisal testimony submitted by the parties. This may become a "battle of the appraisers," and many lenders (and their lawyers) believe that courts are "debtor friendly" in making these determinations.

B. Non-judicial foreclosure (Fast, Relatively Inexpensive, No Right of Redemption and No Deficiency Judgment):

1. No court proceeding required.
2. The procedures are typically handled by a title insurance company. Counsel often involved on larger foreclosures to analyze the best way to pursue remedies, make sure the title company handles the sale process properly, and to obtain appointment of a receiver to collect rents and profits (if warranted).
3. The process generally takes four to five months, unless there is time slippage in the process.
4. The lender may be a bidder at the sale, and may credit bid some or all of its debt.
5. There is no right of redemption. At the end of the four to five month foreclosure process, the lender (or a third-party bidder at the sale) will have clear title.
6. There is no right to a deficiency judgment, but as discussed in Section IV below, the lender may still be able to pursue any other collateral or any guarantors, and without any fair value limitations.

C. Pros and cons of judicial versus non-judicial foreclosure.

1. Real Estate Loans. On real estate loans, judicial foreclosure is rarely pursued. Because of the fair value limitations, no deficiency

judgment can be obtained unless the court determined valuation of the property shows that the lender is undersecured. Since the LTV on a real estate loan is usually significantly less than 100%, there is no realistic prospect for obtaining a deficiency judgment unless:

- There has been a significant downward market shift;
  - The initial underwriting was flawed; or
  - The loan involves a construction project and is halted in mid-construction.
2. Even where real estate has been taken as "additional collateral," judicial foreclosure is still relatively uncommon.
- Prospect of obtaining from the court, and being able to collect from the obligor, a significant deficiency judgment must be substantial enough to outweigh the extra delay and costs involved in a judicial foreclosure.

### III. One Action Rule.

- A. Cannot ignore collateral and sue on note; suit to enforce a note must be a judicial foreclosure.
- B. All real estate collateral must be included in the judicial foreclosure action.
- C. Has been interpreted to embody a "security first" concept, meaning the lender must foreclose on its deed of trust first before seeking a deficiency judgment.
1. This includes not offsetting against bank accounts.
  2. Realization upon a consensual lien on bank accounts is probably permitted, but care must be taken to document exactly what is being done (i.e. realization on lien rather than offset).
  3. Prohibition of offsets applies regardless of whether the lender is foreclosing judicially or non-judicially.
- D. Exceptions.
1. Action to obtain rents and profits receiver.
    - This is often done pending completion of a non-judicial foreclosure.
  2. Action to obtain possession of collateral.

3. Environmental-related exceptions.
4. Letters of Credit.

IV. Anti-Deficiency Rules.

- A. No deficiency judgment following non-judicial foreclosure -- Code of Civil Procedure §580d.
  1. With few exceptions, no deficiency judgment may be obtained against the obligor on the secured obligation following the non-judicial foreclosure sale.
    - This means the borrower, if the note is secured by a deed of trust.
    - This means a guarantor, if the guaranty is secured by a deed of trust (but not the borrower, unless the note is also secured by a deed of trust).
  2. Does not apply to other collateral (real or personal), which can still be foreclosed even though a deficiency judgment is prohibited.
    - The remaining debt for which the collateral may be pursued is the debt less the winning bid (whether credit bid or third-party bid) at the foreclosure sale of the real estate;
    - The "fair value" limitations do not apply.
  3. Guarantors (unless there is real property security for the guaranty) can be pursued, even though real estate securing the underlying debt was non-judicially foreclosed. It requires waivers.
    - There are no "fair value limitations" on the guarantor's liability; the guarantor is liable for the full amount of the difference between the amount of the debt and the bid (credit bid or third-party bid) at the foreclosure sale.
    - But the guaranty must be a "true guaranty;" if the guarantor is already liable on the debt, the guaranty is ignored as a "sham guaranty" (because one cannot guarantee its own debt for anti-deficiency purposes). Examples:
      - Guaranty by borrower will be ignored for anti-deficiency purposes.
      - Guaranty by general partner of partnership borrower will be ignored for anti-deficiency purposes.

- But, absent alter ego, guaranties by limited partners, shareholders, and members of LLC, should not be treated as sham guaranties, since they would not be liable for the debt absent the guaranty.
- B. Purchase money anti-deficiency -- Code of Civil Procedure §580b.
1. Not likely to apply to in a commercial lending context unless the lender takes a pledge of a purchase money note as additional collateral.
  2. There can be no deficiency judgment -- regardless of how the property is foreclosed -- on so-called "purchase money" transactions, rendering them non-recourse from the outset:
    - Seller take-back notes on real estate sales.
    - Third-party loans (e.g., from banks) to finance the purchase of owner occupied one to four family residential real estate.
- V. Waiver of One Form of Action and Anti-deficiency legislation.
- A. May not waive one form of action or anti-deficiency legislation at the time of the "making or renewing of" the secured loan.
  - B. Deed in lieu of foreclosure given at the same time as the mortgage will not work.
  - C. If you forbear and extend the loan, and recognize that there is a default and that lender is forbearing and extending, and not renewing, a waiver may be effective (except for §580b -- purchase money antideficiency).
- VI. Foreclosure where Obligation is Secured by both Real Property and Personal Property -- California Commercial Code Section 9604.
- A. May proceed in any sequence as to the personal property or the real property.
  - B. May include a portion of the personal property or fixtures in the nonjudicial or judicial sale, and the power of sale relating to the real property will relate to personal property or fixtures.

	<u>Judicial</u>	<u>Non-Judicial</u>
<b>How Initiated</b>	File a complaint.	Record and serve a Notice of Default.
<b>Timing</b>	Requires court proceeding (approximately 6-12 months). Could be longer if counter-claims/affirmative defenses are raised, and other matters are contested.	4-5 months.
<b>Expense</b>	Typical costs of a lawsuit.	Trustee fees (statutory amounts that are generally based on the size of the underlying obligation).
<b>Redemption?</b>	Yes.	No.
<b>Deficiency Against Borrower?</b>	Yes, but requires separate proceeding within the lawsuit. Deficiency determined by court. May require expert testimony.	No.
<b>Pursuit of Other Collateral</b>	Yes.	Yes.
<b>Pursuit of Guarantors</b>	Yes.	Yes.



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### OVERVIEW

Alan Martin is a partner and co-chair of the Finance and Bankruptcy Practice Group.

#### Areas of Practice

Mr. Martin specializes in commercial finance law, corporate restructuring, asset disposition and acquisition, creditors rights enforcement, commercial litigation and bankruptcy. His expertise includes extensive work in bankruptcy and state courts, as well as structured finance documentation in such industries as commercial real estate, healthcare, retail, manufacturing, hospitality and recreation. He has represented creditors committees, secured and unsecured creditors, trustees, landlords, federal recession, equipment lessors and debtors and the schools subcommittee (with total claims of over \$1.1 billion) in the County of Orange Chapter 9 case.

### EDUCATION

- J.D., University of Virginia School of Law, 1987
- B.A., University of Virginia, 1984

### ADMISSIONS

- U.S. District Courts for Central, Eastern, Northern and Southern Districts
- Supreme Court of the United States

### HONORS

- Leading Practitioner in Corporate Restructuring, Legal 500 US
- Best Lawyers in America, Bankruptcy and Creditor-Debtor Rights Law, 2007-2009

### PRACTICE AREAS

- Troubled Assets
- Bankruptcy and Restructuring
- Finance
- Litigation
- International Business

### INDUSTRIES

- Financial Services
- Mortgage Banking

## EXPERIENCE

### Representative Clients

American China Technology; Bank of America; California Portland Cement Company; Capmark Finance Inc.; The Catholic Diocese of Orange; CIT Group; General Electric Capital Corporation; Marquette Capital; Orange County Department of Education; Summitt Wood Products; and Taylor Made Golf.

### MEMBERSHIPS

- Former President, Orange County Bankruptcy Forum, 1997-1998
- Former Board of Directors, California Bankruptcy Forum, 1997-2000
- Member, Orange County Bankruptcy Forum
- Member, Los Angeles Bankruptcy Forum
- Member, Orange County Bar Association
- Member, American Bar Association
- Member, American Bankruptcy Institute
- Screening Committee, Ninth Circuit Bankruptcy Judge for the Central District of California, 1991-1993, 2000
- Former President, Orange County Chapter of the University of Virginia Alumni Association, 1989-1995
- Board of Directors, Regional Center of Orange County, 2006-2009

### SPEECHES

- He is frequent speaker on various banking, commercial law, bankruptcy and healthcare topics.