

THE RULES OF FORECLOSURE MUST BE STRICTLY FOLLOWED

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Recently, the Court of Appeal reversed a judgment for judicial foreclosure where the bank failed to follow the requirements of the “one action rule” with devastating results. By its own missteps, the bank lost its right to a deficiency judgment on its loan.

In *First California Bank v. McDonald*, husband and wife signed a 5-year promissory note in the sum of \$1,509,000.00. The note was secured with a deed of trust secured by real property in Wasco, California (Wasco Property) and a deed of trust secured by real property in Shafter, California (Shafter Property). The Shafter Property was owned solely by wife.

At some point within the five years, wife sold the Shafter Property with the bank’s consent subject to the bank receiving the net proceeds and applying the proceeds to the balance of the note. Then, husband died. A probate proceeding was initiated and husband’s children were appointed as the personal representatives of his estate.

After the husband’s death, no further payments were made on the note and the bank declared a default and accelerated all sums due under the note. As of February 2012, the unpaid principal balance was a little over \$1,000,000.00.

The bank filed a complaint for *judicial* foreclosure to sell the Wasco Property and obtain a deficiency judgment against wife and the husband’s children as the personal representatives of the husband’s estate. To resolve some of the disputes, the bank filed a motion seeking a partial resolution on its claim for judicial foreclosure. The trial court granted the motion and ordered the sale of the Wasco Property. The order also stated that wife and husband’s children would be liable for the deficiency in the amount due on the note after the proceeds of the sale were applied. The husband’s children appealed.

On appeal, the personal representatives contended that the bank waived its right to a deficiency judgment when it consented to the sale of the Shafter Property without the consent of co-debtor,

husband, and invoked the one form of action rule. The “one form of action rule” is found in Civil Code section 726(a) and provides that there can be only one form of action in the recovery of any debt or the enforcement of a right secured by a mortgage upon real property.

There are two components of the one form of action rule. The first is the limitation on a multitude of lawsuits to collect a debt secured by real property. Thus, all the parties and properties had to be subject to the same lawsuit. The second is the security first principle which requires a creditor to proceed against the real property security *before* enforcing the underlying debt against the debtor. Thus, the bank had to sell the real property, apply the proceeds to the debt and then proceed against the debtor.

In this case, the note was secured by two parcels of real property which requires one legal action and a sale of the properties first before obtaining a deficiency judgment. By statute, the bank was required to seek foreclosure of *_all_* of the property in a single action. Because the Shafter Property had been sold earlier in time, the bank’s inability to proceed against all of the property provided the husband’s children with an affirmative defense barring the bank from obtaining a deficiency judgment against them.

The bank sought to overcome its failure to include all the real property in the judicial foreclosure action. It argued that the proceeds from the sale of the Shafter Property were credited to the balance due, that they received no advantage with the earlier transaction, and that neither wife nor the husband’s children were prejudiced.

Save and except for certain statutory exceptions that were not applicable, the court found that the bank could have obtained a waiver of the security first principle by husband when wife sought the bank’s consent to sell the Shafter Property, but that was not done. Thus, the bank’s release of the Shafter Property as security for the note without husband’s consent operated as the bank’s *waiver* to a deficiency judgment under the judicial foreclosure statute and the bank lost its right to collect the deficiency against the husband’s estate.

With the routine use of multiple parcels of real property as collateral for loans, a lender must strictly follow the judicial foreclosure statute if it intends to seek a deficiency judgment down the road. A misstep, even without prejudice to the borrower, can be an expensive lesson and a significant loss.