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Antideficiency rule sanctions:
In re Prestige Ltd. Partnership-Concord, 2000
Roger Bernhardt

Secured creditor who sues debtor's guarantor instead of foreclosing on security loses security interest, but may still seek to recover underlying debt.

In re Prestige Ltd. Partnership-Concord (Prestige Ltd. Partnership-Concord v East Bay Car Wash Partners) (9th Cir 2000) 234 F3d 1108

In 1990, Prestige Limited Partnership (Prestige) purchased a car wash business from East Bay Car Wash Partners (East Bay). As part of the purchase price, Prestige gave East Bay a promissory note secured by a deed of trust against Prestige's real property and a security interest in Prestige's personal property (the collateral). The note was signed by Prestige's general partners, one of whom (Brassfield) also personally guaranteed the note. In 1995, Prestige defaulted on the note. Instead of foreclosing on the collateral, East Bay sued on the guaranty and attached some of Brassfield's personal assets, leaving roughly \$700,000 of the debt unsatisfied. Prestige then filed a Chapter 11 bankruptcy petition, listing East Bay as a disputed secured creditor.

Later, Prestige asserted in bankruptcy court that, by proceeding against Brassfield's unpledged assets, East Bay had waived its security interest in the collateral under the one-action rule of CCP §726(a). Prestige also asserted that the underlying note was unenforceable under CCP §580b as a standard purchase money note. The bankruptcy court held that East Bay lost its security interest in the collateral but could still seek to recover the underlying debt. The district court and the Ninth Circuit affirmed.

The one-action rule of CCP §726(a) requires a secured creditor to seek foreclosure as the single form of action for recovering a debt secured by a mortgage or deed of trust on real property. The rule compels the secured creditor to exhaust the security judicially before obtaining a monetary deficiency judgment against the debtor. By electing to sue on the obligation, the creditor waives the right to foreclose on the security. *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201. When East Bay sued Brassfield on the guaranty, it elected a remedy and thereby waived its security interest in the collateral. Relying on *Wozab*, however, the court held that East Bay did not lose the underlying debt.

Code of Civil Procedure §580b precludes a deficiency judgment on a purchase money note after a foreclosure sale of the real property security. Prestige's note was a standard purchase money note, but §580b did not apply because there was no sale of the real property. Section 580b applies only when the property has either been sold, or may be sold in the future, because the creditor still holds a security interest. In this case, because East Bay lost its security interest by violating §726(a), "there has not been and can never be a sale of the property." 234 F3d at 1117. Hence, §580b did not apply and East Bay could seek to recover the underlying debt.

►**THE EDITOR'S TAKE:** Don't describe this case to non-California attorneys: they'll think that we have lost all semblance of sanity, even though the decision is probably a correct application of three of our more bizarre mortgage principles.

Guarantors as Alter Ego Debtors. Because our antideficiency statutes make so many mortgage notes uncollectable, it is not surprising that creditors seek additional security from debtors in the form of guaranties. But therein lies the first catch: since a debtor is protected by the antideficiency rules, a guaranty of his debt by him would constitute an improper waiver of those rules; thus, the guaranty has to come from someone who is not the debtor. The guarantor of a debt thus gets off the hook by showing that he really owes the debt he guaranteed; it is only if he does not owe the debt (as debtor) that he will therefore owe it (as guarantor). You can imagine the kind of testimony this elicits from the parties in disputed fact situations: “Yes, I really did owe her that money, so my guaranty of it was invalid,” or “No, he didn’t owe me a thing, which is why his guaranty is good.”

In this case, the guarantor (Brassfield) was one of the general partners of an Arizona limited partnership that was the general partner of the California limited partnership that executed the underlying note. Since a general partner is liable for partnership debts under California and Arizona law, Brassfield’s guaranty added nothing and was therefore unenforceable.

Since this was also a purchase money loan, Brassfield was not liable as a debtor, even as a general partner, because of CCP §580b. Only Californians can appreciate the logic of saying that a person who voluntarily signs both a note and a guaranty of it should not be liable under either instrument.

Sanctioning the Creditor for Attaching. Outside of California, a suit against a nonliable party (*e.g.*, a guarantor who is an alter ego debtor) would merely be dismissed, and any incidental steps, such as an attachment, would be terminated. In California, however, the CCP §726 loss-of-security sanction means that we don’t stop there. Not only was the creditor’s attachment dissolved, but the security of its deed of trust was also taken from it because the ineffective attachment was held to violate the one-action rule of §726. Attachment might have been proper had Brassfield been only a guarantor, but because he was really a debtor, the attachment constituted an action under §726, triggering the loss-of-security sanction.

Ironically, apart from the attachment, the lawsuit itself did not count as an action (even though it conformed perfectly to the statutory definition of that term); it is only the attachment—although only a provisional remedy—that constitutes an action for §726 purposes. But this only shows how far we have gone from common sense in creating this legal quagmire.

In any event, the lesson is clear: A creditor whose secured note has also been guaranteed may sue the guarantor but should not risk attaching any of his assets, lest it lose both the guaranty *and* the security.

Exempting CCP §580b from the CCP §726 Sanction. The most surprising feature of this court’s decision was its holding that a creditor who had lost its security by virtue of the §726 sanction could nevertheless seek to enforce the underlying debt (at least in bankruptcy), even when the debt is a purchase money obligation!

Preservation of the now unsecured debt may be understandable in some circumstances (as in *Security Pac. Nat’l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, relied on by the court), but when §580b is added in, such a result is extraordinary. In *Wozab*-type scenarios, allowing a nonpurchase money creditor to enforce its note after it has lost its security merely gives it part of

what it previously had (it could earlier have judicially foreclosed and gotten a deficiency judgment against the debtor); but allowing a purchase money creditor to do the same gives it what it never previously had (it could never have obtained a deficiency judgment against the purchase money debtor)!

In some respects, the Ninth Circuit in this case is merely offsetting some of the earlier illogic of *Brown v Jensen* (1953) 41 C2d 193, 259 P2d 425, by a rival illogic of its own. *Brown's* holding that a sold-out junior's action on her note was really one for a deficiency judgment, even though she had never had a foreclosure sale, clearly distorted the conventional meaning of that phrase in order to further certain policy judgments. As a result, the test of what constitutes a deficiency judgment is far more rhetorical than logical. It is thus only one step farther down this path of incomprehensibility to hold that a purchase money creditor that loses its security by its own act is entitled to enforce its monetary claim against the debtor, even though a similarly situated creditor who innocently lost its security because of a senior foreclosure sale is not permitted to do so. —*Roger Bernhardt*