

The Sanction for Violation of California's One-Action Rule

Darren Conley†

In California when a debtor defaults on a real property secured debt, the creditor's options are significantly limited by section 726(a) of the California Code of Civil Procedure. Commonly referred to as the one-action rule, section 726(a) most obviously aims to prevent a real property secured creditor from suing the defaulting debtor on the indebtedness itself prior to foreclosing on the security interest. If the debtor in the situation described does not raise the one-action rule as an affirmative defense and if the creditor obtains a personal judgment on the debt, the one-action rule would forever bar the creditor from foreclosing on the security interest. But what effect does the one-action rule have when a creditor that holds three cross-collateralized, real property secured promissory notes representing a single debt judicially forecloses on the first two mortgages, omitting reference of the third security interest and the note that it secures from the petition for foreclosure? And what happens when a bank, acting as mortgagee, seizes the unencumbered funds of a defaulting mortgagor/depositor prior to foreclosing on the real property security interest? This Comment addresses these less-obvious applications of the one-action rule, providing a definite answer to the first type of problem and a proposal for dealing with the second.

INTRODUCTION

Prior to 1860 a mortgagee in California, upon the default of a mortgagor, was entitled to bring an action on the note as well as an action to foreclose the real property security interest, which could be maintained independently of or concurrently with the action on the note.¹ In 1860

† B.A. 1988, University of California, Davis; J.D. candidate 1992, Boalt Hall School of Law, University of California, Berkeley. I am grateful to Professor John R. Hetland, Professor Charles Hansen, and Jim O'Brien for their efforts and advice.

1. *Felton v. West*, 102 Cal. 266, 269, 36 P. 676, 677 (1894); see also Comment, *Mortgages and Trust Deeds: Enforcement of a Secured Debt in California*, 31 CALIF. L. REV. 429, 430 n.8, 431 n.9 (1943) (describing alternative actions available at common law to California mortgagees) (authored by Aldo P. Guidotti).

The one-action rule is addressed to real property secured transactions. However, throughout this Comment, for simplicity's sake, the term "mortgagor" is used interchangeably with "debtor," and the term "mortgagee" with "creditor."

the legislature enacted California's one-action rule² in response to concerns that mortgagors would be burdened by the multiplicity of actions available to creditors under the prevailing laws.³ Section 726(a) of the California Code of Civil Procedure (the one-action rule) provides, in pertinent part: "There can be but one form of action for the recovery of any debt or the enforcement of any right secured by mortgage upon real property . . . , which action shall be in accordance with the provisions of this chapter."⁴

The effect of the one-action rule is to require a creditor seeking to recover on a debt to judicially foreclose on all security for that debt,⁵ to sue for the entire debt,⁶ and to obtain a personal deficiency judgment

2. See Comment, *supra* note 1, at 429 ("The 'one action rule' first appeared in California by an amendment made in 1860 to section 246 of the Civil Practice Act.")

3. "The express purpose of section 905 of the proposed New York Code of Civil Procedure of 1850, from which section 726 was derived, was stated to be 'to prevent a multiplicity of actions.'" *Id.* at 430 (quoting proposed N.Y. CODE CIV. PROC. § 905 note at 385 (1850)); see R. BERNHARDT, CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE § 4.4, at 187 (2d ed. 1990); *infra* notes 24-26 and accompanying text.

4. CAL. CIV. PROC. CODE § 726(a) (West 1991).

The creditor's one action must be in accordance with the creditor's statutory remedy of judicial foreclosure. *Id.* §§ 725a-730. For a legislative history regarding foreclosure as the only proper action under § 726, see Comment, *Mortgages: Where a Book Account Becomes Secured by a Note and Mortgage the Creditor Must Foreclose*, 11 CALIF. L. REV. 195, 196 n.3 (1923) (authored by T.H. Louttit).

In 1933 the one-action provision was amended to its present form limiting the creditor to "one form of action," in contrast to "one action" as was previously provided. However, the courts have consistently read the statute as limiting the creditor to one action, despite the amendment. See R. BERNHARDT, *supra* note 3, § 4.3, at 186-87; CALIFORNIA REAL PROPERTY FINANCING § 3.41, at 198-99 (G. Graham ed. 1989) (universally accepted interpretation of the statute, that the creditor is limited to a single action, "is consistent with the [statute's underlying] policy of limiting multiplicity of lawsuits"); J. HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS § 6.18, at 258-59 (1970) (citing numerous cases to demonstrate that courts have ignored the amendment); 4 H. MILLER & M. STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE § 9:113, at 374 n.73 (2d ed. 1989) ("[C]ases subsequent to the amendment have [ignored] the statutory change."); see also Comment, *Mortgages and Trust Deeds: Foreclosure Sale of a Portion of the Mortgaged Premises*, 25 CALIF. L. REV. 469, 470 (1937) (authored by Charles L. Heinings) ("Very probably the legislative intent was only to define a *kind* of action."). If the statute were interpreted literally so as to merely limit the creditor to one form of action, it could be argued that the amendment was intended to permit successive foreclosure actions on separate parcels of property to collect a single debt. 4 H. MILLER & M. STARR, *supra* § 9:113, at 374 n.73.

Although the statute refers only to mortgages, it applies equally to deeds of trust, *Bank of Italy Nat'l Trust & Sav. Ass'n v. Bentley*, 217 Cal. 644, 658, 20 P.2d 940, 945, cert. denied, 290 U.S. 659 (1933), and to equitable mortgages, *James v. P.C.S. Ginning Co.*, 276 Cal. App. 2d 19, 22, 80 Cal. Rptr. 457, 459 (1969).

5. See 4 H. MILLER & M. STARR, *supra* note 4, § 9:104, at 343 & n.39 (citing numerous cases in support of this common understanding of the rule's operation).

6. See Hetland & Hansen, *The "Mixed-Collateral" Amendments to California's Commercial Code—Covert Repeal of California's Real Property Foreclosure and Antideficiency Provisions or Exercise in Futility?*, 75 CALIF. L. REV. 185, 205-06 (1987) ("The effect of obtaining a judgment for less than the entire debt—whether or not any part of the security has been foreclosed in the same action—is a waiver of the balance of the debt, i.e., a waiver of that part of the obligation not recovered in the single action." *Id.* at 206.)

against the debtor, if available, all in the same judicial foreclosure action.⁷ The rule has at least two important implications. First, a creditor may not waive a security interest in real property by obtaining a personal money judgment on a debt prior to foreclosing on all security for that debt.⁸ The creditor is prohibited from circumventing the one-action rule in this manner because “[t]he liability of the mortgagor is . . . contingent on the fact that a sale of the mortgaged premises shall fail to satisfy the debt and costs.”⁹ In other words, a creditor must first bring an action on and exhaust the mortgaged security before recovering from the debtor personally. Second, if the creditor does not follow this procedure, for example by bringing an action directly on the note, or by foreclosing on less than all of the security in an action for judicial foreclosure, the creditor may be subject to a sanction for violating the one-action rule.¹⁰

While commentators generally agree that a violation of the one-action rule should be sanctioned, the proper scope of that sanction is vigorously debated. Numerous commentators and practitioners adopt the view that the sanction for violation of the one-action rule should be loss of the creditor's rights in the security only and should never include loss of the underlying debt.¹¹ Others, however, advocate the view that

7. See 4 H. MILLER & M. STARR, *supra* note 4, § 9:104, at 344 (“[T]he creditor must exhaust the security by foreclosure proceedings, and he can only recover a personal judgment against the [debtor] by obtaining a deficiency judgment after a judicial foreclosure sale.”).

8. *Barbieri v. Ramelli*, 84 Cal. 154, 156-57, 23 P. 1086, 1087 (1890).

9. *Biddel v. Brizzolara*, 64 Cal. 354, 362, 30 P. 609, 612 (1883).

10. The creditor will only be sanctioned if the debtor fails to compel the creditor to include all security in the creditor's initial action. See *infra* text accompanying notes 50-75.

11. Professor Cynthia Mertens and Dennis Arnold are among commentators and practitioners who follow the view that the sanction for violation of the one-action rule is loss of the creditor's rights in the security only. Professor Mertens states that “there is no justification” for the loss of the debt in addition to the loss of the security when imposing the one-action rule sanction. Mertens, *California's Foreclosure Statutes: Some Proposals for Reform*, 26 SANTA CLARA L. REV. 533, 554 n.102 (1986); see also Rowan & Mertens, *Bank of America v. Daily: Setoff versus the Right To Foreclose*, 8 REAL PROP. L. REP. 73, 78 (1985) (“A debtor should not . . . be doubly sanctioned for violating CCP § 726.”).

Arnold refers to the loss-of-security and loss-of-debt sanction as an “unduly formalistic turu-of-the-century judicial rationale” involving “rather circular reasoning.” Arnold, *Anti-Deficiency in the Eighties: The “Sanction Aspect,” Fair Value and Where the Action Is (And Isn't)*, CAL. REAL PROP. J., Spring 1987, at 1, 3. According to Arnold, the scope of the sanction question “reinsains a major controversy under C.C.P. section 726.” Hirsch, Arnold, Rabin & Sigman, *The U.C.C. Mixed Collateral Statute—Has Paradise Really Been Lost?*, 36 UCLA L. REV. 1, 46 (1988) [hereinafter Hirsch].

Professor Edward Rabin argues that in the context of an improper banker's setoff, the combined loss-of-security and loss-of-debt sanction is unfair and has no basis in precedent, see Munoz & Rabin, *The Sequel to Bank of America v. Daily: Security Pac. Nat'l Bank v. Wozab*, 12 REAL PROP. L. REP. 204, 209-10 (1989), while Edward Weiner suggests that early cases holding that the one-action rule sanction may include loss of the debt appear to have been overruled by more recent case law, see Weiner & Tranz, *New Breadth to Sanctions Against Foreclosing Secured Creditors*, CAL. REAL PROP. J., Summer 1985, at 1, 2-3. Interestingly, Witkin, arguably the most prominent authority on California law, fails to even mention the possibility that the sanction for violating the

the sanction, under certain circumstances, should include loss of that portion of the debt not reduced to judgment in the creditor's one action in addition to loss of the security.¹²

In this Comment I address the appropriate sanction for violation of the one-action rule in a variety of contexts, focusing on the situation in which a bank, acting as mortgagee, improperly sets off a debtor's unencumbered bank account prior to foreclosing on the property securing the debt.¹³ The question is a controversial one. In 1984 the California Court of Appeal, in *Bank of America v. Daily*,¹⁴ held that the sanction to be imposed on the creditor in such a situation was loss of the creditor's rights in the security.¹⁵ Furthermore, the court's disposition of the case effectively rendered the underlying obligation unenforceable, thereby

one-action rule might include waiver of the underlying debt. See 3 B. WITKIN, SUMMARY OF CALIFORNIA LAW § 119, at 620-24 (9th ed. 1987).

12. Commentators and practitioners supporting the view that the sanction for the violation of the one-action rule may, under certain circumstances, include loss of that portion of the debt not reduced to judgment in the creditor's one action, as well as loss of the security, include Professor John Hetland, Professor David Leipziger, and James Stillman.

Professor Hetland's 1970 treatise on real estate secured transactions is the cornerstone for the argument that the sanction for violation of the one-action rule is loss of both the security and the underlying debt. Hetland stated:

The classic sanction against the creditor who fails to exhaust all his security for the same debt in a single action is harsh, yet it follows inescapably from the availability of but one action to the creditor—he waives the balance of the security and he waives any claim to the unpaid balance of the debt.

J. HETLAND, *supra* note 4, § 6.18 at 258 (citations omitted); see also Hetland & Hansen, *supra* note 6, at 205-06 (sanction triggered "when a creditor proceeds to take a judgment or its equivalent for less than the full amount of the debt, particularly when he compounds the error by failing to include all his security in the same foreclosure action") (footnote omitted).

Like Hetland, Professor Leipziger argues that when a foreclosing mortgagee holds several notes for a single debt and fails to sue on all of the notes and foreclose on all of the security in a single action, the proper sanction is loss of the unencumbered security and loss of that portion of the debt not reduced to judgment. See Leipziger, *Deficiency Judgments in California: The Supreme Court Tries Again*, 22 UCLA L. REV. 753, 789 n.104 (1975).

James Stillman, a respected expert on California real estate law, describes the "full sanction effect of the one-action rule" in eloquent terms:

[I]f the borrower elects not to raise the rule defensively before the creditor's offending collection effort against general assets, the sanction provides that the mortgage is automatically exonerated. Worse yet, from the creditor's point of view, it has long been argued, and courts have uniformly accepted, that the exoneration extends to the collectibility of any remaining portion of the debt not reduced to judgment at the time the sanction arises. Accordingly, both the mortgage and the remaining debt become valueless.

Stillman, *Helping Those Who Help Themselves: The Banker's Offset in California After Security Pacific National Bank v. Wozab*, BANKING L. REV., Spring 1991, at 8, 9.

Miller and Starr's treatise repeatedly states that the sanction for violation of the one-action rule is loss of the security, but also recognizes the controversy by noting that "[t]here is some indication that the sanction may be more severe" in certain situations. 4 H. MILLER & M. STARR, *supra* note 4, § 9:111 at 359.

13. The term "improper banker's setoff" is used in this Comment when referring to this situation.

14. 152 Cal. App. 3d 767, 199 Cal. Rptr. 557 (1984).

15. *Id.* at 773, 199 Cal. Rptr. at 560.

completely releasing the debtor from liability on the debt.¹⁶ In 1989 the California Court of Appeal, in *Security Pacific National Bank v. Wozab*,¹⁷ followed the *Daily* court's sanction analysis even though the improper setoff involved roughly \$2800, while the debt forfeited as a result of the sanction imposed amounted to over \$976,000.¹⁸ In November, 1990, the Supreme Court of California reversed the appellate court,¹⁹ effectively holding that the proper sanction to be imposed was loss of the security only,²⁰ thereby reducing the status of the bank to an unsecured creditor but preserving its ability to pursue the underlying debt.

The supreme court's disposition of *Wozab* has not ended the scope-of-the-sanction controversy in the context of improper banker's setoffs. The main question before the court in *Wozab* was whether the appropriate section 726 sanction for an improper banker's setoff should be loss of the security or loss of both the security and the underlying debt.²¹ Faced with extraordinary facts and a controversial doctrine that was virtually inapplicable to the transaction at issue, the supreme court deepened the sanction controversy by suggesting that each of the sanctions has its place in one-action rule doctrine.²²

In Part I of this Comment I discuss the policy justifications that serve as the driving force behind section 726 sanction cases. Part II describes the mechanics and application of the one-action rule as defined by the statute itself and by cases interpreting the statute. Part III provides an in-depth analysis of the scope of the sanction, including the persuasive rationales, cases, and commentary in support of each side of the controversy. Part IV addresses the sanction controversy in the specific context of improper banker's setoff cases. Part V analyzes the *Wozab* opinion, concluding that the California Supreme Court's careless application of the one-action rule undermined its goal of resolving the sanction controversy. Finally, Part VI presents a proposal for a uniformly applicable sanction in the context of improper banker's setoffs.

16. See *id.* at 771, 774, 199 Cal. Rptr. at 558, 560; *infra* note 137.

17. 223 Cal. App. 3d 1042, 258 Cal. Rptr. 850 (1989), *rev'd*, 51 Cal. 3d 991, 800 P.2d 557, 275 Cal. Rptr. 201 (1990).

18. *Id.* at 1056-57, 258 Cal. Rptr. at 858.

19. *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 1006, 800 P.2d 557, 566, 275 Cal. Rptr. 201, 210 (1990).

20. See *id.* at 1001-02, 1004, 800 P.2d at 563, 565, 275 Cal. Rptr. at 207, 209; *infra* note 136.

21. See *Wozab*, 51 Cal. 3d at 1000-01, 800 P.2d at 562, 275 Cal. Rptr. at 206.

22. See *infra* Part V.D.

I

POLICY JUSTIFICATIONS FOR THE ONE-ACTION RULE AND
THE SECURITY-FIRST PRINCIPLEA. *Policy Justifications*

Section 726 does not provide a sanction for violation of its provisions. As a result, the courts have looked to the legislative intent behind the enactment of the statute to determine the propriety of imposing sanctions in various situations and the appropriate scope of the sanctions to be imposed.²³ The prevention of a multiplicity of actions is most often cited as the driving force behind the enactment and application of the one-action rule.²⁴ This rationale protects a defaulting debtor's unencumbered assets from litigation costs at a time of great financial need.²⁵ It also prevents a creditor from obtaining a judgment lien on everything the debtor owns (the result of a judgment on the note or a personal deficiency judgment) in addition to the consensual lien (i.e., mortgage or deed of trust) securing the note.²⁶

The courts have ascribed other policy rationales to section 726. In *Walker v. Community Bank*²⁷ the California Supreme Court found the

23. The judiciary is solely responsible for creating and mostly responsible for developing one-action rule sanction doctrine, with academic commentators fueling the controversy. See Munoz & Rabin, *supra* note 11, at 209 ("The concept of sanctions for violating the one action rule is purely an invention of the judiciary, as influenced by academic commentators."); see also Rowan & Mertens, *supra* note 11, at 78 ("The sanctions for violating CCP § 726 are all court imposed. The section itself is silent as to what the sanctions should be.")

24. See *Salter v. Ulrich*, 22 Cal. 2d 263, 266, 138 P.2d 7, 9 (1943) ("[S]ection 726 . . . was intended to simplify procedure and to relieve the mortgagor, who was usually the primary debtor, from harassment in repeated litigation."); *Felton v. West*, 102 Cal. 266, 269, 36 P. 676, 677 (1894) ("Formerly the law allowed an action upon a promissory note, and also a suit in equity to foreclose the mortgage The mischief in such a practice lay in the multiplicity of suits, and the harassing of the debtor by two actions, when the creditor could readily enforce all his rights in one."); *Ould v. Stoddard*, 54 Cal. 613, 615 (1880) ("It is generally conceded that the obvious intention of the Legislature in enacting the statute under consideration was to prevent a multiplicity of suits"); Comment, *supra* note 1, at 430-31 ("The sole intention of the legislature was to make a procedural change that would prevent [the] multiplicity of actions arising under the common law."); *supra* note 3 and accompanying text.

25. Note, *Foreclosing a Single Loan with Multiple Security*, 63 CALIF. L. REV. 152, 154 (1975) (authored by Paul M. Rose).

26. Where a creditor brings an action for judicial foreclosure, omits some of the security from its petition for a decree of foreclosure, and subsequently obtains a personal deficiency judgment following the sale of the security,

the creditor obtains an advance deficiency. It is the creation of this advance deficiency—i.e., the judgment and resulting judgment lien on everything the debtor owns, while the creditor still retains a consensual security interest in the . . . property originally put up as security—which so deeply offends the policy of the one-action statute. That policy is to limit a secured creditor to the security which he voluntarily took to secure the obligation in the first instance, and to prevent him from injuring the debtor and prejudicing other creditors by augmenting his unencumbered consensual lien with a judgment lien on potentially all of the rest of the debtor's property.

Hetland & Hansen, supra note 6, at 207.

27. 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974).

purposes of the one-action rule to be: (1) preventing a multiplicity of suits; (2) compelling competitive bidding to test the value of all the security; and (3) forcing the creditor to look to all the security as the primary fund before looking to the debtor.²⁸ The second and third purposes announced by the court in *Walker* are based on the rationale that the parties to the transaction have agreed that the security is to serve as the primary fund for satisfying the obligation, the debtor being secondarily liable contingent upon the exhaustion of the security at a judicial foreclosure sale.²⁹ The one-action rule calls for a judicial foreclosure sale at which the value of the security will, theoretically, be determined by competitive bidding. However, a creditor that disregards the one-action rule by suing on the note, or by failing to include all of the security in an action for judicial foreclosure, has obtained a personal judgment against the unencumbered assets of the debtor without giving the debtor the benefit of having the fair market value of the security applied to reduce the debt.³⁰

An analysis of the interaction of section 726(a) with sections 726(b) and 580d of the California Civil Procedure Code supports this reasoning. When a creditor chooses to foreclose judicially, and does so in compliance with the one-action rule by including all security in the foreclosure action, the court will order the security sold at an execution sale, after which a deficiency judgment will be entered against the debtor for the amount still owed on the debt.³¹ This judgment, however, is limited by section 726(b), which credits the debtor with the fair market value of the security in the event the execution sale produces a below-fair-market

28. *Id.* at 735, 518 P.2d at 333, 111 Cal. Rptr. at 901; 4 H. MILLER & M. STARR, *supra* note 4, § 9:104 at 343.

29. *See* Bank of Italy Nat'l Trust & Sav. Ass'n v. Bentley, 217 Cal. 644, 649, 20 P.2d 940, 941 ("[T]he contract between the parties must be held to impliedly provide that the land constitutes the primary fund to secure the debt, and that a sale under the deed of trust will be had before a suit may be commenced on the note."), *cert. denied*, 290 U.S. 659 (1933); Biddel v. Brizzolara, 64 Cal. 354, 362, 30 P. 609, 612 (1883) ("The liability of the mortgagor is . . . contingent on the fact that a sale of the mortgaged premises shall fail to satisfy the debt and costs."); CALIFORNIA REAL PROPERTY FINANCING, *supra* note 4, § 3.43, at 200-01. Gordon Graham provides an excellent synopsis of the primary fund policy:

The loss of any security not included in the foreclosure action is justified on the grounds that this result is consistent with the agreement of the parties; by posting more than one parcel of property as security for the debt, the debtor understands that all of the encumbered property may be taken if necessary to satisfy the debt. . . . [T]he creditor is understood to have agreed to look primarily to the security for recovery of the debt and not to be entitled to a deficiency judgment unless the security is inadequate.

Id.

30. *See* J. HETLAND, *supra* note 4, § 6.18, at 259.

31. CAL. CIV. PROC. CODE § 726(a), (b) (West 1991).

A creditor that is secured by a mortgage or deed of trust containing a power of sale may foreclose, upon default of the debtor, in one of two ways. The creditor could commence either a private foreclosure action (otherwise known as a nonjudicial foreclosure or a trustee's foreclosure) under the power of sale or a judicial foreclosure.

final bid.³² Furthermore, in the event a creditor chooses to foreclose nonjudicially under a power of sale in the mortgage or deed of trust, a choice that does not trigger the one-action rule,³³ the creditor may not obtain a deficiency judgment under section 580d.³⁴ Thus, the interaction of sections 726(a), 726(b), and 580d creates a statutory antideficiency scheme that finds its roots in the primary fund policy discussed above.

B. *The Security-First Principle—A Corollary to the One-Action Rule*

One common thread runs through any discussion of the justifications of the one-action rule. Whether the policy be preventing a multiplicity of actions, compelling competitive bidding to test the value of the security as the primary fund for satisfaction of the debt, or upholding California's statutory antideficiency scheme, the one-action rule requires the creditor to foreclose on the security before looking to the debtor's unencumbered assets.³⁵ Roger Bernhardt provides an accurate summary of the security-first principle:

Because CCP § 726 bars an independent action on the note, the only method by which a beneficiary may recover from the trustor's personal estate is by a deficiency judgment after a foreclosure sale has failed to produce enough to satisfy the debt. Thus, CCP § 726 is a security-first rule as well as a one-action rule. . . . This security-first principle has the further effect of converting the debtor's promise to pay from an absolute to a conditional obligation. A California trustor who signs a note does not promise unconditionally to pay the note, but rather promises to pay any deficiency that remains if a sale of the encumbered property does not satisfy the note.³⁶

The security-first principle is best termed a corollary to the one-

32. CAL. CIV. PROC. CODE § 726(b) (West 1991); see J. HETLAND, *supra* note 4, § 6.1, at 234, § 6.18, at 259.

33. In *Hatch v. Security-First Nat'l Bank*, 19 Cal. 2d 254, 120 P.2d 869 (1942), the court held that where a single debt is secured by several security interests in real property, a creditor can hold several nonjudicial foreclosure sales because the one-action rule is only invoked where the creditor seeks more than one *judicial* action. *Id.* at 258, 120 P.2d at 872. For a discussion of the implications of *Hatch*, see J. HETLAND, *supra* note 4, § 6.19, at 260-61.

34. CAL. CIV. PROC. CODE § 580d (West 1991).

Section 580d was enacted in 1939 to equalize the costs facing a creditor who must choose between nonjudicial and judicial foreclosure. Prior to 1939, a creditor choosing nonjudicial foreclosure was able to obtain the property at the sale by entering a less than full credit bid and also obtain a deficiency judgment for the difference. In contrast, a creditor choosing judicial foreclosure was faced with time-consuming and costly court procedures as well as with the debtor's statutory right to redeem the property for three months following the sale under §§ 725(a) and 726. J. HETLAND, *supra* note 4, § 6.13, at 249.

35. Indeed, the Supreme Court of California has described the security-first principle as "hornbook law in California [that] warrants no extended discussion." *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 999, 800 P.2d 557, 561, 275 Cal. Rptr. 201, 205 (1990); see also *Munoz & Rabin*, *supra* note 11, at 206 (citing numerous cases adhering to the security-first principle).

36. R. BERNHARDT, *supra* note 3, § 4.4, at 187-88.

action rule. It can be looked at as either a policy behind the one-action rule,³⁷ or as an effect of the application of the one-action rule.³⁸ Although Bernhardt describes the security-first principle as an effect of the application of the one-action rule,³⁹ modern courts view the security-first principle as a policy that must be adhered to in and of itself. In *In re Kristal*⁴⁰ a mortgagee brought an action for judicial foreclosure pursuant to section 726, properly including all of its security in the action.⁴¹ However, the creditor proceeded to execute on unencumbered personal property of the debtor prior to holding a foreclosure sale to exhaust the real property security.⁴² The Ninth Circuit held that the creditor's conduct, while not a technical violation of the one-action rule, "violated the spirit and intent of the statute,"—the security-first principle.⁴³ Similarly, in *Security Pacific National Bank v. Wozab*⁴⁴ the Supreme Court of California decided that when a creditor violates the security-first principle, but does not technically violate the one-action rule because the creditor's act was not an "action" within the meaning of section 726, the creditor is nonetheless subject to sanction for violating section 726.⁴⁵

The latter scenario is of particular relevance to this Comment. An improper banker's setoff is a "nonjudicial act"⁴⁶ and is therefore not an "action" within the meaning of section 726.⁴⁷ When a bank sets off an unencumbered account before foreclosing on the real property security, such a setoff is nevertheless a violation of the security-first principle.⁴⁸ One of the key questions addressed by this Comment is whether the sanction for violating section 726 imposed when a court finds a violation of the security-first principle embodied in the one-action rule should be different from the sanction imposed when a court finds an ordinary violation of the one-action rule. Given the interconnectedness of the rule and the principle, it is arguable that the sanction imposed should be the same

37. See Comment, *supra* note 1, at 431 ("The court . . . has considered the effect of the statute as an expression of legislative purpose and policy, and as a consequence it has become a settled rule of judicial construction in California that where a debt is secured, the security must first be exhausted.").

38. See R. BERNHARDT, *supra* note 3, § 4.4, at 187-88; see also Comment, *supra* note 1, at 430-31 (describing security-first principle as an effect of the application of § 726 as opposed to a legislative purpose for enacting § 726).

39. See *supra* text accompanying note 36.

40. 758 F.2d 454 (9th Cir. 1985).

41. *Id.* at 455.

42. *Id.*

43. See *id.*

44. 51 Cal. 3d 991, 800 P.2d 557, 275 Cal. Rptr. 201 (1990).

45. See *infra* notes 110-15 and accompanying text.

46. The term "action," for the purposes of § 726, is defined in § 22 as "an ordinary proceeding in a court of justice." CAL. CIV. PROC. CODE § 22 (West 1991).

47. *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 998, 800 P.2d 557, 561, 275 Cal. Rptr. 201, 205 (1990).

48. *Id.* at 999-1000, 800 P.2d at 561-62, 275 Cal. Rptr. at 205-06.

regardless of the court's rationale.⁴⁹

II

THE MECHANICS AND APPLICATION OF THE ONE-ACTION RULE

When a creditor seeks a personal money judgment without first exhausting all security, or omits some of the security for a single debt from an action for judicial foreclosure,⁵⁰ the debtor may raise the one-action rule as an affirmative defense, forcing the creditor to exhaust the security before proceeding further.⁵¹ The affirmative defense is based on the judicial interpretation that the one-action rule prohibits a creditor from unilaterally waiving a security interest in real property and seeking a personal judgment.⁵² The reasoning behind preventing a creditor from circumventing the one-action rule in this manner is that the debtor's personal liability is contingent upon the exhaustion of all of the security.⁵³

The one-action rule would have little meaning if, in a creditor's one action, the debtor could not ask the court to compel the creditor to exhaust all security for the debt. Without the ability to raise the one-action rule as an affirmative defense, mortgagors would be at the mercy of their creditors, which would be able to choose freely between either obtaining a judgment on the note and the resulting judgment lien on everything the debtor owns, or alternatively a decree of foreclosure followed by a possible deficiency judgment. The creditor's choice would be a function of the expected market value of the security and the "collectability" of the debtor. The affirmative defense is especially important to a debtor who alleges protection under an equitable mortgage⁵⁴ or a

49. See *infra* Part V.B.

50. The one-action rule may be invoked by a mortgagor in a variety of situations. Historically, the two most common situations resulting in one-action rule litigation and the development of one-action rule doctrine are (1) where a creditor omits all of the security for a single debt from its one action by bringing an action directly on the note, and (2) where a multiply secured creditor omits some of its security from an action for judicial foreclosure. See 4 H. MILLER & M. STARR, *supra* note 4, § 9:110, at 358 n.98.

For an argument that the "one-form-of-action rule may be superfluous in the multiple security context," see Comment, *supra* note 25, at 154 n.12. The applicability of the one-action rule to mixed-collateral situations (real and personal property securing a single debt) is beyond the scope of this Comment. For an in-depth analysis of the issue, see Hetland & Hansen, *supra* note 6, and Hirsch, *supra* note 11.

51. Walker v. Community Bank, 10 Cal. 3d 729, 734, 518 P.2d 329, 332, 111 Cal. Rptr. 897, 900 (1974).

52. Barbieri v. Ramelli, 84 Cal. 154, 156-57, 23 P. 1086, 1087 (1890).

53. Biddel v. Brizzolara, 64 Cal. 354, 362, 30 P. 609, 612 (1883).

54. See, e.g., Coast Bank v. Minderhout, 61 Cal. 2d 311, 313-15, 392 P.2d 265, 266-67, 38 Cal. Rptr. 505, 506-07 (1964) (agreement not to encumber property treated as mortgage for purposes of judicial foreclosure sale).

hidden security interest⁵⁵ because the defense allows the debtor to challenge a creditor's classification of a debt as unsecured.⁵⁶

The debtor is not required to raise the affirmative defense, but instead may elect to forgo raising the defense and rely on the one-action rule as a sanction.⁵⁷ Thus, the California Supreme Court has said:

[S]ection 726 is susceptible of a dual application—it may be interposed by the debtor as an affirmative defense or it may become operative as a sanction. . . . If the debtor does not raise the section as an affirmative defense, he may still invoke it as a sanction against the creditor on the basis that the latter by not foreclosing on the security in the action brought to enforce the debt, has made an election of remedies and waived the security.⁵⁸

Importantly, the sanction becomes operative only after the creditor has reduced its claim to a judgment.⁵⁹ In the case of a creditor that

55. Sometimes the parties may deliberately disguise a secured transaction as a deed absolute, a sale and leaseback, or a sale with an option to repurchase. Their purpose in doing so may be to avoid the usury laws or anti-deficiency judgment legislation, or to achieve a capital gain on resale instead of interest income.

R. MAXWELL, S. RIESENFELD, J. HETLAND & W. WARREN, CALIFORNIA CASES ON SECURED TRANSACTIONS IN LAND 146 (3d ed. 1984) (citing J. HETLAND, SECURED REAL ESTATE TRANSACTIONS 66-67 (1974)).

56. 4 H. MILLER & M. STARR, *supra* note 4, § 9:104, at 346; *see also* J. HETLAND, *supra* note 4, § 6.3, at 236 ("The prelude to unmasking a hidden security interest . . . often is the debtor's insistence on his CCP 726 right to compel judicial foreclosure in lieu of any other judicial activity by the creditor.").

57. By waiving the affirmative defense, the debtor does not waive the one-action rule sanction. *Walker*, 10 Cal. 3d at 734, 518 P.2d at 332, 111 Cal. Rptr. at 900; 4 H. MILLER & M. STARR, *supra* note 4, § 9:104, at 346-47; 3 B. WITKIN, *supra* note 11, § 119, at 621; Comment, *supra* note 25, at 154.

The affirmative defense gives the debtor the power to compel the creditor to include all security in its action. By waiving the defense, the debtor waives the benefits of the defense—the right to compel the creditor to exhaust all of the security first. However, the courts have held that a waiver of the affirmative defense does not affect the debtor's right to invoke the one-action rule sanction, which includes loss of the creditor's rights in the security. *See* Leipziger, *supra* note 12, at 790 n.104. *But see* *United California Bank v. Tijerina*, 25 Cal. App. 3d 963, 102 Cal. Rptr. 234 (1972).

In *Tijerina* the court refused to impose a § 726 sanction where the debtor failed to raise the one-action rule affirmative defense during a judicial foreclosure action and then, in an attempt to prevent the entry of a deficiency judgment, sought to invoke the one-action rule sanction after the security was sold. *Tijerina*, 25 Cal. App. 3d at 967-69, 102 Cal. Rptr. at 237-38. The court held that issues as to the availability of a deficiency judgment must be raised before the entry of a decree of foreclosure and that the debtor was, therefore, estopped from asserting that the creditor had omitted some security from the foreclosure action. *Id.* However, the holding was influenced by the fact that the debtor had full knowledge of the omission at the time the decree of foreclosure was issued and intentionally remained silent so as to reap the benefits of the one-action rule sanction. *See id.*; *see also* 4 H. MILLER & M. STARR, *supra* note 4, § 9:111, at 360 n.7 ("[W]here the debtor has the opportunity to raise the defense but he is intentionally silent, the debtor should be estopped from 'trapping' the creditor, and the creditor should be allowed to enforce the debt."); Leipziger, *supra* note 12, at 804 n.145 (rule announced in *Tijerina* is that courts will not indulge "a debtor who deliberately withholds assertion of C.C.P. 726 as an affirmative defense in an effort to trap his creditor into the C.C.P. 726 sanction effect and loss of a deficiency judgment").

58. *Walker*, 10 Cal. 3d at 734, 518 P.2d at 332, 111 Cal. Rptr. at 900.

59. "The sanction effect of section 726 . . . is triggered when a creditor proceeds to take a

brings an action directly on the note, the creditor's claim is said to be reduced to a judgment when the creditor obtains a personal money judgment from the court.⁶⁰ In contrast, in the case of a creditor that omits security from an action for judicial foreclosure, the point at which the creditor's claim is reduced to judgment is not as obvious. The difficulty arises because the creditor's one allowable action under section 726 involves three important, temporally distinct events.

The first such event is the issuance of a decree of foreclosure, which states the amount of the indebtedness, identifies the real property security to be sold, and names the debtor as being personally liable on that portion of the debt deemed unsatisfied following the foreclosure sale.⁶¹ The second event is the foreclosure sale held pursuant to the decree of foreclosure.⁶² The final event in the creditor's one action that might reasonably be considered the point at which the sanction becomes operative is the entry of a personal deficiency judgment at the deficiency hearing following the foreclosure sale.⁶³ A personal deficiency judgment will be entered for the amount by which the debt exceeds the greater of the sale proceeds or the market value of the security.⁶⁴

Prior to the occurrence of the issuance of a decree of foreclosure, it is clear that the debtor may raise the one-action rule affirmative defense to compel the creditor to include all of its security in the foreclosure action.⁶⁵ It is equally clear that after the entry of a personal deficiency judgment, the one-action rule operates to bar any further action on the debt, including an action on any security omitted from the foreclosure proceedings.⁶⁶ However, while it is clear that the creditor's claim is not

judgment . . . for less than the full amount of the debt" *Hetland & Hansen, supra* note 6, at 205-06; *see also* 4 H. MILLER & M. STARR, *supra* note 4, § 9:105, at 348 ("[W]hen the creditor recovers a personal money judgment against the debtor without first foreclosing on all of the security, the sanctions of the "one-action" rule are applied . . ."); *cf. Walker*, 10 Cal. 3d at 740, 518 P.2d at 336, 111 Cal. Rptr. at 904 ("[W]hen the bank failed to include the real property security and thereby failed to exhaust all security before obtaining a deficiency judgment, it automatically triggered the sanction aspect of section 726 . . ."); *Stillman, supra* note 12, at 9 (under the combined loss-of-security and loss-of-debt sanction, "any remaining portion of the debt not reduced to judgment" is lost). *But see* *Hall v. Arnott*, 80 Cal. 348, 355, 22 P. 200, 202 (1889) (imposing combined loss-of-security and loss-of-debt sanction even though no personal judgment had been entered on the debt).

60. *Cf. Ould v. Stoddard*, 54 Cal. 613, 615 (1880) (holding that by proceeding with an action upon a note secured by a mortgage to final judgment, a creditor exhausts its remedy upon both the note and security).

61. The required substance of the decree of foreclosure and the procedures for obtaining one are statutorily defined. CAL. CIV. PROC. CODE § 726(a), (b) (West 1991).

62. *Id.*

63. *Id.* § 726(b).

64. *Id.*

65. *See* J. HETLAND, SECURED REAL ESTATE TRANSACTIONS 193-94 (1974) ("[t]he defense may be waived subsequent to making the loan, most often by failure to plead" the defense when answering a petition for judicial foreclosure).

66. *See supra* note 59.

treated as having been reduced to a judgment prior to the issuance of a decree of foreclosure, and while it is clear that the creditor's claim is treated as having been reduced to a judgment at the time of entry of a personal deficiency judgment, it is not clear whether the issuance of a decree of foreclosure effectively reduces the creditor's claim to a judgment.⁶⁷

There are two reasons why the issuance of a decree of foreclosure might reasonably be considered the point at which the creditor's claim is reduced to a judgment and the sanction becomes operative. First, the decree of foreclosure contains sufficient information to be considered a binding judgment—it states the amount of the indebtedness, identifies the real property security to be sold, and names the debtor as being personally liable on that portion of the debt deemed unsatisfied following the foreclosure sale.⁶⁸ Second, if the issuance of a decree of foreclosure is *not* considered the point at which the sanction becomes operative, it would seem to follow that a debtor could raise the one-action rule affirmative defense at any time after the issuance of the decree of foreclosure.⁶⁹

Despite the practical arguments for declaring the issuance of a decree of foreclosure as the point at which the creditor's claim is said to be reduced to judgment, one-action rule sanction doctrine strongly suggests that the entry of a personal deficiency judgment is the dispositive

67. *United California Bank v. Tijerina*, 25 Cal. App. 3d 963, 102 Cal. Rptr. 234 (1972), suggested that the issuance of the decree of foreclosure is the point at which the creditor's claim is reduced to judgment. In *Tijerina* the court held that once the decree of foreclosure is issued, all that is left for the court to determine "is the amount, if any, of the deficiency remaining after sale of the mortgaged property. . . . The section [§ 726] obviously contemplates that all other issues have been adjudicated prior to the entry of the decree of foreclosure." *Id.* at 968, 102 Cal. Rptr. at 237. In other words, the court read § 726 to mean that once the decree of foreclosure is issued, the debtor's substantive protections under the statute are forever waived. Thus under *Tijerina*, the issuance of the decree of foreclosure seems to be the point at which the debtor is deemed to have waived its right to compel the creditor to foreclose on all security and, therefore, the point after which the one-action rule sanction may be raised by the debtor.

68. CAL. CIV. PROC. CODE § 726(b) (West 1991); *see also Tijerina*, 25 Cal. App. 3d at 968, 102 Cal. Rptr. at 237 ("The first stage, culminating in the decree of foreclosure, orders the sale of the mortgaged property and determines whether the defendant is personally liable for the debt and subject to the entry of a deficiency judgment.").

69. Allowing the debtor to raise the one-action rule affirmative defense after the issuance of a decree of foreclosure does not seem to comport with the statutorily defined process of judicial foreclosure. Under § 726, a mortgagee must file a petition for judicial foreclosure directing the court to foreclose on the real property securing the debt. In its discretion, the court may then issue a decree of foreclosure describing the real property to be sold as identified in the creditor's petition for foreclosure. *Id.* § 726(a). When a creditor neglects to identify all real property securing the debt in its petition for foreclosure, the debtor has the opportunity to raise the one-action rule affirmative defense prior to the issuance of a decree of foreclosure. *See Tijerina*, 25 Cal. App. 3d at 968-69, 102 Cal. Rptr. at 238. If the debtor fails to raise the affirmative defense and the decree of foreclosure is issued as per the creditor's petition, the debtor is deemed to have waived the right to compel the creditor to include the omitted security in the foreclosure action. *See J. HETLAND, supra* note 4, § 6.10, at 243.

event. In *Walker v. Community Bank*⁷⁰ the Supreme Court of California held that “when the bank failed to include the real property [in the judicial foreclosure action] and thereby failed to exhaust all security *before obtaining a deficiency judgment*, it automatically triggered the sanction aspect of section 726 and thereby lost all security rights in the real property.”⁷¹ The *Walker* court’s doctrinally correct analysis relies equally on the security-first principle⁷² and the dual-lien-avoidance principle⁷³ of the one-action rule, the implicit assumption in the court’s analysis being that the one-action rule is not offended until a creditor obtains a personal judgment against the debtor while still retaining an unforeclosed-on, consensual, real property security interest. Thus under *Walker*, in order for the sanction to operate in the context of a judicial foreclosure, the creditor must have failed to foreclose on all security for the debt and must have subsequently obtained a personal deficiency judgment—the occurrence of the latter event triggering the one-action rule sanction.⁷⁴

This solution does not, however, address the issues of whether a debtor may raise the affirmative defense after the issuance of a decree of foreclosure and whether a creditor can ask the court to “amend” a decree of foreclosure to include a previously omitted parcel of real property security without bringing a one-action rule sanction upon itself. The dearth of authority on these issues has created a gap of inapplicability for the one-action rule’s substantive protections—a gap that spans the period beginning with the issuance of a decree of foreclosure and ending with the entry of a personal deficiency judgment.

When confronted with these issues, future courts should look to the

70. 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974).

71. *Id.* at 740, 518 P.2d at 336, 111 Cal. Rptr. at 904 (emphasis added).

72. *See supra* Part I.B.

73. *See supra* note 26 and accompanying text.

74. This rule is the result of what Professor Hetland describes as “modern one-action analysis.” Hetland & Hansen, *supra* note 6, at 206 n.78 (“If a creditor elects to obtain a judgment for less than the full amount of a single debt, he keeps the judgment but loses everything else.”). For a thorough look at the mechanics of “modern one-action analysis,” see *infra* Part III.B.

Under “early one-action analysis,” Hetland & Hansen, *supra* note 6, at 206 n.78, the rule as to when the one-action rule sanction became operative was slightly different. Professor Hetland describes the theory behind the early analysis as follows: “[I]f the creditor [is] allowed only one action, he [can] not have another, so anything excluded from the first judgment [is] necessarily waived, there being no means to enforce it.” *Id.*; see also *infra* note 92. Courts applying the “early one-action analysis” imposed the one-action rule sanction in partial foreclosure situations to deprive the offending creditor of a personal deficiency judgment. In these cases, the one-action rule sanction effect was not triggered by the entry of a personal money judgment, but rather by an event that made it impossible for the creditor to exhaust all security for the debt by judicial foreclosure sale. *See, e.g., Woodward v. Brown*, 119 Cal. 283, 292-94, 51 P. 2, 4 (1897) (refusing to enter deficiency judgment where creditor unilaterally waived part of security for the debt); *Hall v. Arnott*, 80 Cal. 348, 355, 22 P. 200, 202 (1889) (holding that when a creditor brings an action for judicial foreclosure, omits some of the security from the action, and sues for less than the entire debt, the creditor is deemed to have waived the unforeclosed-on security as well as that portion of the debt not sued for, even though no personal deficiency judgment has been entered on the debt).

statutorily defined procedures for the one-action rule in fashioning or denying relief. Curiously, such an analysis suggests that the gap of inapplicability described above may be inevitable. For example, as to the first issue, whether a debtor may raise the affirmative defense after the issuance of a decree of foreclosure, a court should probably deny relief on the grounds that the affirmative defense, which compels a creditor to include all of its security in the foreclosure action, must be raised prior to the issuance of the document directing the sale of property identified in the creditor's petition for foreclosure as security for the debt. Put simply, unless the debtor objects to a petition that fails to identify all security for the debt, the debtor has waived the right to compel the creditor to foreclose on all security for the debt. As to the second issue, whether a creditor can ask the court to amend a decree of foreclosure, a court should probably grant relief on the grounds that "amending" a decree of foreclosure to include a previously omitted real property security interest would not be the same as subjecting the debtor to another action because the creditor's one allowable action under section 726 is not complete until the court renders its judgment at the deficiency hearing.

The dual application of the one-action rule—as an affirmative defense and as a sanction—raises an interesting problem in the context of an improper banker's setoff. A banker's setoff is a unilateral act of a nonjudicial nature. Therefore, an improper banker's setoff deprives the debtor of the opportunity to assert the section 726 affirmative defense to prevent unencumbered assets from being seized prior to exhaustion of all security. At the same time, the bank may be faced with an automatic section 726 sanction without an opportunity to reverse the transaction in cases of inadvertent error because the unilateral act of setoff is analogous to the entry and simultaneous enforcement of a personal judgment by a court. In *Wozab* the court attempted to address this problem by suggesting that if promptly returned, an inadvertent setoff should not trigger one-action rule consequences.⁷⁵

III

THE SCOPE-OF-THE-SANCTION CONTROVERSY

The scope-of-the-sanction controversy involves the question of whether the proper sanction for violating section 726 is loss of the security interest only, or alternatively loss of both the security interest and that portion of the underlying debt not reduced to judgment by the creditor's one action.⁷⁶

75. *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 1001 n.8, 800 P.2d 557, 563 n.8, 275 Cal. Rptr. 201, 207 n.8 (1990).

76. See *supra* notes 11-12 and accompanying text.

Professor Edward Rabin sheds a different light on the controversy by suggesting that the

A. Loss of Security Only

The doctrine of election of remedies is a commonly suggested rationale for imposing the loss-of-security-only sanction on a creditor that has violated section 726. The doctrine is based on the theory that when a creditor sues on the note and thereby obtains a personal judgment, the creditor is deemed to have chosen the personal judgment as the sole remedy in lieu of resorting to the security.⁷⁷ The doctrine of election of remedies supports imposing a loss-of-security-only sanction when a creditor brings an action directly on the note and the debtor fails to raise the one-action rule affirmative defense. In that situation, the action on the note is the creditor's one action under section 726 and the creditor, now unsecured, is deemed to be satisfied by the personal judgment.⁷⁸ However, the operation of the one-action rule is not so simple.

Consider the situation in which a creditor brings an action for judicial foreclosure but mistakenly omits some of its security from the action. If the debtor fails to raise the section 726 affirmative defense and the court subsequently enters a personal deficiency judgment following the sale of the mortgaged premises, the creditor has obtained a valid and enforceable judgment. This judgment is the result of the creditor's one action under section 726. Accordingly, no other action on the debt is permitted. As a result, when a creditor in the situation described above also mistakenly sues for less than the entire debt and obtains a personal deficiency judgment based on the incorrect statement of indebtedness, the creditor is deemed to have lost the unincorporated portion of the debt.⁷⁹ Any remaining unsecured-on security is necessarily lost because there is no debt left to be secured—all that remains is an unsecured personal deficiency judgment.⁸⁰

By analogy, when a creditor, ignoring the security, brings an action directly on the note and therefore necessarily sues for the full amount of the debt as evidenced by the note, there is no debt left to be waived. Of course, the security is deemed to be waived because there is no debt left to be secured—all that is left is an unsecured personal judgment. Curiously, this simple analysis, which is grounded in basic secured transac-

concept of sanctions is entirely misplaced in the context of § 726 violations. He argues that the results in one-action cases can best be described in terms of merger of claims. *See* Munoz & Rabin, *supra* note 11, at 210.

77. *See* *Ould v. Stoddard*, 54 Cal. 613, 615 (1880) (holding that by proceeding with an action upon a note secured by a mortgage to final judgment, a creditor exhausts its remedy upon both the note and security). *Leipziger* notes that the election is really in the hands of the debtor because the creditor cannot sue on the note in lieu of foreclosure unless the debtor fails to raise § 726 as an affirmative defense. *Leipziger*, *supra* note 12, at 788.

78. *Ould*, 54 Cal. at 615.

79. *See* *Hetland & Hansen*, *supra* note 6, at 206 & n.78.

80. *See id.* at 206.

tions law, has caused a great deal of confusion.⁸¹

Commentators supporting the loss-of-security-only sanction often bolster their contention that there is no other proper sanction by citing cases in which that sanction was applied. *Walker v. Community Bank*⁸² and *Salter v. Ulrich*⁸³ are two such commonly cited cases. In *Walker* the court held that by judicially foreclosing on personal property collateral and obtaining a deficiency judgment without including the real property security in the foreclosure action, the creditor violated the one-action rule.⁸⁴ The court imposed the sanction of loss of the security but noted that the bank could still "levy execution upon any of [the debtor's] property in order to satisfy the deficiency judgment."⁸⁵ In other words, although the debt was satisfied by the entry of a personal deficiency judgment and was therefore no longer in existence, the bank could still effectively "collect on the debt" by enforcing its personal deficiency judgment.

Similarly, in *Salter* the court held that a creditor, who obtained a personal judgment on a note upon the default of the debtor and thereafter foreclosed on and purchased at a foreclosure sale the property securing the debt in partial satisfaction of the debt, lost his lien priority over a judgment lienor who had purchased the same property at a different foreclosure sale.⁸⁶ Thus, the creditor lost his rights in the security interest but retained the right to enforce the personal money judgment.

The argument that the sanction for violation of the one-action rule should never include loss of the debt because cases like *Walker* and *Salter* resulted in a less harsh sanction is highly questionable because the creditors in both cases obtained a valid judgment for the full amount of the debt.⁸⁷ As noted above, when a creditor omits some or all of its security from its one action, the one-action rule bars any further action on the debt.⁸⁸ When the same creditor obtains a valid judgment for the full amount of the debt, the one-action rule's prohibition of any further action on the debt is rendered moot. Of course, the unsecured-on security is deemed to be waived because there is no debt left to be secured—all that remains is an unsecured personal judgment.

For lack of an adequate argument based in one-action rule doctrine,

81. See *infra* Part V.B.

82. 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974).

83. 22 Cal. 2d 263, 138 P.2d 7 (1943).

84. *Walker*, 10 Cal. 3d at 741, 518 P.2d at 337, 111 Cal. Rptr. at 905.

85. *Id.* at 741 & n.6, 518 P.2d at 337 & n.6, 111 Cal. Rptr. at 905 & n.6.

86. *Salter*, 22 Cal. 2d at 268, 138 P.2d at 9-10.

87. *Walker*, 10 Cal. 3d at 741, 518 P.2d at 337, 111 Cal. Rptr. at 905; *Salter*, 22 Cal. 2d at 265, 138 P.2d at 8; see also *United California Bank v. Tijerina*, 25 Cal. App. 3d 963, 967-69, 102 Cal. Rptr. 234, 236-38 (1972) (refusing to impose loss-of-debt sanction where creditor obtained a personal deficiency judgment for full amount of debt and where debtor intentionally failed to raise the one-action rule affirmative defense prior to issuance of decree of foreclosure).

88. See *supra* text accompanying notes 79-81.

other commentators resort to a fairness argument to advocate the loss-of-security-only sanction and criticize the harsher dual sanction. One commentator argues that if one of the purposes of imposing a sanction is to deter future violations of the one-action rule, reducing the creditor to the status of an unsecured creditor is a sufficient deterrent in that it "materially diminishes the chances or amount of any ultimate recovery, especially in the shadow of the Bankruptcy Code."⁸⁹ In the context of improper banker's setoffs, another commentator opines: "Assuming that the setoff was improper, the sanction imposed [loss of the security and the debt] violates the principle of proportionality. Damages or sanctions imposed for the commission of a wrong should bear some reasonable relation to the wrongfulness of the act and the damages caused by it."⁹⁰ Indeed, the Supreme Court of California resorted to a fairness argument in holding that the loss-of-debt sanction was inappropriate in most improper banker's setoff cases.⁹¹ Policy arguments like these dominate the rhetoric of critics of the harsher sanction, rendering the academic debate unproductively nonresponsive—one side arguing pure policy, the other pure doctrine.

B. *Loss of Security and Debt*

Professor Hetland's commonsense argument in support of imposing the combined loss-of-security and loss-of-debt sanction is that if a creditor takes a judgment for less than the full amount of the debt prior to the exhaustion of all security, the creditor may not have another action on the unincorporated portion of the debt.⁹² In other words, any portion of the

89. Arnold, *supra* note 11, at 3; *see also* Security Pac. Nat'l Bank v. Wozab, 51 Cal. 3d 991, 1001, 800 P.2d 557, 562, 275 Cal. Rptr. 201, 206 (1990) (noting the predictable position of the California Banker's Association that "loss of the security is by itself sufficiently drastic to deter improper setoffs"); Hirsch, *supra* note 11, at 52-53 (Arnold, as co-author, arguing that if goal of the "sanction aspect" is to deter violations of § 726, loss-of-security sanction is sufficiently daunting). Leipziger adds support to the argument that loss of security may be a harsh enough sanction in itself:

[T]he lender will not be able to enforce [a personal] judgment by levying on the formerly encumbered property if the debtor has sold it before recordation of an abstract of the judgment, and even if he does levy successfully, he may have a lower priority than he formerly had under his mortgage because of intervening liens.

Leipziger, *supra* note 12, at 789 (citations omitted).

90. Munoz & Rabin, *supra* note 11, at 208.

91. *See* Security Pac. Nat'l Bank v. Wozab, 51 Cal. 3d 991, 1005-06, 800 P.2d 557, 568, 275 Cal. Rptr. 201, 213 (1990) ("[T]he result advocated by the Wozabs—allowing them to evade their debt almost in its entirety—would be a gross injustice to the bank and a corresponding windfall to the Wozabs." (citing Mertens, *California's Foreclosure Statutes: Some Proposals For Reform*, 26 SANTA CLARA L. REV. 533, 555 (1986))).

92. Put simply, "[i]f a creditor elects to obtain a judgment for less than the full amount of a single debt, he keeps the judgment but loses everything else." Hetland & Hansen, *supra* note 6, at 206 n.78; *see also supra* text accompanying notes 79-80.

Another commonly argued rationale in support of imposing the combined loss-of-security and loss-of-debt sanction is that the exhaustion of all security by the creditor is a condition precedent to the availability of a personal judgment against the debtor. *See* J. HETLAND, *supra* note 4, § 6.18, at

debt that is not included in the creditor's action, and is therefore not included in the creditor's judgment, is deemed to be waived. Any remaining unencumbered security is necessarily waived because there is no debt left to be secured.⁹³

For example, when a creditor forecloses to recover on a debt secured by multiple parcels of real property but inadvertently omits one of the parcels from the foreclosure proceedings, the creditor has waived any unincorporated portion of the debt because the creditor has already had one action. Furthermore, because a security interest is unenforceable without an underlying debt, any omitted security is also necessarily waived. Similarly, when a bank improperly sets off a debtor's unencumbered bank account, one could argue that the setoff is the equivalent of an "action" under section 726, and that therefore any subsequent attempt to foreclose on the real property security or to collect from the debtor personally would be barred by the waiver of debt and waiver of security mechanism.⁹⁴

Courts in several multiple-security cases have imposed the combined loss-of-security and loss-of-debt sanction.⁹⁵ The seminal case of this

258; 4 H. MILLER & M. STARR, *supra* note 4, § 9:111, at 361 n.8; Arnold, *supra* note 11, at 3; Weiner & Tranz, *supra* note 11, at 2. Professor Hetland provided a complete statement of this rationale in his 1970 treatise:

A prerequisite to a personal judgment against the debtor is exhaustion of all the security for the debt. . . . Having brought one action to judgment without exhausting all security, the creditor may not have another action to exhaust the balance. Since a deficiency or personal judgment against the debtor depends on the now-impossible exhaustion of all security, the debtor also escapes liability on whatever balance remains on the debt. Thus, the sanction for failure to exhaust all . . . security for the same debt in one action . . . [is] a waiver of the remaining security as well as a waiver of the balance of the debt.

J. HETLAND, *supra* note 4, § 6.18, at 258 (citing *Stockton Savings & Loan Soc'y v. Harrold*, 127 Cal. 612, 60 P. 165 (1900), and *Hall v. Arnott*, 80 Cal. 348, 22 P. 200 (1889)). This rationale, which Professor Hetland describes as "early one-action analysis," Hetland & Hansen, *supra* note 6, at 206 n.78, has been criticized by loss-of-security-only advocates as "unduly formalistic" and involving "rather circular reasoning." Arnold, *supra* note 11, at 3.

93. See Hetland & Hansen, *supra* note 6, at 206 & n.78. Even if the creditor in the situation presented did foreclose on all its security, the one-action rule would still prevent the creditor from collecting that portion of the debt not reduced to judgment. For example, a creditor that brings an action for judicial foreclosure and forecloses on all its security, but inadvertently fails to sue for the full amount of the debt and therefore fails to obtain a judgment on the full amount of the debt, is barred by the one-action rule from bringing any further action to collect on the unincorporated portion of the debt even though the creditor did not violate the security-first principle. See Hetland & Hansen, *supra* note 6, at 205-06.

94. See R. BERNHARDT, *supra* note 3, § 4.5 at 190. In *Bank of America v. Daily*, 152 Cal. App. 3d 767, 199 Cal. Rptr. 557 (1984), the court found merit in this very argument and imposed a combined loss-of-security and loss-of-debt sanction. See *id.* at 772-74, 199 Cal. Rptr. at 559-60; *infra* note 137. In *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 800 P.2d 557, 275 Cal. Rptr. 201 (1990), however, the Supreme Court of California rejected this argument, reversing *Daily* in part. *Id.* at 998-99 & n.7, 800 P.2d at 560-61 & n.7, 275 Cal. Rptr. at 204-05 & n.7. For an analysis of the *Daily* and *Wozab* opinions, see *infra* Parts IV & V.

95. See, e.g., *Stockton Savings & Loan Soc'y v. Harrold*, 127 Cal. 612, 616-17, 60 P. 165, 168-

type, *Hall v. Arnott*,⁹⁶ involved a mortgagor who defaulted on a debt secured by two parcels of real property. The creditor judicially foreclosed on one of the parcels and erroneously sued for less than the full amount of the debt. Following the foreclosure sale, a deficiency of \$1800 remained as to the amount sued on, and a deficiency of \$2500 remained as to the total amount of the debt. The debtor then sold the unenclosed property and the purchaser sought to clear title as between the creditor and himself by tendering \$1800 to the creditor. The creditor refused, arguing that he was entitled to the full \$2500 deficiency representing the amount owing on the entire debt after the foreclosure sale.⁹⁷ The supreme court held that the creditor's failure to foreclose on the second parcel of property during the foreclosure action extinguished the creditor's interest in the unenclosed portion of the debt and in the omitted security.⁹⁸ Thus under *Hall*, when a creditor judicially forecloses on less than all of the security and sues for less than the entire debt in the foreclosure action, the creditor may not bring another action on the debt, and is therefore deemed to have waived the unenclosed balance of the

69 (1900); *Woodward v. Brown*, 119 Cal. 283, 292-94, 51 P. 2, 4 (1897); *Hall v. Arnott*, 80 Cal. 348, 350-51, 22 P. 200, 202 (1889).

Commentators supporting the combined loss-of-security and loss-of-debt sanction often cite *Woodward v. Brown*, 119 Cal. 283, 51 P. 2 (1897), as dispositive. However, that case involved a creditor who unilaterally and intentionally released liens on several parcels of real property and then sought to obtain a personal judgment against the debtor. *Id.* at 292-94, 51 P. at 4. Thus, *Woodward* may be limited to situations in which the creditor unilaterally releases a security interest in real property with the intent of circumventing the one-action rule. See *Hirsch, supra* note 11, at 51-52 (noting that courts treat the debt as extinguished when the secured party unilaterally waives or releases its real property security and suggesting that such cases are distinguishable from cases involving the omission of security from an action for foreclosure); see also *Hibernia Sav. & Loan Soc'y v. Thornton*, 109 Cal. 427, 429, 42 P. 447, 448 (1895) ("[W]hen [a] mortgagee, by his own act or neglect, deprives himself of the right to foreclose the mortgage, he at the same time deprives himself of the right to an action upon the note."); *Pacific Valley Bank v. Schwenke*, 189 Cal. App. 3d 134, 141-42, 234 Cal. Rptr. 298, 302 (1987) (holding that reconveyance of a deed of trust from the creditor to the mortgagor released a coinaker of the note from liability for a violation of § 726 where the coinaker had no knowledge of the reconveyance).

96. 80 Cal. 348, 22 P. 200 (1889).

97. *Hall*, 80 Cal. at 350-51, 22 P. at 201; see also *Hirsch, supra* note 11, at 49-50 (describing the complex facts presented in *Hall*); Comment, *supra* note 25, at 155 (same).

98. *Hall*, 80 Cal. at 354-55, 22 P. at 202 ("[H]aving waived their first mortgage . . . [the creditors] exhausted their security, and could not obtain a personal judgment for any deficiency, until they exhausted their security . . . by sale on foreclosure."); accord *Stockton Sav. & Loan Soc'y v. Harrold*, 127 Cal. 612, 616-17, 60 P. 165, 168 (1900) ("[W]hen the same debt is secured by two distinct mortgages the foreclosure of but one of these has the effect to waive and nullify the lien of the other. . . . [T]he remedy of foreclosure being waived in part, the personal liability of the mortgagor is also waived.") (citations omitted); see also *Leipziger, supra* note 12, at 789 n.104 (Where a creditor has "several notes as well as several properties as security[,] [t]he first foreclosure under such circumstances may not result in a deficiency on the particular note involved in that foreclosure, [and] an attempt to collect the balance of the debt represented by the other notes is treated like an attempt to collect a deficiency and is barred for failure to have exhausted the security in the first sale.").

debt as well as the unforeclosed-on security.⁹⁹

Professor Hetland's analysis is complemented by the writings of Professor Leipziger, who argues that the combined loss-of-security and loss-of-debt sanction should be available only in certain circumstances.¹⁰⁰ Leipziger begins his analysis by setting out the model facts under which the harsher sanction has been imposed—when the “debt is secured by more than one item of collateral and the lender neglects to include [the] entire security in the one foreclosure action allowed.”¹⁰¹ He then argues, as does Hetland, that the appropriate sanction in this situation is loss of the security and loss of the debt.¹⁰²

At this point Leipziger further defines the circumstances under which this sanction may be properly imposed. In addition to the creditor's failure to include all of the security in the foreclosure action, the creditor must have “also neglected to sue on all the notes in the same action”¹⁰³ and the multiple notes must be “cross collateralized so that they are all part of the same obligation.”¹⁰⁴ The holding in *Walker v. Community Bank*¹⁰⁵ supports Leipziger's limitation of the application of the combined loss-of-security and loss-of-debt sanction. The rule announced in *Walker*, Leipziger notes, is that “[w]here the lender holds only one note . . . he can recover a personal judgment on the entire debt without including all the security in the action, so long as the debtor has failed to plead C.C.P. 726 as an affirmative defense.”¹⁰⁶ Although the

99. The purchaser of the unforeclosed property was required to pay the creditor “the remainder due upon the decree of foreclosure.” *Hall*, 80 Cal. at 355, 22 P. at 202. Thus, the redemption amount was held to be \$1800 (the amount of the debt sued on less the proceeds of the foreclosure sale) and not \$2500 (the total amount of the debt less the proceeds of the foreclosure sale). This interpretation is consistent with Professor Hetland's and Professor Leipziger's analysis of the proper sanction to impose where a multiply secured creditor omits security from a judicial foreclosure action and fails to sue on all of the notes. See *infra* notes 100-09 and accompanying text. The only inconsistency, which stems from the fact that *Hall* was decided under “early one-action analysis,” is that the sanction in *Hall* was imposed even though a personal judgment had not yet been entered. See *supra* note 74 and accompanying text.

100. See Leipziger, *supra* note 12, at 789 & n.104.

101. *Id.* at 789. The paradigm case in which the loss-of-security and loss-of-debt sanction has been imposed involves a multiply secured creditor that omits security from a judicial foreclosure action. See J. HETLAND, *supra* note 4, § 6.18, at 258.

102. See Leipziger, *supra* note 12, at 789 & n.104. Here Leipziger and Hetland differ in form but not in result. Leipziger argues that the interaction of the loss-of-security sanction with the debtor's waiver of the affirmative defense results in a loss of the debt, see *id.*, while Hetland argues that the sanction in such a situation is loss of the security and loss of the debt, see *supra* text accompanying notes 92-93.

103. Leipziger, *supra* note 12, at 789 n.104.

104. *Id.* If the notes are not cross-collateralized, it would be more difficult for the debtor to prove that the notes represent a single debt. See J. HETLAND, *supra* note 4, § 6.12, at 248 (Where “the parties break the [loan amount] into distinct amounts represented by separate notes that are independently secured or partially unsecured, they have separate debts.”).

105. 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974).

106. Leipziger, *supra* note 12, at 790 n.104.

bank in *Walker* omitted real property collateral from its judicial foreclosure action, it sued for the entire debt and therefore obtained an enforceable personal deficiency judgment representing the amount owing on the entire debt after the foreclosure sale.¹⁰⁷

Thus, Leipziger argues that a creditor must fail to sue on the entire debt and therefore fail to obtain a judgment representing the amount owing on the entire debt in order for the harsher sanction to operate.¹⁰⁸ This distinction is of great importance because a multiply secured creditor who omits some of the security from a judicial foreclosure action is likely to neglect to sue on the entire debt. For example, when a single debt is expressed by several notes each of which is independently secured, the creditor may erroneously believe that each item of security represents a separate debt. In other words, the creditor may think that there are several independently secured debts and, accordingly, may proceed against only part of the security and sue for less than the entire obligation in the foreclosure action.¹⁰⁹ Furthermore, when a single debt is expressed by a single note secured by more than one mortgage or deed of trust, the creditor may erroneously believe that each consensual lien represents a certain portion of the debt. Again, the creditor might proceed against only part of the security and sue for less than the entire obligation in the foreclosure action.

IV

THE SANCTION CONTROVERSY IN IMPROPER BANKER'S SETOFF CASES

California courts have consistently held that an improper banker's setoff may violate section 726.¹¹⁰ However, the reasoning employed has not been consistent. The inconsistency stems from the ambiguity of the

107. *Walker*, 10 Cal. 3d at 732-33, 518 P.2d at 331, 111 Cal. Rptr. at 899.

108. Leipziger, *supra* note 12, at 790 n. 104.

Professor Hetland's 1970 treatise might suggest that he has not so limited the application of this sanction: The debtor "may ignore [the affirmative] defense and rely instead on the subsequent CCP 726 sanctions—the creditor's loss of the balance of the debt and the balance of the security, which occurs only if the creditor has taken a judgment that fails to foreclose on all the security in the same action." J. HETLAND, *supra* note 4, § 6.10, at 243. However, Hetland's 1987 article analyzing the mixed collateral amendments places Hetland and Leipziger on common ground. See Hetland & Hansen, *supra* note 6, at 205-06.

109. For a discussion of the issue of when multiple notes represent a single debt as opposed to separate debts, see J. HETLAND, *supra* note 4, § 6.12, at 245-48.

110. *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 999, 800 P.2d 557, 562, 275 Cal. Rptr. 201, 206 (1990); *Gnarini v. Swiss Am. Bank*, 162 Cal. 181, 184, 121 P. 726, 727-28 (1912); *McKean v. German-American Sav. Bank*, 118 Cal. 334, 340-41, 50 P. 656, 659 (1897); *Bank of Am. v. Daily*, 152 Cal. App. 3d 767, 771-72, 199 Cal. Rptr. 557, 558-59 (1984); *Woodruff v. California Republic Bank*, 75 Cal. App. 3d 108, 110, 141 Cal. Rptr. 915, 916 (1977).

In general, absent a violation of § 726, a bank may take monies or other things of value on deposit in satisfaction of a matured obligation owed by the borrower to the bank. Where money on deposit is at issue, the bank has access to

term "action" as used in section 726, which is defined at section 22 as "an ordinary proceeding in a court of justice by which one party prosecutes another for the declaration, enforcement or protection of a right."¹¹¹ Some cases have held that a banker's setoff is an action or the equivalent of an action for the purposes of section 726,¹¹² while the holdings of other cases have suggested that even though not technically an action, a banker's setoff violates the security-first principle of the one-action rule.¹¹³

In *Security Pacific National Bank v. Wozab* the Supreme Court of California put the matter to rest by holding that a banker's setoff was not an action for the purposes of section 22 or section 726.¹¹⁴ The court recognized, however, that allowing a bank to unilaterally set off a depositor's account in order to satisfy part of a debt secured by real property before foreclosing on the security would undermine the security-first principle of the one-action rule. Consequently, the *Wozab* court held that although the setoff was not an action for the purposes of section 726, it was a violation of the security-first principle embodied in the one-action rule and, therefore, the bank should be sanctioned for violating section 726.¹¹⁵ This holding prevents a bank from obtaining, and simultaneously enforcing, a nonjudicial "personal judgment" against the debtor by unilaterally, and without notice, seizing the debtor's unencumbered assets held by the bank.

The *Wozab* court was silent with regard to the hotly debated issue of whether California's counterclaim¹¹⁶ and setoff¹¹⁷ statutes permit a bank to set off a depositor's account to reduce an obligation despite the existence of real property security and section 726. The dispute originated

the funds via an equitable right of setoff, that is, a right to [set off] the account owed to the depositor in payment or partial payment of the obligation owed to the bank.

Stillman, *supra* note 12, at 10.

111. CAL. CIV. PROC. CODE § 22 (West 1991).

112. *Daily*, 152 Cal. App. 3d at 771-72, 199 Cal. Rptr. at 558-59; *McKean*, 118 Cal. at 340-41, 50 P. at 659; *see also* Munoz & Rabin, *supra* note 11, at 206 ("[T]he courts in *McKean* and *Daily* found that the creditor's conduct violated the one action rule and constituted an 'action' for purposes of § 726."). *But see Wozab*, 51 Cal. 3d at 999 & n.7, 800 P.2d at 562 n.7, 275 Cal. Rptr. at 206 n.7 (stating that *McKean* did not hold that a setoff is the equivalent of a judicial action for the purposes of §§ 22 or 726).

113. *Gnarini*, 162 Cal. at 184, 121 P. at 727-28; *Woodruff*, 75 Cal. App. 3d at 110, 141 Cal. Rptr. at 916; *see also* Munoz & Rabin, *supra* note 11, at 206 (Some "supreme court decisions [have] held that the creditor's conduct, in failing to exhaust the real property collateral first, was contrary to the mandate of § 726 and so resulted in the waiver of the collateral because the conduct had frustrated the protection of § 726 and the restrictions on collecting a deficiency.").

114. *Wozab*, 51 Cal. 3d at 998-99, 800 P.2d at 560-61, 275 Cal. Rptr. at 204-05.

115. *Id.* at 999-1000, 800 P.2d at 561-62, 275 Cal. Rptr. at 205-06. The *Wozab* court's holding that an improper banker's setoff violates the security-first principle has much support from commentators and authorities on California law. *See, e.g.*, R. BERNHARDT, *supra* note 3, at 189-90; Arnold, *supra* note 11, at 10-11; Munoz & Rabin, *supra* note 11, at 206-07.

116. CAL. CIV. PROC. CODE §§ 428.10 (West 1991) (formerly § 438).

117. *Id.* § 431.70 (formerly § 440).

almost 100 years ago with *McKean v. German-American Savings Bank*.¹¹⁸ In *McKean* the assignee of a bank account brought an action against a bank to recover funds deposited by the assignor of the account. Prior to the assignment of the account, the bank had applied the deposit to reduce a debt of the assignor that was secured by real property.¹¹⁹ The bank argued that section 438 permitted it to set off the depositor's account despite the real property security.¹²⁰ The supreme court rejected this argument and held that section 726 barred the setoff.¹²¹ In 1927 the legislature amended section 438, arguably to overrule *McKean*.¹²² As amended, section 438 provided for the maintaining of a counterclaim despite the existence of real property security¹²³ and arguably had the effect of allowing a bank to set off a debtor's account under section 440 despite the existence of real property security.¹²⁴ In fact, since the amendment, two cases have implied that a bank has a right of setoff under sections 438 and 440 despite the existence of real property security and despite section 726.¹²⁵

Several more recent cases, including *Wozab*, have assumed with little or no argument that section 726, not section 428.10 (the successor of

118. 118 Cal. 334, 50 P. 656 (1897).

119. *Id.* at 334, 50 P. at 657.

120. *Id.* at 337-41, 50 P. at 658-59.

121. *Id.* at 118 Cal. at 341, 50 P. at 659; *accord* *Gnarini v. Swiss Am. Bank*, 162 Cal. 181, 184, 121 P. 726, 727-28 (1912) (relying on *McKean* and holding that the setoff was barred under the security-first principle).

122. *See* *Munoz & Rabin*, *supra* note 11, at 208 (citing *Nelson v. Bank of America*, 76 Cal. App. 2d 501, 173 P.2d 332 (1946)).

123. As amended, § 438 provided that "the right to maintain a counterclaim shall not be affected by the fact that either plaintiff's or defendant's claim is secured by mortgage or otherwise, nor by the fact that the action is brought, or the counterclaim maintained, for the foreclosure of such security." Note, *Banks and Banking: Right of Set-Off Against Secured Loan to Depositor*, 35 CALIF. L. REV. 118, 119 n.6 (1947) (authored by J. Taber).

124. "*McKean* had previously held that setoffs would be allowed under former CCP § 440 whenever counterclaims were allowed under CCP § 438. Because the 1927 amendment to § 438 allowed counterclaims involving secured and unsecured debts, it is apparent that setoffs under former § 440, involving secured and unsecured claims, were also permitted." *Munoz & Rabin*, *supra* note 11, at 208 (citation omitted); *see also* *Rowan & Mertens*, *supra* note 11, at 75 ("It has been suggested that the 1927 amendment to CCP § 438 impliedly amended CCP § 440 as well, thus allowing the setoff of a secured debt."); Comment, *supra* note 123, at 120 ("It would appear . . . that a bank's right of set-off is not limited by section 726."). *But see* Comment, *Mortgages and Trust Deeds: When Foreclosure is Required Under Cal. Code Civ. Proc. § 726: Counterclaim and Set Off When One Claim is Secured*, 25 CALIF. L. REV. 347, 357 (1937) (authored by Charles L. Hemmings) ("The section [§ 438] clearly allows an action for foreclosure to be made the subject of a counterclaim, but it is not so certain that the amendment was meant to allow a counterclaim without foreclosure.").

125. *Walters v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 9 Cal. 2d 46, 54, 69 P.2d 839, 842-43 (1937) (assuming *arguendo* that the bank was entitled to set off the debtor's account "even though the note was secured and without first exhausting the security"); *Nelson v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 76 Cal. App. 2d 501, 510, 173 P.2d 322, 327 (1946) ("[S]ince the amendment of [§ 438], the bank has a right to set up as a counterclaim the customer's debt to the bank, regardless of whether it is secured by mortgage or not.").

section 438), controls the appropriateness of a setoff.¹²⁶ For example, the court in *Woodruff v. California Republic Bank*¹²⁷ held that the right to a setoff found in section 431.70 (formerly section 440) "presumes a lawful and proper [setoff], which in this case can only arise after a judgment of foreclosure has been procured and a deficiency judgment entered."¹²⁸ Thus, the court viewed the one-action rule as a rule of substantive law that could not be undermined by a procedural statute.

In deciding *Wozab* the California Supreme Court failed to address this issue, although it was argued by the parties at the appellate level.¹²⁹ The only reference to this issue in *Wozab* is indicative of the supreme court's belief that a bank can no longer argue that the 1927 amendment allows banks to set off a debtor's account despite the existence of real property security: "We also note the record before us does not indicate that the prohibition of bank setoff against a secured debt has caused significant problems for the banking industry."¹³⁰

Having settled the issue of whether an improper banker's setoff violated section 726, the court in *Wozab* then turned to the scope of the sanction issue. The court had to choose from at least three alternatives.¹³¹ The first alternative was the remedy granted by the courts in *McKean v. German-American Savings Bank*,¹³² *Gnarini v. Swiss American Bank*,¹³³ and *Woodruff v. California Republic Bank*.¹³⁴ In those cases, the debtors sought recovery of deposits improperly set off in viola-

126. *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 996-1000, 800 P.2d 557, 559-62, 275 Cal. Rptr. 201, 203-06 (1990); *Bank of America v. Daily*, 152 Cal. App. 3d 767, 771-72, 199 Cal. Rptr. 557, 558-59 (1984); *Woodruff v. California Republic Bank*, 75 Cal. App. 3d 108, 111, 141 Cal. Rptr. 915, 916 (1977); see also *Aplanalp v. Forte*, 225 Cal. App. 3d 609, 615-17, 275 Cal. Rptr. 144 (1990) (holding that where the sellers of a mobile home park obtained an order to enforce their equitable right to set off a money judgment owed to the purchasers against delinquent payments owed by the purchasers on a note secured by a deed of trust, § 726, and not §§ 428.10 and 431.70, controlled the appropriateness of the setoff).

127. 75 Cal. App. 3d 108, 141 Cal. Rptr. 915 (1977).

128. *Id.* at 111, 141 Cal. Rptr. at 916.

129. *Security Pac. Nat'l Bank v. Wozab*, 223 Cal. App. 3d 1042, 1052-53, 258 Cal. Rptr. 850, 854-55 (1989), *rev'd*, 51 Cal. 3d 991, 800 P.2d 557, 275 Cal. Rptr. 201 (1990).

130. *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 1000, 800 P.2d 557, 562, 275 Cal. Rptr. 201, 206 (1990). Further support for the argument that § 726 is dispositive when in conflict with the procedural counterclaim and setoff statutes is "the omission in CCP § 428.10 [formerly § 438] of the proviso in CCP § 438 that 'the right to maintain a counterclaim shall not be affected by the fact that either plaintiff's or defendant's claim is secured by mortgage or otherwise.'" Rowan & Mertens, *supra* note 11, at 75. However, commentators have pointed to the Legislative Committee Comment in West's Annotated California Codes in arguing that the new procedural sections, despite any omissions, were meant to "continue the law under former §§ 438 and 440 for the most part [and] to further liberalize the rules permitting cross-claims and setoffs." Munoz & Rabin, *supra* note 11, at 209; see Rowan & Mertens, *supra* note 11, at 75.

131. *Wozab*, 51 Cal. 3d at 1000-01, 800 P.2d at 562, 275 Cal. Rptr. at 206.

132. 118 Cal. 334, 334, 341, 50 P. 656, 657, 659 (1897).

133. 162 Cal. 181, 184, 121 P. 726, 727-28 (1912).

134. 75 Cal. App. 3d 108, 110, 141 Cal. Rptr. 915, 916 (1977).

tion of section 726 and prevailed, while the enforceability of the security and the underlying debt was unaffected.¹³⁵ The second of the alternatives was the loss-of-security sanction. This sanction had never been imposed in an improper banker's setoff case, but was effectively adopted by the *Wozab* court as the proper sanction under the particular facts of that case.¹³⁶ The third alternative was the combined loss-of-security and loss-of-debt sanction imposed by the California Courts of Appeal in *Bank of America v. Daily*¹³⁷ and *Security Pacific National Bank v.*

135. Munoz & Rabin, *supra* note 11, at 210. The court in *Wozab* explicitly addressed and rejected this alternative. *Wozab*, 51 Cal. 3d at 1002, 800 P.2d at 563-64, 275 Cal. Rptr. at 207-08. However, elsewhere in the opinion the court suggested that if a bank promptly returns improperly seized funds, no further sanction, other than liability for compensatory damages, should be imposed. *Id.* at 1001 n.8, 1006, 800 P.2d at 563 n.8, 566, 275 Cal. Rptr. at 207 n.8, 210.

136. *Id.* at 1001-02, 1004, 800 P.2d at 563-65, 275 Cal. Rptr. at 207-09. Curiously, the court in *Wozab* never held that the bank waived its security interest. The issue of whether the bank had waived its security interest was considered moot because prior to the filing of the case the bank had voluntarily reconveyed the security interest upon the Wozabs' request. *Id.* at 1001, 800 P.2d at 563, 275 Cal. Rptr. at 207. However, the court indicated that, but for the reconveyance, it would have imposed the loss-of-security sanction because "a creditor bank that violates section 726(a) by taking an improper extrajudicial setoff must be held to have waived the bank's security interest in its depositor's real property." *Id.* at 1001-02, 800 P.2d at 563, 275 Cal. Rptr. at 207.

137. 152 Cal. App. 3d 767, 199 Cal. Rptr. 557 (1984). Although not readily clear from the holding, the *Daily* court's reliance on Professor Hetland's treatise and the procedural disposition of the appeal indicated that the sanction imposed included loss of the debt. *Id.* at 771-72, 774, 199 Cal. Rptr. at 558-60; Arnold, *supra* note 11, at 3; Hirsch, *supra* note 11, at 48-49; Weiner & Trainz, *supra* note 11, at 3.

In *Daily*, the trial court judgment was a standard form foreclosure judgment for the full amount of the debt with an order to sell the property security, the court reserving jurisdiction to determine the amount of the deficiency upon proper motion after the foreclosure sale, all as mandated by West's Ann.Cal.C.C.P. §§ 726a, 726b. The appellate court in *Daily* reversed this judgment with instructions to the trial court to enter judgment in favor of the Dailys.

R. MAXWELL, S. RIESENFELD, J. HETLAND & W. WARREN, CALIFORNIA CASES ON SECURED TRANSACTIONS IN LAND 287 (4th ed. 1991). By holding that the setoff was an action for the purposes of § 726, *Daily*, 152 Cal. App. 3d at 771-72, 199 Cal. Rptr. at 559, and by reversing the decree of foreclosure issued by the trial court, *id.* at 774, 199 Cal. Rptr. at 560, the appellate court destroyed the bank's ability to collect on the debt. The one-action rule's prohibition of a second action on a single debt would have barred an action directly on the note or a private trustee's sale to foreclose on the deed of trust.

The Supreme Court of California badly misconstrued both the result in *Daily* and the operation of § 726 in *Security Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 800 P.2d 557, 275 Cal. Rptr. 201 (1990). In responding to the Wozabs' argument that *Daily* was dispositive, the *Wozab* court stated that "the [*Daily*] court did not have occasion to decide whether the bank was precluded from" pursuing the underlying debt despite its waiver of the security. *Id.* at 1003, 800 P.2d at 564, 275 Cal. Rptr. at 208. However, as noted above, the one-action rule's prohibition of multiple actions for a single debt clearly "precluded" the bank from ever collecting on the debt.

The court then discarded *Daily* as irrelevant to the issue of whether the sanction should include loss of the debt: "The cause of action in *Daily* was for foreclosure of the bank's security interest. Unlike in the present case, the bank was not seeking to recover on the debt." *Id.* This statement demonstrates a misunderstanding of the nature of judicial foreclosure in California. In a lien-theory state like California, real property security is held only to satisfy the underlying debt upon the default of the debtor. See J. HETLAND, SECURED REAL ESTATE TRANSACTIONS 65-66 (1974). Therefore, a judicial foreclosure under § 726 is necessarily an action on the debt. In fact, if an action

Wozab.¹³⁸ These decisions play a large role in the scope-of-the-sanction controversy because they are the only two cases that have held the harsher sanction to be applicable in the context of an improper banker's setoff.

In *Daily* a bank set off the amount of accrued interest due on a delinquent loan secured by a deed of trust from the checking account of the debtor prior to foreclosing on the deed of trust.¹³⁹ The court held that the setoff was an action for the recovery of a debt within the meaning of section 726 and, therefore, that the bank waived its rights to the security.¹⁴⁰ Furthermore, the court's disposition of the case rendered the underlying obligation unenforceable.¹⁴¹ The harshness of the sanction imposed was deemed necessary to uphold the protections afforded to mortgagors under California's statutory antideficiency scheme.¹⁴²

Despite the available doctrinal support for the result,¹⁴³ the *Daily* court's sanction analysis was woefully deficient. It relied on *McKean*, *Walker*, and an excerpt from Professor Hetland's authoritative 1970 treatise.¹⁴⁴ The court's use of these authorities hardly supported imposition of the more severe sanction. *McKean* merely held that the debtor could recover the amount improperly set off.¹⁴⁵ *Walker* held that the sanction to be imposed when a creditor obtains a judgment on the full amount of the debt in a judicial foreclosure action prior to exhausting all security is loss of the security.¹⁴⁶ Finally, Professor Hetland's treatise

to judicially foreclose on a real property security interest is not considered an action to recover on the debt, the one-action rule would be meaningless because a multiply secured mortgagee could bring successive actions for judicial foreclosure with impunity.

138. 223 Cal. App. 3d 1042, 1056-57, 258 Cal. Rptr. 850, 857-58 (1989), *rev'd*, 51 Cal. 3d 991, 800 P.2d 557, 275 Cal. Rptr. 201 (1990).

139. *Daily*, 152 Cal. App. 3d at 770, 199 Cal. Rptr. at 558.

140. *Id.* at 772-74, 199 Cal. Rptr. at 559-60. Of course, the court could have simply held that the setoff was a violation of the security-first principle instead of holding that the setoff was an action for the purposes of § 726. Rowan & Mertens, *supra* note 11, at 76; *supra* notes 113-15 and accompanying text.

141. *See supra* note 137.

142. *Daily*, 152 Cal. App. 3d at 773, 199 Cal. Rptr. at 560; *see also* *Woodruff v. California Republic Bank*, 75 Cal. App. 3d 108, 111, 141 Cal. Rptr. 915, 917 (1977) ("Under California law, '... the creditor must rely upon his security before enforcing the debt. (Code Civ. Proc., §§ 580a, 725a, 726.) If the security is insufficient, his right to a judgment against the debtor for the deficiency may be limited or barred by sections 580a, 580b, 580d, or 726 of the Code of Civil Procedure.'" (quoting *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 38-39, 378 P.2d 97, 98, 27 Cal. Rptr. 873, 874 (1963))); Arnold, *supra* note 11, at 11 (Both *Daily* and *Woodruff* "rely on the concept that the 'fair value' limits of Section 726, or the absolute prohibition on deficiency judgments after a trustee's sale codified in CCP § 580d might bar any recovery of a deficiency judgment altogether following a creditor's exhaustion of its collateral.").

143. *See infra* Parts V.B. & VI.

144. *Daily*, 152 Cal. App. 3d at 771-73, 199 Cal. Rptr. at 559-60.

145. *See supra* notes 132-35 and accompanying text.

146. *See supra* notes 105-08 and accompanying text. This is not to say that *Walker* could not be used to support the stronger sanction, *see infra* Part V.B., but only that the court in *Daily* failed to do so articulately.

was not directed to the peculiar nuances of the improper banker's setoff cases.¹⁴⁷

The court of appeal in *Wozab* was faced with the same issues addressed in *Daily*. The Wozabs had executed guarantees for loans to their company and later executed a deed of trust on their residence as security for their guarantees. In an effort to reduce losses prior to the company's filing for protection in bankruptcy, the bank set off \$2800 in the Wozabs' personal accounts against the company's \$976,600 debt. The Wozabs' attorney then informed the bank that under *Daily*, by taking the setoff, it waived any claim against the Wozabs under their guarantees. The bank then reconveyed the deed of trust to the Wozabs and filed suit to collect on the underlying debt.¹⁴⁸

The court, relying on *Daily* and citing to *Ould v. Stoddard*¹⁴⁹ and *Commercial Bank v. Kershner*,¹⁵⁰ held that an improper banker's setoff should result in loss of the security and of the underlying debt.¹⁵¹ Both *Ould* and *Kershner* are distinguishable from *Wozab*. In *Ould* the court stated "that by prosecuting an action upon the note secured by the mortgage to final judgment, the plaintiff has exhausted his remedy upon both the note and the security."¹⁵² *Ould*, unlike *Wozab*, involved a creditor who obtained a personal judgment against the debtor and then sought to foreclose on the mortgage securing the debt. The court held that the creditor had elected to bring an action on the note in contravention of section 726 and had, therefore, waived his right to foreclose on the mortgage.¹⁵³ In other words, because the creditor elected to sue on the note in lieu of bringing an action for foreclosure, the creditor's claim was deemed to be satisfied by the judgment on the note. Similarly, the court in *Kershner* noted that when a creditor obtained a personal judgment in an attachment suit and enforced it on execution, "such proceedings

147. Professor Hetland's discussion of the loss of security and loss of debt sanction focused on a multiple-security situation where the creditor fails to foreclose on all of the security in a single foreclosure action. See J. HETLAND, *supra* note 4, § 6.18, at 257-60. In such a case it is apparent that the creditor would be unable to pursue the amount owing on the debt (because the bank may not have a second action on the debt) or the unsecured security (because there would be no debt left to be secured).

However, in the case of an improper banker's setoff, the one-action rule is violated not because the creditor has already had an action (the statutory definition of an action is an ordinary judicial proceeding), but because the setoff violates the security-first principle, which requires the exhaustion of all security prior to the availability of a deficiency judgment against the debtor. It is not so apparent what the sanction should be in this situation. See *infra* Part V.D.

148. *Security Pac. Nat'l Bank v. Wozab*, 223 Cal. App. 3d 1042, 1045-46, 258 Cal. Rptr. 850, 850-51 (1989), *rev'd*, 51 Cal. 3d 991, 275 Cal. Rptr. 201, 800 P.2d 557 (1990).

149. 54 Cal. 613 (1880).

150. 120 Cal. 495, 52 P. 848 (1898).

151. *Wozab*, 223 Cal. App. 3d at 1056-57, 258 Cal. Rptr. at 858.

152. *Ould*, 54 Cal. at 615.

153. *Id.*

amounted to a waiver of the right to foreclose."¹⁵⁴ Thus, both *Ould* and *Kershner* involved a creditor that elected to sue directly on the debt instead of bringing a foreclosure action as required under section 726 and, therefore, the sanction imposed was loss of the security. In contrast, *Wozab* involved a creditor that, by choosing the self-help remedy of set-off, effectively obtained, and simultaneously enforced, a nonjudicial personal judgment representing only a fraction of the entire debt.

In referring to the appellate court opinion in *Wozab*, and prior to the supreme court's decision in *Wozab*, one commentator noted that "[o]ther courts are likely to find a more appropriate sanction than loss of the entire amount of a legitimate claim when an unpaid creditor has inadvertently taken an asset out of order."¹⁵⁵ The supreme court heeded this advice in *Wozab*, but it did so carelessly.

V

THE *WOZAB* OPINION—CARELESS APPLICATION OF ONE-ACTION RULE DOCTRINE

The California Supreme Court neatly disposed of two biting issues in *Wozab*. First, the court held that a setoff was not an action as described in section 22 and was, therefore, not an action under section 726.¹⁵⁶ Second, despite the extensive discussion by the court of appeal about the relationship between section 726 and California's counterclaim¹⁵⁷ and setoff¹⁵⁸ statutes, the supreme court ignored the issue, allowing section 726 to trump the other statutes.¹⁵⁹ Unfortunately, the court only deepened the scope of the sanction controversy through careless application of one-action rule doctrine.¹⁶⁰

A. Careless Language

The court began its analysis of the sanction controversy by noting that a creditor who sues only on the underlying debt waives the secur-

154. *Kershner*, 120 Cal. at 498-99, 52 P. at 850.

155. R. BERNHARDT, *supra* note 3, § 4.5, at 190. It should be noted, however, that the setoff by the bank in *Wozab* was meant to reduce losses from an impending bankruptcy filing and, therefore, was less than "inadvertent." See *Wozab*, 223 Cal. App. 3d at 1045-46, 258 Cal. Rptr. at 851.

156. Security Pac. Nat'l Bank v. *Wozab*, 51 Cal. 3d 991, 998, 800 P.2d 557, 560-61, 275 Cal. Rptr. 201, 204-05 (1990).

157. CAL. CIV. PROC. CODE §§ 428.10 (West 1991) (formerly § 438).

158. *Id.* § 431.70 (West 1991) (formerly § 440).

159. See *supra* text accompanying notes 114-30.

160. Many of the ideas for Part V of this Comment were presented and discussed in Professor Hetland's Real Property Secured Transactions course. He deserves full credit for revealing the inadequacies of the *Wozab* opinion. See R. MAXWELL, S. RIESENFELD, J. HETLAND & W. WARREN, *supra* note 137, at 286-89 (4th ed. 1991).

ity.¹⁶¹ This is an accurate statement of the law.¹⁶² The court then compared these facts with the situation in which "a creditor has multiple security interests for a debt and proceeds against less than all of them in a judicial foreclosure action, in which he obtains a deficiency judgment."¹⁶³ The court stated that in such circumstances the security is waived but the debt remains "unaffected."¹⁶⁴ Although the court's assertion would be an accurate statement of the law under the rule of *Walker v. Community Bank*¹⁶⁵ if the creditor sued for the entire debt, foreclosed on some of the security, and obtained a deficiency judgment for the amount owing on the entire debt following the foreclosure sale, the court's language was not so precise.

The significance of this carelessness is apparent when a creditor in the situation described by the court forecloses on only part of the security without suing for the full amount of the debt. If the debtor fails to raise the one-action rule affirmative defense, and the creditor obtains a personal deficiency judgment representing the amount owing on the part of the debt sued on, the creditor may not recover any amount owing on the debt other than the judgment obtained or foreclose on any omitted security. The creditor has already expended its one action and may not sue again; the portion of the debt not sued upon is forever lost.

B. Careless Reasoning

The court stated that because the setoff of the Wozabs' account was not a judicial action, the bank did not obtain a judgment for the full amount of the debt, or a deficiency judgment representing the amount owing on the debt, in exercising the setoff.¹⁶⁶ Accordingly, the court reasoned that under *Walker* and *Salter v. Ulrich*¹⁶⁷ the bank "must be allowed to seek a judgment for the full balance of the debt."¹⁶⁸ In *Walker*, however, the bank *did* have a deficiency judgment representing the amount owing on the entire debt,¹⁶⁹ and in *Salter* the creditor *did* have a personal judgment for the full amount of the debt.¹⁷⁰ If the bank in *Walker* or the creditor in *Salter* had not had some type of judgment representing the full debt, they would have been precluded from bringing another action on either the security or the debt to satisfy the amount

161. *Wozab*, 51 Cal. 3d at 1004, 800 P.2d at 565, 275 Cal. Rptr. at 209.

162. *See supra* Part III.A.

163. *Wozab*, 51 Cal. 3d at 1004, 800 P.2d at 565, 275 Cal. Rptr. at 209.

164. *Id.*

165. 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974); *see supra* text accompanying notes 84-85, 105-08.

166. *Wozab*, 51 Cal. 3d at 1004, 800 P.2d at 565, 275 Cal. Rptr. at 209.

167. 22 Cal. 2d 263, 138 P.2d 7 (1943).

168. *Wozab*, 51 Cal. 3d at 1004, 800 P.2d at 565, 275 Cal. Rptr. at 209.

169. *Walker*, 10 Cal. 3d at 732, 518 P.2d at 331, 111 Cal. Rptr. at 899.

170. *Salter*, 22 Cal. 2d at 265, 138 P.2d at 8.

owing on the debt.¹⁷¹ The situation in both *Walker* and *Salter*—a debtor failing to raise the one-action rule affirmative defense and a creditor obtaining a judgment for the full amount of the debt—is fundamentally different from the situation in *Wozab*, in which the bank effectively obtained, and simultaneously enforced, a nonjudicial personal judgment representing only a fraction of the entire debt.¹⁷² Thus, the supreme court in *Wozab* was hardly justified in citing *Walker* and *Salter* as support for imposing the loss-of-security-only sanction.

Perhaps the court intended to argue that because the setoff was not technically an action for the purposes of section 726, the setoff was a nullity and therefore had no effect on the bank's ability to bring a judicial action on the debt. Yet, this reasoning would conflict with the court's holding that the setoff violated the security-first principle of the one-action rule and that the proper sanction was loss of the security.¹⁷³

By holding that the setoff was a violation of the security-first principle, it follows that the court viewed the setoff as behavior just as condemnable as a judicial action achieving the same purpose. After all, if the bank had brought a judicial action to appropriate the funds in the Wozabs' bank account without suing for the full amount of the debt and had obtained a judgment allowing the seizure of the funds and executed the judgment, the bank would have been unable to pursue either the amount owing on the debt (because the bank would not have been able to bring a second action on the debt) or the unencumbered security (because there would have been no debt left to be secured).¹⁷⁴ In other words, if the bank had proceeded by judicial action, the combined loss-of-security and loss-of-debt sanction would have applied.

However, rather than subjecting the bank to the stronger sanction, the supreme court simply indicated that the bank had waived its security interest, leaving the debt intact. Thus, the court seemed to argue that because a banker's setoff is not technically an action for the purposes of section 726, it is a less serious infraction of the one-action rule than achieving the same result through judicial means.

171. See *supra* Part III.B.

172. *Wozab*, 51 Cal. 3d at 1015, 800 P.2d at 572, 275 Cal. Rptr. at 216 (Broussard, J., concurring and dissenting).

173. *Id.* at 999, 800 P.2d at 562, 275 Cal. Rptr. at 206.

174. Just as the bank would clearly be barred from bringing a second action to collect the remainder of the debt if it had obtained the proceeds of the debtor's bank account through an initial judicial action against the debtor, the bank should similarly be barred from seeking additional recovery from the debtor when, without exhausting the security, it improperly seized nonsecured property without the debtor's consent through its unilateral extrajudicial conduct.

Id. at 1015, 800 P.2d at 572, 275 Cal. Rptr. at 216 (Broussard, J., concurring and dissenting).

C. Careless Equities

The *Wozab* court was guilty not only of careless language and reasoning, but also of distorting the facts of the case in a manner favorable to the bank in order to justify its holding. The court stated that the Wozabs "voluntarily relinquished" their rights under section 726 by accepting the reconveyance of the deed of trust and engaged in "gamesmanship" by later asserting their rights under the statute.¹⁷⁵ As the dissent pointed out,

[w]hen the debtor, after discovering the setoff, took the legal position that the bank's misconduct had resulted in the bank's loss of both its security interest and the balance of the underlying debt, the debtor was relying on the holding and reasoning of the only judicial authority on point—*Bank of America v. Daily* It was in light of the *Daily* decision that the bank voluntarily agreed to reconvey the secured property to the debtor, and then filed this action to attempt to limit the scope of the *Daily* decision.¹⁷⁶

In other words, the only reason that the Wozabs accepted reconveyance of the deed of trust was that they knew, as did the bank, that under *Bank of America v. Daily*¹⁷⁷ the sanction for an improper banker's setoff was at least loss of the creditor's rights in the security.¹⁷⁸ This undisputed fact was halfheartedly acknowledged by the majority: "[W]e think it important to note that the bank's voluntary reconveyance was an accurate reflection (and perhaps implicit acknowledgment by the bank) of the long-established rule as to the effect of an improper setoff."¹⁷⁹

Thus, in order to support its holding that the combined loss-of-security and loss-of-debt sanction should not be imposed on the bank, the supreme court in *Wozab* inaccurately portrayed the bank as naive and the Wozabs as condemnably crafty. Although the imposition of the stronger sanction seems unfair under the extraordinary facts presented in *Wozab*, the court should have based its holding on sound interpretation of one-action rule doctrine or should have explained why the particular facts of the case warranted a holding inimical to current legal doctrine. What the court should not have done, of course, was distort the facts in an attempt to legitimize its holding.¹⁸⁰

175. *Id.* at 1005, 800 P.2d at 565-66, 275 Cal. Rptr. at 209-10.

176. *Id.* at 1015 n.4, 800 P.2d 572 n.4, 275 Cal. Rptr. at 217 n.4 (Broussard, J., concurring and dissenting).

177. 152 Cal. App. 3d 767, 772-74, 199 Cal. Rptr. 557, 559-60 (1984).

178. *Wozab*, 51 Cal. 3d at 996, 800 P.2d at 559, 275 Cal. Rptr. at 203.

179. *Id.* at 1001, 800 P.2d at 563, 275 Cal. Rptr. at 207.

180. The political makeup of the court that decided *Wozab* provides some insight into its "inequitable" treatment of the Wozabs:

Five of California's seven Supreme Court justices, all distinguished career jurists, had been appointed by California's fiscally conservative ex-governor, Republican George Deukmejian. The four justices voting with the majority in *Wozab* were all Deukmejian

D. Careless Dicta

The main question before the court in *Wozab* was whether the proper sanction under section 726 for an improper banker's setoff should be loss of the security, or alternatively loss of the security and loss of the underlying debt. The sanction effectively imposed by the court was loss of the security only.¹⁸¹ As noted earlier, the reasoning employed by the court in choosing this sanction, as opposed to a combined loss-of-security and loss-of-debt sanction, was questionable because the court's analysis turned on the technical definition of an action.¹⁸² It is understandable that the court settled on a middle ground when faced with extraordinary facts and a controversial doctrine that was virtually inapplicable to the transaction at issue. What is not understandable was the court's suggestion, in dicta, that the combined sanction or no sanction at all would be appropriate given different facts.

The court considered four different fact scenarios in its sanction analysis. It first confronted the facts presented in *Wozab*: a bank intentionally sets off a debtor's unencumbered account, the debtor does not ask for a return of the funds set off, and the creditor keeps the funds.¹⁸³ In considering the proper sanction to impose under these facts the court noted that the issue of whether the bank had waived its right to foreclose on the security was mooted by the reconveyance of the deed of trust at the request of the *Wozabs* prior to suit.¹⁸⁴ However, so as not to render the case meaningless as precedent, the court, relying on *Walker* and *Daily*, stated that absent the reconveyance, the proper sanction to impose would have been loss of the security.¹⁸⁵

The court next considered the scenario in which a bank inadvertently sets off a debtor's unencumbered account, but promptly and unilaterally returns the funds set off.¹⁸⁶ Carefully noting that this issue was not presented under the facts of the case, the court argued that imposing a sanction would be unduly harsh and that the appropriate remedy might be to hold the bank liable for compensatory damages.¹⁸⁷ Careful consid-

appointees and registered Republicans. The three voting against were the court's two Democrats, and its sole declines-to-state, Hon. Joyce L. Kennard.

Stillman, *supra* note 12, at 10.

181. *Wozab*, 51 Cal. 3d at 1001-02, 1004, 800 P.2d at 563, 565, 275 Cal. Rptr. at 207, 209; see *supra* note 136.

182. See *supra* Part V.B.

183. *Wozab*, 51 Cal. 3d at 1001, 800 P.2d at 563, 275 Cal. Rptr. at 207.

184. *Id.*

185. *Id.* at 1001-02, 800 P.2d at 563, 275 Cal. Rptr. at 207.

186. *Id.* at 1001 n.8, 800 P.2d at 563 n.8, 275 Cal. Rptr. at 207 n.8.

187. *Id.* Curiously, the court rejected this very remedy (return of the setoff and compensatory damages) in its analysis of the proper sanction to impose under the actual facts of the case. The court argued that this remedy would provide debtors with little economic incentive to bring suit to recover improperly set off funds, would provide attorneys with little incentive to accept such cases,

eration exposes this approach as untenable for the following reasons.

First, litigation concerning the appropriate standard for promptness would be inevitable.¹⁸⁸ Second, litigation would arise as to whether the setoff was truly a mistake or was an attempt to cut losses in anticipation of bankruptcy proceedings. Third, unless "compensatory damages" refers to interest accrued during the period the funds were seized, some type of legal proceedings would be necessary to determine compensatory damages.¹⁸⁹ For example, even were the funds taken only for a short while, if the debtor needed those funds to keep from defaulting on another mortgage or to wrap up a business deal in which time was of the essence, compensatory damages could be very high¹⁹⁰ and very difficult to ascertain. Therefore, the court's dicta suggesting compensatory damages as an exclusive remedy should be ignored by future courts looking to *Wozab* for guidance.

The third fact pattern considered by the court was a slight variation of the second: a bank inadvertently sets off a debtor's unencumbered account, the debtor objects to the setoff and requests the return of the funds set off, and the creditor complies with the debtor's request.¹⁹¹ Again the court suggested that the fair result would be to require the bank to pay compensatory damages.¹⁹² As noted above, the remedy of compensatory damages is both impractical and inadequate as an exclusive remedy in improper banker's setoff cases.

The court only worsened matters by suggesting that a debtor in this situation would also be able to compel the creditor to proceed against the security: "a debtor can object to an improper setoff and require the bank to return it and proceed first against the security interest."¹⁹³ This statement by the court contradicted its earlier holding that a setoff is not the equivalent of a judicial action for purposes of section 726. After all, a

and would provide banks with little economic incentive to comply with § 726. *Id.* at 1002, 800 P.2d at 563-64, 275 Cal. Rptr. at 207-08.

The court also argued that forcing debtors to bring suit to reverse improper setoffs would violate the one-action rule's prohibition on a multiplicity of actions because the bank could still bring suit to foreclose on the security. *Id.* Although it is true that requiring debtors to bring suit to recover improper setoffs would impose a substantial burden on debtors' time and resources, it should be noted that the one-action rule's policy of preventing a multiplicity of actions would not be implicated because the policy is only addressed to actions initiated by creditors.

The court did not state why these otherwise legitimate objections to a damages remedy as an exclusive remedy do not counsel against imposing the remedy where a bank inadvertently sets off a debtor's unencumbered account but promptly returns the funds.

188. Furthermore, it would be absurd if the degree of culpability attributed to a misunderstanding of the law or a clerical error depended on the length of time before it was detected.

189. *Id.* at 1002, 800 P.2d at 563, 275 Cal. Rptr. at 207.

190. *Id.* at 1011, 800 P.2d at 570, 275 Cal. Rptr. at 214 (Broussard J., concurring and dissenting).

191. *Id.* at 1001 n.8, 800 P.2d at 563 n.8, 275 Cal. Rptr. at 207 n.8.

192. *Id.*

193. *Id.* at 1006, 800 P.2d at 566, 275 Cal. Rptr. at 210.

debtor may raise the one-action rule affirmative defense to compel a creditor to foreclose on all security for a debt only after the creditor has brought an action on the debt. Furthermore, banks could routinely engage in improper setoffs with impunity, knowing that a percentage of the depositors so victimized would not pursue the matter.¹⁹⁴

Incredibly, the court also provided a scenario under which the combined loss-of-security and loss-of-debt sanction would be appropriate: "Of course, if the bank refused the debtor's demand and retained the setoff funds, the security-first rule . . . would preclude the bank from foreclosing the security interest or proceeding on the underlying debt."¹⁹⁵ The carelessness of this dictum lies not in its legitimacy but in its lack of elaboration. Rather than articulating a doctrinal rationale for imposing the combined loss-of-security and loss-of-debt sanction, the court irresponsibly set forth an arbitrary standard for imposing the stronger sanction—namely, when a bank acts in bad faith by refusing upon the debtor's demands to return funds improperly set off. Thus, the majority would impose the combined sanction as a purely punitive measure without regard to doctrinal concerns.

Nonetheless, the court's failure to explain the basis for its suggested application of the combined loss-of-security and loss-of-debt sanction does not undermine the potential legitimacy of applying this sanction in the context of an improper banker's setoff. Consider a situation in which a bank has improperly set off a debtor's account with the knowledge that its position would be much better with the setoff and a personal judgment for the amount owing on the debt than with a decree of foreclosure and a potential personal deficiency judgment. Should the bank be deemed to have waived the security but to have retained an enforceable personal judgment? Clearly not.

With a personal judgment, a creditor, along with all other unsecured creditors of the debtor, must enforce the judgment to obtain any money. In contrast, when a bank improperly sets off a debtor's account, it has effectively obtained, and simultaneously enforced, a nonjudicial "personal judgment," depriving the debtor and competing creditors of funds to which the bank may never be entitled, given the fair value deficiency limitation of section 726(b) (judicial foreclosure sales) and the absolute deficiency bar of section 580d (nonjudicial foreclosure sales).¹⁹⁶ In other words, this nonjudicial "personal judgment" is a far more serious violation of the security-first principle than a judicial personal judgment.

194. *Id.* at 1013, 800 P.2d at 571, 275 Cal. Rptr. at 215 (Broussard, J., concurring and dissenting).

195. *Id.* at 1006, 800 P.2d at 566, 275 Cal. Rptr. at 210.

196. *Id.* at 1010, 800 P.2d at 569, 275 Cal. Rptr. at 213 (Broussard, J., concurring and dissenting).

Analogizing to the paradigm case in which the combined loss-of-security and loss-of-debt sanction has been imposed—when a multiply secured creditor omits part of the security from an action for judicial foreclosure and neglects to sue on the entire amount of the debt—it would seem that the proper sanction to impose when faced with an improper banker's setoff should be loss of that portion of the debt not seized and the consequent loss of all security for that debt.

VI

A PROPOSAL FOR A UNIFORMLY APPLICABLE REMEDY IN IMPROPER BANKER'S SETOFF CASES

The highly subjective and inescapably ad hoc approach adopted in *Wozab* for resolving scope-of-the-sanction litigation in improper banker's setoff cases creates serious problems for lower courts seeking guidance in interpreting one-action rule sanction doctrine. Legislative reform of section 726—a statute that has remained essentially unchanged since its adoption in 1860¹⁹⁷—is unnecessary.¹⁹⁸ What is necessary is recognition of a uniformly applicable remedy that is firmly grounded in one-action rule doctrine and could be imposed regardless of the culpability of the bank.

Before discussing the proposal, it bears repeating that an honest

197. See Comment, *supra* note 1, at 429 (“the first sentence of section 726 which embodies the ‘one action’ rule has undergone no material change since its original enactment”).

198. Prior to the decision in *Wozab*, one commentator ambitiously set out to clarify one-action rule sanction doctrine with a proposal to amend § 726. Mertens, *supra* note 11, at 577-79. The three-part proposal suggested (1) incorporating the definition of the term “action” found in § 22 into the language of § 726, (2) adding a statement of legislative policy so as to codify the security-first principle, and (3) adding a section spelling out the operation of the statute and limiting the sanction for violation of the statute to loss of the security. *Id.* The first suggested amendment has been mooted by *Wozab*. See *Wozab*, 51 Cal. 3d at 998, 800 P.2d at 560-61, 275 Cal. Rptr. at 204-05 (holding that a banker's setoff was not an “action” based on the plain language of § 22). The second suggested amendment, that of codifying the security-first principle, is unnecessary given the judiciary's universal recognition of the principle as a corollary to the one-action rule. See *supra* Part I.B. Lastly, the third suggested statutory amendment, if enacted, would overturn numerous multiple-security cases, see, e.g., *Stockton Sav. & Loan Soc'y v. Harrold*, 127 Cal. 612, 616-17, 60 P. 165, 167 (1900); *Woodward v. Brown*, 119 Cal. 283, 292-94, 51 P. 2 (1897); *Hall v. Arnott*, 80 Cal. 348, 350-51, 22 P. 200, 201 (1889), and at least one equitable setoff case, *Aplanalp v. Forte*, 225 Cal. App. 3d 609, 275 Cal. Rptr. 144 (1990).

In *Aplanalp*, a case decided just eight days before the supreme court decided *Wozab*, the sellers of a mobile home park obtained an order from the trial court to enforce their equitable right of setoff of a money judgment owed by the sellers to the purchasers against delinquent payments owed by the purchasers on a note and deed of trust. The court of appeal held the sellers were barred from foreclosing on the note under § 726. *Id.* at 612-15, 275 Cal. Rptr. at 146-48. Because the debtors sought to quiet title and to cancel the note and deed of trust, *id.* at 612, 275 Cal. Rptr. at 146, and the court of appeal reversed the trial court in favor of the purchasers, *id.* at 617, 275 Cal. Rptr. at 149, it would appear as though the court imposed a combined loss-of-security and loss-of-debt sanction. See R. MAXWELL, S. RIESENFELD, J. HETLAND & W. WARREN, *supra* note 137, at 293-95.

application of section 726 in the context of an improper banker's setoff points to a different result—namely, loss of the security and loss of the underlying debt.¹⁹⁹ As noted earlier, if the bank in *Wozab* had brought a judicial action to appropriate the funds in the Wozabs' bank account without suing for the full amount of the debt and had obtained a judgment allowing seizure of the funds and executed the judgment, the bank would have achieved the same result as the unilateral seizure of the funds by setoff, but would have been unable to pursue the amount owing on the debt (because the bank would have been barred from bringing a second action on the debt) or the unencumbered security (because there would have been no debt left to secure).²⁰⁰

Thus, in searching for an answer to the sanction controversy, doctrinal honesty dictates that one analogize to the paradigm case in which the combined loss-of-security and loss-of-debt sanction has been imposed—a multiply secured creditor omits part of the security from an action for judicial foreclosure and neglects to sue on the entire amount of the debt. The court's holding in *Wozab* eliminated this approach because, according to the court, a setoff is "not an action within the meaning of section 22" and therefore is not an action for judicial foreclosure within the meaning of section 726.²⁰¹ Accordingly, the following proposal is necessarily a second-best solution.

The California Supreme Court in *Wozab* was faced with the problem of determining the proper sanction to impose on a bank that has violated section 726 by improperly setting off a debtor's account.²⁰² Ignoring the values of judicial efficiency and certainty of outcome, the supreme court suggested that the debtor's remedy should vary depending on whether the setoff was intentional or not and whether it was returned promptly or not at all.²⁰³ As a result, the scope-of-the-sanction controversy was left unresolved. The following discussion advances a proposal for a single, uniformly applicable remedy in all improper banker's setoff cases—requiring the return of the funds set off, awarding the debtor compensatory and perhaps punitive damages, and providing the debtor with the option either to raise the one-action rule affirmative defense or to be excused from liability on the security interest.

This proposal is grounded in part in the law of conversion. When a bank improperly sets off a debtor's unencumbered account to collect on a debt secured by real property, it has committed the tort of conversion. Notwithstanding the potential for section 726 sanction effects, the debtor

199. See *supra* Part V.B.

200. See *supra* note 174 and accompanying text.

201. *Wozab*, 51 Cal. 3d at 998, 800 P.2d at 560-61, 275 Cal. Rptr. at 204-05.

202. See *supra* text accompanying notes 131-38.

203. See *supra* Part V.D.

can always sue for return of the funds set off and for compensatory damages²⁰⁴ so as to restore the parties to their respective positions before the setoff.

Although this remedy was not available to the Wozabs because they failed to sue for return of the funds set off,²⁰⁵ the majority nonetheless discussed the implications of adopting such a remedy. Not surprisingly, the court planted another seed of confusion by outright rejection of the remedy as an inadequate deterrent, arguing that, as a matter of "commercial reality," a debtor would have a difficult time financing and litigating an action to reverse a setoff.²⁰⁶ The court further argued that forcing the debtor to bring an action to recover the funds set off and then to defend another action for foreclosure under section 726 would confound the purpose of section 726 to prevent a multiplicity of actions.²⁰⁷

What each of these criticisms failed to take into account is that the remedy of return of the funds set off and compensatory damages is not an exclusive remedy—rather, it is merely a preliminary remedy to be accompanied by the appropriate section 726 sanction.²⁰⁸ The proposed uniformly applicable remedy recognizes this. Following an improper setoff, the debtor would file a complaint alleging that, under section 726, the creditor is liable for the tort of conversion and for violating the security-first principle. In pleading its remedy, the debtor would first ask for return of the funds set off (if not already returned) and for compensatory damages (including interest). As discussed below, the debtor would then ask the court either to impose the loss-of-security sanction on the creditor, or alternatively to compel the creditor to foreclose on all of its security. Thus under the proposed remedy, a debtor would only have to go to court once. Furthermore, given the potential for significant tort damages in addition to a section 726 sanction, creditors would be sufficiently deterred from improperly exercising their powers of setoff, and debtors

204. *Wozab*, 51 Cal. 3d at 1011, 800 P.2d at 569-70, 275 Cal. Rptr. at 213-14 (Broussard, J., concurring and dissenting); Stillman, *supra* note 12, at 10.

205. *Wozab*, 51 Cal. 3d at 996, 800 P.2d at 559, 275 Cal. Rptr. at 203.

206. *Id.* at 1002, 800 P.2d at 563-64, 275 Cal. Rptr. at 207-08.

207. *Id.*

208. *Id.* at 1011, 800 P.2d at 569-70, 275 Cal. Rptr. at 213-14 (Broussard, J., concurring and dissenting); Stillman, *supra* note 12, at 10.

The majority in *Wozab* argued that where a bank promptly returns an improper setoff, the creditor should not be subject to the loss-of-security sanction. *Wozab*, 51 Cal. 3d at 1001 n.8, 800 P.2d at 563 n.8, 275 Cal. Rptr. at 207 n.8. Although it is not clear, the majority probably reasoned that once an improper setoff is reversed and compensatory damages awarded, the bank has completely atoned for its violation of the security-first principle. This fails to recognize that the seizure of a debtor's unencumbered assets is a far more serious violation of the security-first principle than a typical violation in which the creditor obtains an unsecured personal judgment and must compete with other unsecured creditors in enforcing its judgment. *See supra* text accompanying note 196.

would have sufficient incentive to raise a section 726 claim.²⁰⁹

The second part of the proposed uniformly applicable remedy analogizes, in part, to the typical section 726 scenario in which a creditor brings an action on the note. The sanction imposed in this situation is a reduction in the status of the creditor from secured to unsecured, while preserving the enforceability of the personal judgment.²¹⁰ The analogy between this scenario and the improper banker's setoff scenario is based on the fact that, in each case, the creditor demonstrates an intent to resort to the debtor's personal assets. Although seeming to fail in light of the California Supreme Court's holding that a nonjudicial setoff is not an action within the meaning of section 726, the analogy could be legitimately recognized in section 726 sanction doctrine by allowing a debtor to raise an equitable estoppel defense.

The defense would be simple and powerful. If in the course of a debtor's suit for violation of section 726 the creditor alleges that it can proceed to foreclose on the security interest, the debtor could argue that the creditor is estopped from foreclosing on the security on the grounds that by improperly seizing the debtor's funds in violation of the security-first principle, the creditor has demonstrated an intent to resort to the debtor's personal assets. In other words, the creditor would be treated as though it had obtained a final and valid personal judgment on the debt. Although this analysis detours from traditional one-action rule doctrine, it recognizes that the seizure of a debtor's unencumbered assets is a far more serious violation of the security-first principle than a typical violation in which the creditor obtains an unsecured personal judgment and must compete with other unsecured creditors in enforcing its judgment.²¹¹

As explained thus far, a uniformly applicable remedy should include return of the funds set off, compensatory damages, and loss of the security. As will be explained below, this remedy is far from complete. What must be addressed at this point is the debtor's right to raise section 726 as an affirmative defense to prevent its unencumbered assets from being seized prior to exhaustion of all security. In addition to the obvious rea-

209. Thus, the proposed uniformly applicable remedy addresses the *Wozab* majority's concern that compensatory damages as an exclusive remedy would not be a sufficient disincentive for banks to violate § 726 and would not be a sufficient incentive for debtors to bring suit to recover an improper setoff. *Wozab*, 51 Cal. 3d at 1002, 800 P.2d at 563-64, 275 Cal. Rptr. at 207-08. In fact, compensatory damages alone may provide debtors with sufficient incentive to bring a § 726 claim. For example, even if the funds were only taken for a short while, if the debtor needed those funds to keep from defaulting on another mortgage or to wrap up a business deal in which time was of the essence, compensatory damages could be very high indeed. *See id.* at 1011, 800 P.2d at 570, 275 Cal. Rptr. at 214 (Broussard, J., concurring and dissenting) ("[A] debtor may suffer substantial damages as a result of being deprived of the proceeds of a personal bank account.").

210. *See supra* Part III.A.

211. *See supra* text accompanying note 196.

sons why a debtor might want to protect its personal assets by raising the affirmative defense,²¹² there are at least two reasons why a creditor might prefer an unsecured personal judgment over the right to foreclose on a real property security interest. First, if the creditor knows that the debtor is in possession of highly liquid assets sufficient to cover the debt, the creditor would likely prefer to obtain a personal judgment so that it can levy on the debtor's assets rather than proceed with a time-consuming foreclosure sale. Second, a creditor holding a security interest on a parcel of real property subject to federal environmental cleanup liability under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA)²¹³ would clearly prefer an unsecured personal judgment over becoming a potentially responsible party for a multimillion-dollar cleanup bill. Thus, imposing a loss-of-security sanction on a creditor without giving the debtor a chance to raise the affirmative defense could, under certain circumstances, create a windfall for the creditor. The proposed uniformly applicable remedy should give debtors the option either to raise the affirmative defense, or alternatively to ask the court to impose a loss-of-security sanction.²¹⁴

212. See *supra* text accompanying notes 50-56.

213. 42 U.S.C. §§ 9601(20)(A), 9607(a)(1)-(2) (1988). CERCLA imposes liability on "owners or operators" of facilities targeted for cleanup by the EPA. A real property secured creditor may be liable as an owner under CERCLA if it forecloses on the contaminated property, purchases the property at the foreclosure sale by entering a credit bid for the amount of the debt, and holds on to the property for a significant length of time. See *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 579 (D. Md. 1986). Furthermore, a real property secured creditor may be liable as an operator under CERCLA if it is found to have "participat[ed] in the financial management of a facility to a degree indicating a capacity to influence the [debtor's] treatment of hazardous wastes." *United States v. Fleet Factors Corp.*, 901 F.2d 1550, 1557 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 752 (1991).

Until recently, a California creditor holding a security interest in contaminated real property was prevented from waiving its security interest under § 726. Recently adopted § 726.5 allows such a creditor to waive its security interest in "environmentally impaired" property and proceed against the debtor as an unsecured creditor under certain circumstances. Act of October 14, 1991, ch. 1167, § 3, 1991 Cal. Legis. Serv. 4846 (West) (to be codified at CAL. CIV. PROC. CODE § 726.5) (effective Jan. 1, 1992). Generally, § 726.5 is available to a creditor if: (1) the costs of cleanup exceed 25% of the fair market value of the real property security, which is determined without considering the effect of the contamination on the value of the property, *id.* at 4847 (to be codified at CAL. CIV. PROC. CODE § 726.5(e)(3)), and (2) the borrower or an agent of the borrower had actual knowledge of the contamination problem at the time of the creation of the obligation, or the borrower or an agent of the borrower caused, contributed to, or permitted the occurrence of the contamination, *id.* at 4846 (to be codified at CAL. CIV. PROC. CODE § 726.5(d)). Importantly, although § 726.5 allows a California secured creditor to waive an environmentally impaired and therefore potentially valueless security interest, it does not operate to shield a secured creditor from CERCLA liability under the rules announced in *Maryland Bank & Trust Co.* and *Fleet Factors*.

214. This approach, providing the debtor with an option to raise the affirmative defense or to rely on the sanction, comports with the established, but not completely accepted, rule that a debtor may elect to waive the affirmative defense and rely instead on the one-action rule sanction. See *supra* note 57 and accompanying text. It would not be unfair to allow the debtor to make this election after the improper setoff has occurred because a unilateral setoff wrongfully deprives the debtor of

It is necessary to examine how the proposed remedy would respond to the supreme court's suggestion that the sanction should vary in severity depending on whether the setoff was inadvertent or intentional. A footnote to the majority opinion suggested that where a bank improperly sets off a debtor's bank account inadvertently or due to ignorance of the law, and promptly returns the funds either unilaterally or at the request of the debtor, compensatory damages should be the sole remedy.²¹⁵ However, as noted earlier, this rule would be impractical.²¹⁶ In addition, imposing a single, uniform remedy, regardless of whether the setoff was an error or not, would be consistent with one-action rule doctrine²¹⁷ and would announce to the banking industry the seriousness of an improper setoff.²¹⁸

The court confirmed its use of a sliding-scale-of-culpability analysis by announcing in the last sentence of the opinion that if a creditor refuses a debtor's demand to reverse an improper setoff, a court would be justified in imposing the combined loss-of-security and loss-of-debt sanction.²¹⁹ Although it is unclear what prompted the court to make this completely unforeshadowed statement, it is possible that the court was concerned with the possibility that if tempted with a large enough setoff, a bank may prefer to execute the setoff and obtain an unsecured personal judgment for the remainder of the debt rather than to preserve its security interest.²²⁰ The proposed remedy would address such an intentional

the opportunity to assert the one-action rule affirmative defense to prevent unencumbered assets from being seized prior to exhaustion of all security.

215. *Wozab*, 51 Cal. 3d at 1001 n.8, 800 P.2d at 563 n.8, 275 Cal. Rptr. at 207 n.8 (When a bank inadvertently sets off a debtor's unencumbered bank account, but promptly returns the funds, "[a] sufficient remedy might be to hold the bank responsible for any compensatory damages suffered by the depositor."); see also *Bank of Am. v. Daily*, 152 Cal. App. 3d 767, 772, 199 Cal. Rptr. 557, 559 (1984) ("Arguably the fairest sanction is to require the bank to refund to the Dailys the money taken from their checking account plus accrued interest as a condition to proceeding with the judicial foreclosure.").

216. See *supra* text accompanying and following notes 186-90.

217. In imposing sanctions for the violation of § 726, the courts have not been concerned with whether the creditor made a mistake or misunderstood the application of the one-action rule. See, e.g., *Walker v. Community Bank*, 10 Cal. 3d 729, 732, 518 P.2d 329, 330-31, 111 Cal. Rptr. 897, 898-99 (1974) (inadvertent omission of security); *Salter v. Ulrich*, 22 Cal. 2d 263, 268, 138 P.2d 7, 9 (1943) (ignorance of law). If such violations were allowed to be overlooked on the basis of mistake or misunderstanding, § 726 cases would be rare indeed.

218. Furthermore, imposing the uniformly applicable sanction proposed by this Comment would have a minor impact on cases involving inadvertent setoffs because the banking industry has already been put on notice by *Daily* and *Wozab* that such an error can be extremely costly. Presumably, banks are taking every necessary precaution to avoid inadvertent setoffs. See *Wozab*, 51 Cal. 3d at 1015-16, 800 P.2d at 573, 275 Cal. Rptr. at 217 (Broussard, J., concurring and dissenting) ("[I]t is reasonable to conclude that as a general rule banks are well aware that when a debt is secured by real property they are required to exhaust the security before resorting to any nonsecured property of the debtor . . . and that, under the threat of a potentially harsh sanction, they have successfully established procedures to comply with this rule.").

219. *Id.* at 1006, 800 P.2d at 566, 275 Cal. Rptr. at 210.

220. Ironically, this strategy would only have been possible under the majority's erroneous

violation of section 726 by allowing the debtor to include a claim for punitive damages in its action for recovery of the setoff.²²¹

CONCLUSION

The one-action rule is at the very heart of California's statutory antideficiency scheme.²²² Despite the virtual omnipresence of the one-action rule in California real estate litigation, the effect of its application is frequently misunderstood. As a result, the scope of the sanction for violation of the one-action rule has become an issue of heated debate. Analysis of relevant cases from the past century and commentary addressing the controversy leads to the conclusion that, under the modern inmajority view, the sanction for violation of the one-action rule should be loss of any unforced-on security and loss of that portion of the debt not reduced to judgment by the creditor's one action.

In *Security Pacific National Bank v. Wozab* the Supreme Court of California turned up its collective nose at the modern majority view in the context of a banker's setoff executed in violation of the security-first principle of the one-action rule. By suggesting that the debtor's remedy should vary depending on whether the setoff was intentional or not and whether it was returned promptly or not at all, the court raised more problems than it solved. In light of the *Wozab* decision, what is needed is a uniformly applicable remedy for all improper banker's setoff cases. The proposed remedy—requiring return of the funds set off, awarding compensatory and perhaps punitive damages, and providing the debtor with the option either to raise the one-action rule affirmative defense or to be excused from liability on the security interest—addresses the shortcomings of the *Wozab* opinion by providing the courts with a single uniformly applicable remedy that is not an overtly punitive measure, that recognizes the seriousness of an improper setoff, and that is grounded in one-action rule doctrine.

belief that a suit for conversion of funds, in addition to a suit for violation of § 726, would not lie. This is clearly not the case. See *supra* note 208 and accompanying text.

221. Stillman, *supra* note 12, at 10.

222. Hetland & Hansen, *supra* note 6, at 195 ("Section 726 is the linchpin of the entire system; it is the statute which, both in its text and its decisional exegesis, most fully and vividly reflects the fundamental policy concerns and choices of the real property system.").