California's One Action Rule: A Cautionary Tale for Energy Lenders

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It may be surprising to some that the state of California ranks third in the nation in crude oil production, behind only Texas and North Dakota.[1] Accordingly, it should be no surprise that many energy lenders have exposure to loans secured by oil and gas assets located there. At least a handful of exploration and production (E&P) companies with California assets have filed for bankruptcy protection in the last two years and there may be more to come as commodity prices have yet to fully recover.

Lenders that have taken real property security in California likely recall there is something unique about this type of collateral. California's so-called "One Action Rule" is often mentioned by counsel during the drafting stage of the loan documents and then fades to the background as the loan runs its course. However, as lender groups organize to discuss forbearances, workouts and strategic options, they should be mindful of the operation of this rule because, in some cases, violations can result in the loss of a lender's real property collateral located in California.

California's One Action Rule

California's "One Action Rule" is found in Section 726(a) of the California Code of Civil Procedure and provides that: "[t]here 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."[2] The purpose of this rule is twofold. It requires a secured creditor to bring a single action to enforce its real property security for the underlying debt. In addition, it also embodies the "security first rule," which, according to the Supreme Court of California, is "hornbook law" in the state. The "security first" aspect of the One Action Rule requires a secured creditor to proceed first against the real property collateral before seeking a money judgment against the borrower.

The One Action Rule can be raised by an obligor as an affirmative defense to require the creditor to foreclose on the real property collateral before seeking a money judgment against that obligor. However, it can also be used as a sanction against a secured lender for violating the rule, resulting in the loss of the real property security. This is based on the theory that, by not first foreclosing on the real property security, the lender made an election of remedies and therefore waived its rights in respect of the security.[3]

It must be noted that oftentimes, although there is real property collateral located in California, the principal loan documents are governed by the laws of another state. This may lead one to question whether the One Action Rule does, or even should, apply to such a transaction. California jurisprudence on this issue needs to develop further before we have a definitive answer to these questions. However, the One Action Rule, including its "security first" principle, have been described as "fundamental" and grounded in the public policy of the state. Accordingly, it is unclear whether the California courts or legislature will consistently permit parties to contract around the

rule by choosing the law of another state to govern their loan documents. In the interim, lenders should carefully navigate the boundaries of the rule and be conscious of it in any transaction where real property collateral is located in the state of California.

What Actions Violate the Rule?

Each of the following has been found to be a creditor's "one action" for purposes of the One Action Rule, after which the creditor cannot seek recourse to any remaining real property collateral:

1. judicial foreclosure of only a portion of the real property securing a debt;
2. recovery of a money judgment on the debt; and
3. pre-judgment attachment of assets not constituting collateral.

Importantly, the California Supreme Court has also held that, although not technically an "action" within the meaning of the One Action Rule, a bank's setoff against the unpledged bank accounts of a customer in (partial) satisfaction of an obligation that was secured by real property, nevertheless violated the "security first" principle of the One Action Rule. In that case, the bank set off approximately $3,000 from the obligor's accounts against a total outstanding debt of around $1,000,000. Because the obligation was secured by real property collateral that was not first exhausted, the court held that the setoff amounted to a waiver of the bank's security interest in the real property – an alarming result for the lender, considering it lost its security in return for a 0.3% recovery via setoff.[4]

What Should Lenders Do?

The potential for such a devastating result gives rise to questions as to how to prevent loss of one's rights in collateral by inadvertent or unwitting application of the One Action Rule. In the first instance, loan documents in transactions involving a lending group that are secured by any California real property should prohibit the lenders, along with any hedge providers or other creditors that share in the collateral, from taking enforcement actions, including exercising setoff rights, without first obtaining the consent of the administrative agent. This allows the administrative agent to retain control of the exercise of any enforcement actions, police compliance with the One Action Rule, and obtain local counsel advice if necessary before any action is undertaken.

The question of whether setoff in particular is permissible often comes up in the context of E&P loans where the collateral for the loan also secures hedges provided to the borrower and other obligors by the lenders, their affiliates, or even third parties. If a hedge is terminated and the hedge provider owes the borrower a cash termination payment, can the hedge provider set that amount off against amounts owed by the obligors under the loan documents? Can hedge providers set off against separate collateral that is not shared with the lender group if they are owed a payment by the borrower under the hedge agreement? We think the prudent course of action is to subject these hedge providers to the same restrictions that are applicable to the lender group in the loan documents when it comes to the One Action Rule, so that each potential action can be closely analyzed at the relevant time under the loan documents and then existing legal authority.

Additionally, as a loan secured by California real property approaches workout, foreclosure or bankruptcy, the administrative agent and its counsel should consistently remind the lender group and any other secured creditors not only of the restrictions imposed by the One Action Rule, but also the severe consequences that could arise if they are not complied with strictly. The

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administrative agent and lenders should also work closely with California licensed counsel to make sure that any actions they are contemplating do not violate the One Action Rule. Of course, of utmost importance is retention of the security, but value also lies in not providing the borrower or any junior creditors with leverage in negotiations based on lender actions that could be seen as falling into the “gray area” of the One Action Rule.

The bottom line is that lenders holding distressed loans secured by California real property should not ignore the One Action Rule. It must be taken into account in strategizing in respect of their possible remedies, as the ramifications for a miscalculation under the rule could be catastrophic.

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[1] U.S. Energy Information Administration, March 2016.

[2] Although the statute refers only to mortgages, it is equally applicable to deeds of trust.

[3] In addition to the One Action Rule, secured creditors must take into account the various "anti-deficiency" rules that also exist under California law in determining how to proceed with enforcement of the secured obligations.

[4] See Security Pacific National Bank v. Wozab, 51 Cal. 3d 991 (1990).