One Action or One Exception: Bank of America v Graves

Roger Bernhardt
Golden Gate University School of Law, rbernhardt@ggu.edu

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In these columns I generally try to reflect about how attorneys may have to revise their behavior because of some new legal development. This time, however, I cannot say that the decision in *Bank of America v Graves* (1996) 51 CA4th 607, 59 CR2d 288, reported at 20 CEB RPLR 79 (Mar. 1997), means that we have to do anything differently, only that the settled old way of behaving may not be as secure as it formerly was.

When a distressed borrower defaults on its real-property-secured loans, it usually fails to pay on all of its mortgages, whether senior or junior. If your client was the junior mortgagee on a loan in default, the old way of doing things was to advise her that she had the choice of foreclosing on her second mortgage or, instead, letting the senior mortgagee foreclose on its first mortgage, thereby transforming her into a sold-out junior. The term “sold-out junior” refers to the situation in which the senior lienholder forecloses and extinguishes the junior’s security interest; consequently, the junior’s security interest has become “worthless” through no fault of its own and the junior is permitted to sue the borrower directly on the note despite the one-action rule (CCP §726). See California Mortgage and Deed of Trust Practice §4.8 (2d ed Cal CEB 1990).

Contrary to lay intuitive beliefs, it is often better for the junior to let herself be sold out than to take any affirmative collection steps on her own. If the security’s value is dubious, it is unlikely the junior will fully recover if she acquires the property at her own junior foreclosure. If the junior forecloses by trustee sale rather than judicial sale, CCP §580d bars a postforeclosure deficiency judgment. Even in a judicial sale, which can entitle the lender to both foreclosure of its interest and (with certain exceptions) a deficiency judgment against the borrower, the whipsaw combination of fair value limitations (CCP §726(b)) and the borrower’s postsale redemption rights (CCP §§726(e), 729.010–729.090) makes this option much less attractive.

Alternatively, if the junior lets the senior foreclose first, neither the fact that the senior sale was nonjudicial nor the possibility that the property had enough value to pay both loans has any effect on her right to sue the debtor for the entire unpaid balance of her note. She will lose her security, but a money judgment unencumbered by deficiency judgment limitations against a solvent debtor may be a good trade. (The CCP §580b restrictions on deficiency judgments on purchase money notes alter all these outcomes, so purchase money juniors are not considered in this column.)

It’s easy enough to let the senior go first when the debtor has defaulted on both obligations: the junior just does nothing. Inevitably the senior will act, and when that action entails a foreclosure, the junior is then free to sue on her note and go after the debtor’s other assets instead.
Any device that works so well for creditors, however, is bound to be unpopular to debtors; they would much rather see the junior foreclose than see her elevated into a §726-free status. Debtors have twice lost the argument that the one-action rule should force juniors to join in senior foreclosures so as to consolidate two proceedings into one. See Roseleaf Corp. v Chierighino (1963) 59 C2d 35, 27 CR 873, and Savings Bank v Central Market (1898) 122 C 28, 54 P 273. Their basic argument came up again in a slightly different guise, however, and the margin of defeat was narrow enough to make this observer wonder how solid the creditors’ position is.

The sold-out junior exception requires that the lienholder be “without fault” regarding the loss of security, lest secured creditors otherwise merely tear up their security documents in order to sue on their notes. Mortgage and Deed of Trust §4.8. That inevitably led debtors to contend that the lender was at fault in their particular case. The contention almost worked in Bank of America v Graves.

In Graves, the junior—a bank holding a defaulted equity line account—started its own trustee sale proceeding, but then postponed it so the senior could go to sale before it. That kind of active inertia, claimed the borrowers, meant that the junior had brought its sold-out status on itself and should bar it from then suing on its note.

From the appellate court’s description of their position, the borrowers were not really that persuasive. Their contention that “once the Bank commenced its foreclosure action, it was obliged to complete it” (51 CA4th at 615) was easy for the court to reject through a parade of horribles (51 CA4th at 615):

If the junior lienholder must complete the proceedings, why would the junior lienholder not also be required to commence the proceedings immediately upon default of its debtor? Otherwise, the lienholder could be accused of sleeping upon its rights and “losing” its lien by allowing the senior lienholder to commence its foreclosure. . . .

The Banks’ only recourse would be to start and, without interruption, complete foreclosure, lest their hesitancy caused them to lose their secured position. If they delayed the process to work things out with the debtor, they could be found to have slept on their rights and therefore to have lost their security.

And, worse yet, in all cases, the holder of the second lien would be obliged to pay or assume the first lien position.

The majority’s logic made it easy for the dissenting judge to argue that a contrary rule would not force the junior to go first, but would merely bar it from starting and then stopping its own sale so the senior could go first, which it referred to as “taking affirmative action with the intent to circumvent the one-action rule.” 51 CA4th at 618.

I have omitted the extensive policy discussions offered by both the majority and the dissent. The majority was concerned about the effects that a contrary rule would have on lending practices and loan availability, and the dissent worried about lenders manipulating the one-action rule. Sold-out junior issues are not as set in concrete as we thought, apparently.

The Underlying Issues

If courts are really prepared to undertake a true critical analysis of the issues behind the question raised in Graves, they will have to ask:
• Why do we read CCP §726 to prohibit actions on notes when other states do not and our own Commercial Code (Com C §9504) does the opposite for chattel security? Does such a reading offer any real protection to debtors (except by way of tripping up creditors)?

• Assuming there is some reason to read §726 as a foreclosure-first rule, why do we create an exception to it for juniors who are sold out, but not for other juniors with equally worthless security? Where is that distinction to be found in the statute, and who benefits from it?

• Assuming there is some reason to treat sold-out juniors specially, why is the exception limited to cases where there is no fault? What is such a tort concept doing in a financial rule; do we care about why a debtor defaults?

• Assuming there is some reason to protect sold-out juniors only when they are without fault, why does that protect the junior who elects to let the senior go first (whether by starting and then stopping its own foreclosure or by never starting in the first place)? Doesn’t the bedrock antimultiplicity policy of §726 make that the worst kind of fault possible?

Long ago the California Supreme Court held that a junior was not at fault in declining to join in the senior’s judicial foreclosure, but did not really explain why. Savings Bank v Central Market Co. (1898) 122 C 28, 33, 54 P 273. Mandatory joinder would have certainly furthered the antimultiplicity policy that our courts divine as an underpinning to §726 (the commonly stated purpose of §726 being to eliminate the possibility that numerous actions will be brought against the defaulting debtor), and the burden on the junior (i.e., having to join in the senior’s proceeding rather than being able to initiate its own) certainly seems outweighed by the burden on the debtor (i.e., being subject to two proceedings in a jurisdiction that has a policy against multiplicity). A different result in Central Market would merely have led to some kind of consolidated foreclosure sale held on behalf of both lienholders, with all the deficiency rules thereafter applicable to the junior as well as the senior.

**Incompatible Values**

I predict that some day our courts will realize that the sold-out junior exception they have created to §726 is inconsistent with the antimultiplicity policy they find in §726. Graves came close to facing up to it; the next time, we may all be surprised.