Practical Guidance

Commercial Real Estate Loan Defaults and Remedies (CA)

A Practical Guidance® Practice Note by William J. Bernfeld and Steven A. Paletz, Akerman LLP

William J. Bernfeld
Akerman LLP

Steven A. Paletz
Akerman LLP

This practice note examines borrower defaults and lender remedies under commercial real estate financing documentation in California and discusses common workout options. Additionally, this note details California's one-action rule and anti-deficiency rules and outlines key considerations for lenders bringing an action under an environmental indemnity. Finally, this note provides an overview of receivership and deeds in lieu of foreclosure under California law.

For further guidance, see Commercial Real Estate Financing Transactions (CA), Foreclosure of Real Property, and Workouts of Commercial Real Estate Loans. For more information on defaults and remedies generally in commercial real estate financing transactions, see Commercial Real Estate Loan Defaults and Remedies.

For related forms and additional resources, see Commercial Real Estate Acquisition Loan Resource Kit (CA).

From the Beginning – Defaults and Workouts

If a borrower defaults under its loan documents, the lender may elect to accelerate the loan, make a demand on the borrower for the full amount of the loan, and pursue its remedies under the loan documents. Alternatively, the lender may choose to restructure the loan in a workout. Several considerations may inform the lender's decision, including whether the loan is part of a securitized pool or held by a balance sheet lender and whether the lender believes the default is subject to cure or likely to result in a systemic default.

If the lender wishes to declare a default, the lender should study the loan documents carefully to make sure that (1) the default falls within the four corners of the loan documents, and (2) the lender strictly adheres to the notice provisions. If the lender wishes to accelerate the loan, it may do so, but the California Civil Code permits a borrower to reinstate the loan up until five business days prior to the foreclosure sale. Cal. Civ. Code § 2924c. If the loan is part of a securitized pool, it is important to consult the pooling and servicing agreement to make sure that declaration of a default or acceleration does not require additional notices (to other class members, for instance).

When a lender or borrower faces a default, the parties may start with discussions for a modification or workout if there is no clear borrower culpability. Whether or not a lender or servicer will consider a modification or workout may depend on the nature of the default. For example, is the underlying nonperformance in the vein of "bad boy" behaviors, such as intentional actions in contravention of the loan documents? Or is it an isolated one-time event, such as a disruption in cash flow due to a major tenant vacating the premises early or a (non-borrower-caused) significant increase in an operating expense?

A workout is essentially a modification of the loan documents. It enables a lender to avoid holding a defaulted loan, which is important to most lenders (especially regulated lenders), and affords the borrower time to bring the loan back into compliance. Borrowers should be mindful that a lender is unlikely to engage in workout discussions after declaring an event of default. As a result, it is in the interest of the borrower to keep open lines of communication with the lender or servicer prior to the declaration of an event of default. Even if the lender has declared an event of default, the parties may pursue a workout and negotiate for a variety of things, including:

- **Restructuring of the loan.** This could include extending the term, lengthening the amortization schedule, lowering the interest rate, or, if hard cash management is available to the lender, reordering the waterfall to pay operating expenses before debt service to keep the property running.
- **Waivers/extensions.** The lender might temporarily waive or extend the time for performance of the underlying event(s) giving rise to the default (and potentially any secondary performance tests that are to follow), or waive the calculation of one or more financial covenants for a limited period of time.
- **Access to reserves.** The lender might permit the borrower to access a portion of reserves, with an obligation to restore them when the cash flow turns positive.
- **Cash management.** The lender might implement cash management controls, if not already in place. Active and/or hard cash management would allow the lender to control property revenue by requiring the borrower to deposit all property cash flow into a lender-controlled lockbox account subject to a payment priority waterfall. Note that most real estate finance loans contemplate, at the very least, springing lender controls on property revenues. However, if the borrower is a regulated operating company (e.g., a school, a healthcare facility, or not-for-profit), and the borrower's real estate is serving as collateral, depending on the nature of the operating company, the particular restrictions on the use of funds, and the lenders expertise in managing such restricted funds, the lender might not elect to have a lockbox account and cash flow waterfall in place.
- **Collateral modification.** The parties might agree on additional secured collateral or other credit enhancements. For example, the lender could require the borrower to fund additional equity into reserves or deliver a letter of credit or a guaranty.
- **Forbearance agreement.** Under this agreement, the lender would agree not to exercise its remedies under the loan documents for a specified amount of time, subject to the borrower's compliance with certain conditions (which may vary depending on the nature of the default at issue).

If the lender is willing to discuss workout modifications with the borrower, the lender should require the borrower to sign a pre-negotiation agreement before starting negotiations. Pre-negotiation agreements allow the parties to maintain the status quo while engaging in nonbinding discussions without the lender waiving any of its rights or remedies. For more information on pre-negotiation agreements, see Workouts of Commercial Real Estate Loans. For a form of pre-negotiation agreement, see Pre-Negotiation Agreement (Commercial Real Estate Acquisition Loan).

The One-Action Rule

The California one-action rule and anti-deficiency rules (discussed below) are part of a complex legislative framework. Even though these statutes are well established, courts continue to interpret them on an ongoing basis. Given the intricacy of these rules, if a transaction involves California law or California real property, a lender seeking remedial action must strictly follow California law or risk impairing its security interest. While these issues are important considerations in the context of a foreclosure, the lender must give them substantial thought when exercising remedies short of a foreclosure as well.

Overview

California's one-action rule, Cal. Civ. Proc. Code § 726, limits a lender's ability to recover debt secured by real property collateral in California. It does so in two ways:

- First, it requires the lender to foreclose on its deed of trust before pursuing a debtor's unpledged assets (the security first rule).
- Second, it prohibits a lender from bringing more than one action against a debtor.

In certain circumstances, California's anti-deficiency rules add further restrictions by limiting a lender's ability to collect a deficiency after foreclosure. Violation of the one-action rule has severe penalties, potentially resulting in complete forfeiture of the lender's real property collateral.

Location of Real Property Collateral — One-Action Rule

California courts generally apply the one-action rule whenever the real property securing the debt is located in California, regardless of whether the parties have chosen the law of another jurisdiction as the governing law. As a result, when the collateral involves real property in California, a lender must understand and comply with California's one-action rule or risk forfeiting its lien on the real property in California (and potentially recovery on the debt).

That being said, California courts have ignored the security first mandate of the one-action rule whenever the real property securing the debt is located outside of California, but the underlying loan documents were governed by California law. See Felton v. West, 102 Cal. 266 (1894); First-Trust Joint SL BK v. Meredith, 5 Cal. 2d 214, 217–18 (1936); Hersch and Co. v. C and W Manhattan Associates, 700 F.2d 476, 478–79 (9th Cir. 1983). In *Felton v. West*, the court ruled that the lender's foreclosure on real property in Oregon did not preclude an action in California to collect a deficiency remaining on a note. Felton v. West, 102 Cal. 266 (1894). It is important to note that the decision in Felton v. West predated Sections 580(b) and 580(d) and therefore the court did not address the applicability of such sections. Recent decisions have affirmed that anti-deficiency provisions arising under Sections 580(b) and 580(d) still apply even when the real property sercuring the debt is located outside of California (Cal. Civ. Proc. Code § 580b and Cal.Civ. Proc. Code § 580d) (See the discussion of foreign real property collateral under Anti-deficiency Rules below.)

Waiver of One-Action Rule

The one-action rule is designed as protection for principal debtors. A debtor may not waive its rights under the one-action rule. Cal. Civ. Code § 2953. California courts routinely hold waivers of the one-action rule to be unenforceable, and it is well settled law that waivers that a debtor gives at the origination of loan are invalid. Civil Code Section 2953 speaks to waiver in connection with "the making of or renewing of any loan." Thus, it may be possible to waive these rights post-default, in connection with a workout, depending upon how it is structured.

Guarantors may—and, at loan origination, are routinely required to—waive certain benefits under the California Code of Civil Procedure, including the one-action rule (Cal. Civ. Proc. Code § 726) and anti-deficiency rules (Cal. Civ. Proc. Code § 580b and Cal. Civ. Proc. Code § 580d). These waivers are known as the Gradsky waivers. For more information on the Gradsky waivers and the Gradsky defense, see Anti-defiency Rules below.

Security First Rule

Under the security first rule, lenders must exhaust recovery against real property collateral before pursuing the debtor personally.

A seminal case that addressed the security first rule is Security Pacific National Bank v. Wozab, 51 Cal. 3d 991 (1990). In *Wozab*, the California Supreme Court unequivocally affirmed the security first mandate: "[S]ection 726 and the statutory scheme of which it is a part require a secured creditor to proceed against the security before the underlying debt." Wozab, 51 Cal. 3d at 999, citing Walker v. Community Bank, 10 Cal. 3d 729 (1974). In *Wozab*, the court found that a creditor's setoff against funds from a deposit account prior to the exhaustion of real property collateral violated the security first rule. See also Bank of America v. Daily, 152 Cal. App. 3d 767 (1984).

Lenders should be aware that a debtor may either raise the security first rule as an affirmative defense to an action for personal liability on a debt secured by real property or plead it as its own action. In either case, a successful defense or cause of action would require the lender to look to the real property collateral to satisfy the debt before attempting to sue the debtor personally for the debt.

Note as well that courts have generally interpreted the security first rule to include sanctions for violations, which can bar the lender from recovering against the debtor or collecting against the real property collateral. For instance, if a lender commences an action (other than judicial foreclosure) and obtains a judgment in that action, the court may determine that the lender waived its security by electing its remedy and failing to foreclose on the security first. Walker, 10 Cal. 3d at 738–39.

When any part of the collateral is located in California, lenders should consult California counsel before taking action—including setoff, suits against guarantors, draws on letters of credit, or use of or action against any collateral—to confirm that it does not violate the one-action rule. This is especially important when there are multiple forms of collateral or collateral in multiple states. Failure to comply (e.g., by instituting one of these actions before pursuing the real property collateral located in California) could cause the lender to forfeit its lien on the California real property.

What Is an Action?

An action generally refers to a judicial action. See Wozab, 51 Cal. 3d 991. It is generally accepted that a lender can pursue each of the following without violating the one-action rule:

- **Nonjudicial foreclosure.** Lenders can, and typically do, commence judicial and nonjudicial foreclosure simultaneously. However, nonjudicial foreclosure may prevent a lender from pursuing the debtor personally for any deficiency because of the anti-deficiency rules. For more, see Anti-deficiency Rules.
- **Appointment of receiver.** A receiver may be appointed under the terms of the deed of trust or mortgage without violating the one-action rule. Cal. Civ. Proc. Code § 564(d).
- **Environmental protections.** A lender may enforce an environmental indemnity or environmental provisions related to the secured real property in California without violating the one-action rule (Cal. Civ. Proc. Code § 736), subject to certain limitations on damages (Cal. Civ. Proc. Code § 726.5). For more on the interplay between the

anti-deficiency rules and environmental indemnities, see Actions on on Environmental Indemnity.

When Is an Action Problematic under the One-Action Rule?

Foreclosure on Other Collateral

In Walker v. Community Bank, 10 Cal. 3d 729 (1974), a creditor completed an action by obtaining a deficiency judgment in a judicial foreclosure of chattel security, and the court held that this action was a waiver of the real property collateral.

Foreign State Action and California Property

Courts in California have held that if a lender merely commences an action outside of California to enforce debt that is secured by California property, and the action does not result in a judgment, that is not sufficient to extinguish the lender's lien on the California property. In re Madigan, 122 B.R. 103 (B.A.P. 9th Cir. 1991). However, an affirmative defense may be available if the lender commences an action in California.

Additionally, in *In re Madigan*, the bankruptcy court found that the lender did not waive its real property collateral (in California) by commencing an out-of-state action to enforce a guaranty secured by a deed of trust since no judgment was entered. That being said, if an out-of-state action results in the recovery of a judgment on the note, the action may release the mortgage lien on California property. See Ould v. Stoddard, 54 Cal. 613 (1880). Lenders should take care when commencing actions out of state when California collateral is involved.

Prejudgment Attachment

If a lender attaches a debtor's unpledged assets without first foreclosing on its lien, a court may determine that the lender waived it security by electing its remedy and failing to foreclose against the security first. Wozab, 51 Cal. 3d at 1001.

Additionally, in cases involving the attachment of property, the court may follow the sanctions aspect of Cal. Civ. Proc. Code § 726. For example, in *Shin v. Superior Court*, the court invalidated a deed of trust secured by California real property after a creditor successfully attached the obligor's real property located in Korea. Shin v. Superior Court, 26 Cal. App. 4th 542 (1994). In this case, the creditor commenced two actions: one in California and one in Korea. In the Korea action, the writ of attachment deprived the obligor of ability to use the real property as source of funds to fend off creditors. The California court equated the creation of an attachment lien with seizure of bank accounts (see Wozab, 51 Cal. 3d at 1001) and held that the attachment was inconsistent with security first mandate of Cal. Civ. Proc. Code § 726.

Note that the court in *Shin* refused to follow *In re Madigan* and In re Tidrick, 105 B.R. 584 (Bankr. C.D. Cal. 1989), which held that commencement of an out-of-state action was not sufficient, by itself, to extinguish a lien on California property. The *Shin* court also rejected the argument that the Korean prejudgment attachment was consistent with Cal. Civ. Proc. Code § 483.010, which authorizes the creation of an attachment lien where the real property collateral has decreased in value or become valueless through no fault of the plaintiff.

One Action under the California Uniform Commercial Code

Similar to Cal. Civ. Proc. Code § 726, Cal. U. Com. Code § 9604(a)(5) provides that an action will not trigger sanctions unless the lender obtains a monetary judgment on the debt.

Anti-deficiency Rules

The basic elements of California's anti-deficiency rules are as follows:

- **Deficiency judgments.** Personal liability for a deficiency judgment, if any, will be determined by the decree for foreclosure unless a deficiency judgment is waived by the judgment creditor or prohibited by Section 580(b). Cal. Civ. Proc. Code § 726(b). If a deficiency judgment is waived or prohibited, the real property or estate for years therein shall be sold subject to the right of redemption. Cal. Civ. Proc. Code § 726(e).
- **Sale under power of sale.** No deficiency judgment may be rendered, owed, or collected in any case in which the real property has been sold by the mortgagee or trustee under the power of sale contained in the mortgage or deed of trust (except as provided in Cal. Civ. Proc. Code § 580d(b), which is applicable to a guarantor or other secured indebtedness). Cal. Civ. Proc. Code § 580d(a).
- **Prohibition on deficiency judgments.** Deficiency judgments are prohibited after the foreclosure of:
    - o Seller financing of purchase money loans secured by real property –and–
    - o Third-party financing of purchase money loans secured by real property if the real property is (1) four dwelling units or less and (2) owner/buyer occupied
- **Exceptions to the anti-deficiency bar.** Note the following exceptions to the prohibition on deficiency judgments:
    - o A non-purchase money junior lender who loses its lien as a result of a foreclosure sale by a senior lender (a "sold-out junior") is permitted to pursue the debtor for repayment of its loan. Roseleaf Corp. v. Chierighino 59 C2d 35 (1963).
    - o The anti-deficiency bar does not apply to fraud claims asserted by the debtor. For instance, a debtor is not shielded from damages sought by a lender where the loan proceeds have been fraudulently diverted.

Glendale Fed. Sav. & Loan Assn. v. Marina View Heights Dev. Co., 66 Cal. App. 3d 101 (1977). Nor does the anti-deficiency bar protect a debtor from an action for rescission by the lender where the debtor has misrepresented the value of the security. Kass v. Weber, 261 Cal. App. 2d 417 (1968).

- The anti-deficiency bar also does not apply to bad faith waste, where, for example, the lender under a purchase money loan was permitted to recover damages where the debtor did not maintain an orchard property thus diminishing the value of the property. Hickman v. Mulder, 58 Cal. App. 3d 900 (1976).

Can Guarantors Claim Anti-deficiency Protections?

California courts have held that guarantors have defenses under the anti-deficiency rules. For example, under Section 2810 of the California Civil Code, a guarantor is not liable for the debt if the debtor ceases to be liable on the contract. Additionally, a trustee's sale cuts off a guarantor's rights of subrogation and its rights of reimbursement against the principal.

Gradsky Waivers

A guarantor may waive its rights and defenses of subrogation, as well as certain suretyship protections in Cal. Civ. Code §§ 2787–2855. (Among other things, these sections require creditors to pursue the debtor and the security first and provide that guarantors are entitled to be subrogated to the lender's position.)

Prior to the decision in Union Bank v. Gradsky, 265 Cal. App. 2d 40 (1968), a number of California decisions suggested that enforcing a guaranty in a deficiency context, particularly after nonjudicial sale of the real property, would be extraordinarily difficult; as noted above, the guarantor would be able to raise defenses of impairment of subrogation and reimbursement rights. *Gradsky*, together with the line of cases and legislation that followed, provides a framework for guarantor waivers:

- **Cal. Civ. Proc. Code § 580a.** Cal. Civ. Proc. Code § 580a states that before a court may issue a deficiency judgment (after a trustee's sale), the court must determine the fair market value of the real property at the time of sale; the debtor is not bound by the sale price at the trustee's sale for purposes of determining the value of any deficiency judgment.
- **Cal. Civ. Proc. Code § 580d.** Cal. Civ. Proc. Code § 580d was later enacted and creates a complete bar to deficiency judgments post-trustee's sale, but Cal. Civ. Proc. Code § 580a was never repealed.
- **Talbott v. Hustwit.** In 2008, the Third Appellate District issued a decision clarifying that guarantors cannot benefit from Cal. Civ. Proc. Code § 580a. See Talbott v. Hustwit, 164 Cal. App. 4th 148 (2008).
- **Cal. Civ. Code § 2856.** Section 2856 permits parties to a guaranty agreement to expressly waive the protections afforded to principal debtors by anti-deficiency rules, including California Code of Civil Procedures Sections 580a, 580b, and 726.

Most lenders, consistent with the pre-*Talbott* practice, require guarantors to deliver a guaranty that includes a waiver of Cal. Civ. Proc. Code § 580a.

Similarly, because guarantors can waive Cal. Civ. Proc. Code § 580d (as long as the guaranty itself is not secured by real property in California and includes the appropriate waiver language), a lender could—in addition to pursuing a deficiency judgment after a nonjudicial foreclosure—enforce its guaranty without violating the one-action rule or the anti-deficiency rule. See Guardian Savings and Loan Assn v. MD Associates, 64 Cal. App. 4th 309 (1998).

Assuming a guarantor has provided an enforceable waiver, the court will likely hold that the guaranty is independently enforceable and allow the lender to institute an action against the guarantor prior to or following nonjudicial foreclosure. If the lender commences the guarantor action after foreclosure, the guarantor should be bound by the bid price paid at the foreclosure sale in determining any deficiency.

Choice of Law Considerations

As long as the parties have not selected California law to govern the loan documents, Cal. Civ. Proc. Code § 580d generally does not bar a deficiency judgment outside of California following a nonjudicial foreclosure in California.

You should review the choice of law provisions in your loan documents if your transaction involves either (1) a foreign (non-California) debtor and California real property or (2) foreign (non-California) real property and a California debtor/guarantor. Although a lender waives its rights to a deficiency judgment against a debtor in California under Cal. Civ. Proc. Code § 580d after a foreclosure under power of sale, the lender may be able to pursue a deficiency judgment against the debtor (and the debtor's unsecured assets) in another jurisdiction if the underlying loan documents are not governed by California law.

Note that California courts generally follow the Second Restatement on conflict of law issues. See Second Restatement of Conflict of Laws § 187. The Second Restatement calls for applying the law of the state that the parties chose unless:

- The chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the choice –or–
- Applying the law of the chosen state would be contrary to a fundamental policy of a state (1) with a materially

> greater interest than the chosen state and (2) which would be the state of the applicable law in the absence of an effective choice of law by the parties

Id.

To find a conflict, California must have a "materially greater interest than the chosen state in the determination of the particular interest." See Nedlloyd Line B.V. v. Superior Court, 3 Cal. 4th 459 (1992); 1-800-Got Junk?LLC v. Superior Court, 189 Cal. App. 4th 500 (2010). If there is no conflict, California courts will generally enforce the choice of foreign law.

Foreclosure Issues Unrelated to Interest in Land

In Kerivan v. Title Insurance and Trust Company, 147 Cal. App. 3d 225 (1983), the court interpreted another section of the Second Restatement in determining which foreclosure law applies where the issue is unrelated to an interest in land. In the *Kerivan* matter, the debtor attempted to use California's anti-deficiency defenses by suing the trustee under a deed of trust for breach of fiduciary duty for failing to cancel a note governed by Colorado law after completion of a trustee sale of California property. The court held the lender would only be required to cancel the note when the laws of California are applied, but not when another jurisdiction's laws are applied. The court relied on Section 229 on Restatement of Conflicts (2d), which states that issues that do not relate to any interest in the land but relate to "foreclosure are determined by the law which governs the debt" (i.e., collection of a post-foreclosure sale deficiency and the right to recover debt without exhaustion of collateral was to be determined by the law that governed the debt and the debtor could not avail itself of the anti-deficiency rules in California).

Enforcing a Foreign State Judgment

In United Bank of Denver v. K&W Trucking Company, Inc., 147 Cal. App. 3d 217 (1983), the court recognized that different rules apply when it comes to enforcement of a foreign state judgment. Here, the lender foreclosed nonjudicially on real property located in California, and a deficiency remained after the sale. The note was governed by Colorado law. The lender then brought an action in Colorado for deficiency judgment and obtained a judgment. The California court recognized that even though Cal. Civ. Proc. Code § 580d would have prohibited the action on the note in California, California should recognize the enforcement of a judgment of sister states under the U.S. Constitution's "full faith and credit" clause. Citing Biewend v. Biewend, 17 Cal. 2d 108, 111–12 (1941), the court observed:

> It is well settled that once a valid judgment has been rendered it must be accorded full faith and credit by every other court within the United States even though the cause of action upon which the judgment was based is against the law and public policy of the state in which enforcement is sought.

Biewend, 17 Cal. 2d at 223.

Foreign Real Property Collateral with California Obligor / California Law

In the event a transaction involves real property collateral located outside of California, but the borrower and/or guarantor is a California entity or California law governs the loan documents, the California anti-deficiency provisions under Section 580b and 580d will still apply. When representing an obligor or a lender, keep in mind the following authority addressing anti-deficiency provisions:

- In Younker v. Manor, 255 Cal. App. 2d 431 (1967), a borrower and guarantor executed a purchase money note and guaranty, respectively, in Nevada secured by a junior deed of trust on Nevada land. The borrower, an individual, was a California resident and the guarantor, a corporation, was formed in California. The senior deed of trust foreclosed and the junior lien was wiped out. The lender brought an action in California to recover the debt against both the maker of the note and guarantor. The court found that the deed of trust was governed by Nevada law, but the court did not make a finding as to which law governed interpretation of the note and guaranty. The court ruled in favor of the borrower and guarantor and held that the California anti-deficiency limitations barred recovery against them, noting the following:

  > We do not mean by this that California has an interest in protecting its residents, corporate or individual, from paying their debts in general, but only that in one particular kind of transaction, land sales, where the land is given as security for the debt to the vendor, this state has an interest in protecting purchasers from judgments for deficiency.

  Younker, 255 Cal. App. 2d at 437.
- In Hersch and Company v. C and W Manhattan Associates, 700 F.2d 476, 478–89 (9th Cir. 1983), the lender sued on a note which was secured by real property in Iowa and New Mexico without foreclosing. California law governed. Even though no sale had occurred, the Circuit Court of Appeals used Cal. Civ. Proc. Code § 580b to bar liability on debt.
- In Consolidated Capital Income Trust v. Khaloghli, 183 Cal. App. 3d 107 (1986), a guaranty and note stated they were governed by California law, and the trust deed provided it was governed by Texas law. The court ruled that Cal. Civ. Proc. Code § 580d applied with respect to the lender's attempt to enforce a guaranty to collect a deficiency judgment after a nonjudicial foreclosure of the real property in Texas. However, it should be noted that Gradsky waivers were not included in the guaranty, and there was a triable issue as to whether Cal. Civ. Proc.

Code § 580d could trigger a Gradsky defense without analysis of the applicability of Cal. Civ. Proc. Code § 580d to property located outside of California.

Actions on an Environmental Indemnity

California Code of Civil Procedure § 736

California Code of Civil Procedure § 736 permits a lender to bring a separate action against the debtor—without violating Cal. Civ. Proc. Code § 726 or 580d—to enforce the debtor's obligations under environmental provisions in the loan documents and recover damages.

Lenders should be aware, however, of a potential risk: If non-California law governs the environmental indemnity, and the lender obtains a judgment under the indemnity before foreclosing on California real property collateral, the security first rule (Cal. Civ. Proc. Code § 726) might extinguish the deed of trust.

In an action under Cal. Civ. Proc. Code § 736, the damages that a lender can recover are limited to "those that relate to a reasonable and good faith clean up, remediation or other response action." The statute does not authorize indemnification claims by third parties. It also does not permit recovery of the principal amount or accrued interest on the loan, except for amounts that the lender advanced to cure or mitigate the environmental condition.

California Code of Civil Procedure § 726.5

California Code of Civil Procedure § 726.5 permits a lender to waive its security and proceed as an unsecured creditor (without violating the one-action rule with respect to the real property collateral) if the property is environmentally impaired. A property is environmentally impaired if:

- Hazardous waste exists at the property and the lender either did not have actual knowledge of it or it was not disclosed in writing to the lender when the parties entered into the loan –and–
- The estimated cost to remediate the hazardous waste exceeds 25% of the fair market value of all security for the loan

Cal. Civ. Proc. Code § 726.5(e)(3).

Properties on certain state and federal lists of contaminated property are also considered environmentally impaired under the statute. Id.

The rights under this statute are available to the lender only if the borrower or a related party knowingly or negligently caused or permitted the environmental harm. Cal. Civ. Proc. Code § 726.5(d).

Additionally, in order to waive its security interest and proceed on the debt, the lender must establish a value for the security, including the value of the property that is subject to environmental contamination. If the amount of damage is unknown, a hearing might be necessary to determine the value of the property and the measure of damages. The lender should be aware that having the property valued is not without risk. If the property valuation is less than the outstanding debt, and the borrower then files for bankruptcy, the lender might lose certain adequate protection and other rights that are available to fully secured creditors in a reorganization or a liquidation.

Appointment of a Receiver

Before or during Foreclosure

After an event of default, lenders often consider appointing a receiver. Receivership is generally viewed as a provisional remedy—meaning that it maintains the status quo until relief is granted—but is also available post-judgment in various situations. See Highland Sec. Co. v. Superior Court, 119 Cal. App. 107 (1931). Below is a discussion of the statutory requirements for appointing a receiver in California.

Assignment of Rents

California law allows the court to appoint a receiver in an action "for specific performance of an assignment of rents provision in a deed of trust, mortgage, or separate assignment document." Cal. Civ. Proc. Code § 564(b)(11).

Deeds of trusts generally always contain an assignment of rents provision, and many secured lenders also require the borrower to execute a separate assignment of rents document. That being said, the statute does not give the lender an unqualified right to have a receiver appointed. The lender must expressly assert a claim for specific performance to rely on this statute, and as specific performance is an equitable remedy, the court may grant or deny it in its discretion. See Barclays Bank of California v. Superior Court, 69 Cal. App. 3d 593, 609 (1977). An action for specific performance under Cal. Civ. Proc. Code § 564(b)(11) may be its own cause of action or may be joined with a cause of action for judicial foreclosure.

Additionally, if the court appointed a receiver pursuant to a specific performance action, the court can continue the appointment after entry of a judgment for specific performance if appropriate to protect, operate, or maintain secured real property or collect rents from it while a nonjudicial foreclosure is in process. Cal. Civ. Proc. Code § 564(b)(11).

Absence of Assignment of Rents

If the loan documents do not contain an assignment of rents, the lender can look to Cal. Civ. Proc. Code § 564(b)(2) for appointment of a receiver. For the lender to successfully invoke this subsection, there must be:

- An action for foreclosure pending –and–
- An admission that the property is probably insufficient to discharge the debt

Be aware that this type of admission might pose difficulties for the lender later on. Similar to the valuation discussed above for an environmental indemnity action, if the lender makes the admission that this statute requires and the borrower then declares bankruptcy, the lender might lose certain protections as an under-secured or unsecured creditor.

Given that this subsection allows for the appointment of a receiver in the absence of an assignment of rents, the receiver's authority might be limited to preserving the property from waste and collecting rents only as needed to avoid waste. See Walmsley v. Holcomb, 61 Cal. App. 2d 578 (1943); Locke v. Klunker, 123 Cal. 231 (1898); Turner v. Superior Court, 72 Cal. App. 3d 804, 815 (1977). It is important to note that, absent an assignment of rents clause, California law treats rents and profits as an unencumbered asset separate from the real property. See Snyder v. Western Loan and Bldg. Co., 1 Cal. 2d 697 (1934).

Receivership and One Form of Action Rule

There is statutory authority to support the argument that appointing a receiver does not violate the one form of action rule under Cal. Civ. Proc. Code § 726. The relevant statutes provide for the following:

- A receiver may take possession of real property and collect rents during the pendency of a foreclosure or trustee's sale (i.e., prior to a judgment of foreclosure). Cal. Civ. Proc. Code § 564(b)(2) and (b)(11).
- An action by a secured lender to appoint a receiver does not constitute an action under the one-action rule. Cal. Civ. Proc. Code § 564(d).
- The appointment of a receiver and the collection, distribution, or application of rents, issues, or profits by the assignee do not violate the one-action rule or bar a deficiency judgment. Cal. Civ. Code § 2938(e).
- The application of, or failure to apply, rents, issues, or profits will not result in the loss of any lien or security interest that the lender may have in the real property collateral or render the security unenforceable in violation of the one-action rule. Cal. Civ. Code § 2938(c).

If the lender seeks a deficiency judgment, or if the lender is concerned about foreclosing under power of sale, be sure to include a cause of action for judicial foreclosure in the complaint for specific performance of the assignment of rents and profits clause.

After Foreclosure

After a judgment or sale of real property through foreclosure, a receiver may:

- Carry the judgment into effect
- Dispose of the property according to the judgment –or–
- Preserve property during the pendency of an appeal

See Cal. Civ. Proc. Code § 564(b)(3)–(b)(4).

Additionally, during the redemption period following the sale of real property, the receiver may "collect, expend and disburse rents as directed by the court or otherwise provided by law." See Cal. Civ. Proc. Code § 564(b)(4); see also Fox v. Hale & Norcross Silvermine Co., 108 Cal. 475 (1985).

For more information on receivership in the real estate context generally, see Receivership in Real Estate Transactions.

Deeds in Lieu of Foreclosure

A deed in lieu may be an attractive alternative to foreclosure for both the debtor and the lender. For a debtor, it avoids the public record of a trustee's deed or decree of foreclosure and the expense of foreclosure. For a lender, it provides quicker access to the property and sidesteps issues such as maintenance costs, rent collection, and the risk of waste or destruction (which may be high if there is no receiver in place).

There are risks to the lender, though, in accepting title by a deed in lieu. The lender might face junior or intervening lienholders at the property, liability for construction, or burdensome condominium or planned unit development requirements. To protect against these issues, lenders engage in a two-step process:

- First, they accept a deed in lieu to gain title to the property.
- Second, they pursue a nonjudicial foreclosure of the mortgage to wipe out any junior or intervening liens.

Lenders started experiencing some hiccups in this process after the economic downturn in 2008. Title companies were refusing to insure the clean transfer of title to the lender, arguing that the mortgage lien merged with the fee because they were both held by the lender. The California Court of Appeals addressed this issue in 2014, noting that a mortgage lien does not merge with the fee merely because the same party holds both. Decon Group Inc. v. Prudential Mortgage Capital Co. LLC, 227 Cal. App. 4th 665 (2nd Dist. 2014). Specifically, the court held that if a senior lienholder receives a grant deed in lieu of foreclosure—and the grant deed contains an antimerger clause—the senior deed of trust does not merge into title of the fee and the senior lienholder retains the right to foreclose on its deed of trust. Id. The applicable rule here (on not merging equity and lien title) has been in place for more than 100 years. California courts have respected that merger is a question of intent when the question is as to whether a mortgage lien is merged in the fee upon both being united in the same person. See Davis v. Randall, 117 Cal. 12, 16–17 (1897); Hines v. Ward, 121 Cal. 115 (1898).

Foreclosure

Though a detailed discussion of foreclosure is beyond the scope of this practice note, it is important to briefly mention the foreclosure process. A lender may pursue judicial and nonjudicial foreclosure concurrently, and frequently do when seeking appointment of a receiver. Unless a lender is entitled (and desires) to seek a deficiency judgment against a borrower, the lender will likely pursue a nonjudicial foreclosure (i.e., a trustee's sale) to the end. This is in part because a nonjudicial foreclosure takes approximately 4 months, while a judicial foreclosure can take between 12 to 24 months to complete, and is subject to appeal. While a foreclosing lender in a nonjudicial or judicial foreclosure sale may credit bid up to the amount of the debt, a full credit bid will destroy the right of the lender to pursue a deficiency.

William J. Bernfeld, Partner, Akerman LLP

William ("Bill") Bernfeld focuses his practice on real estate and commercial law. He regularly assists clients in acquisitions and dispositions, leasing, and financing of real estate projects in a variety of sectors throughout California including office, retail, restaurant, hospitality, and industrial. Bill regularly works on behalf of lenders to secure permanent, construction, and distressed project financing, as well as handling asset-based and commercial lending transactions on behalf of institutional clients. Bill has also developed a niche practice in representing lenders in trusts and estates transactions. Bill's background as a bankruptcy attorney puts him in a unique position to assist clients with distressed real estate transactions including loan workouts and other restructuring needs.

Steven A. Paletz, Associate, Akerman LLP

Steven Paletz represents local, regional, and national developers throughout the lifecycle of a commercial real estate transaction. His clients represent a diversity of real estate sectors including residential, industrial, retail, office, mixed use, and hospitality projects. His experience includes all aspects of a real estate transaction including agreements, leases, entitlement work, financing and construction agreements. Steven has also represented lenders in connection with the drafting and negotiation of loan documents.

Steven has experience representing landlords and tenants in commercial leases for office, retail and industrial properties. In addition, he previously served as a general counsel for a national homebuilder based in Colorado. In November of 2021, Steven was appointed as a Commissioner on the Colorado Economic Development Commission.