

# REAL PROPERTY LAW

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## Mixed Collateral Foreclosures: New Turns on a Twisted Path

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Lenders frequently take mixed collateral (i.e., real property and personal property or fixtures) to secure their loans. Counsel for both lenders and borrowers often do not fully understand their rights and remedies under the California statute that governs disposition of mixed collateral after a debtor's default. Norma J. Williams provides a clear and concise explanation of the mixed collateral statute, discusses recent developments in the law, and addresses questions about the statute that remain unanswered.



Norma J. Williams

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## Mixed Collateral Foreclosures: New Turns on a Twisted Path

NORMA J. WILLIAMS

How would you advise a lender client to collect on a defaulted debt that is secured by both real estate (*e.g.*, the debtor's home or commercial building) and personal property (*e.g.*, the debtor's inventory or equipment)? Conversely, if the debtor came to you for advice, could you properly advise her of available defenses arising from the lender's proposed or actual disposition of the collateral? These situations commonly arise for attorneys because lenders in both large and small business transactions frequently take mixed collateral (*i.e.*, real and personal property) to secure the debt.

Because failure to observe proper foreclosure or disposition procedures can have drastic consequences for the lender (*e.g.*, loss of security or denial of deficiency against the debtor), counsel for both lenders and debtors should be thoroughly familiar with the options and procedures in dealing with mixed collateral, which are primarily embodied in Comm C §9501(4). This article discusses the mixed collateral foreclosure scheme in California, the first direct judicial interpretation of Comm C §9501(4) in *Aspen Enters., Inc. v Bodge* (1995) 37 CA4th 1811, 44 CR2d 763, and some of the unresolved issues under that section. Unless otherwise indicated, all section references in this article are to the Commercial Code, and a disposition of real or personal property collateral will be referred to as a foreclosure. This article will not discuss those aspects of the mixed collateral statutes relating to real-property-secured loans to an individual primarily for personal, family, or household purposes (see Comm C §9501(4)(c)(v)).

### Mixed Collateral Financing

Mixed collateral financing occurs when both real property and personal property or fixtures secure a single obligation. This is to be distinguished from situations in which there are multiple separate obligations, each of which is either unsecured or secured by either real property or personal property but not both.

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Mixed collateral financing might occur in a number of scenarios:

- A creditor takes both types of collateral with respect to an asset in which the real and personal property or fixtures are integrally related, such as a hotel, a factory, a winery, or a dairy;
- The mixed collateral consists of unrelated personal and real property, each taken to enhance the amount of security for the obligation;
- One asset, usually the real estate, is the main asset and personal property is taken as additional security;
- There are separate obligations, separately secured, but documentation contains a dragnet clause such that security for one obligation is also security for others.

### Inconsistent Remedies Systems

If not for Comm C §9501(4), a creditor's remedies for a default under an obligation secured by mixed collateral would be governed by two separate bodies of law: the Commercial Code (for personal property) and the real property statutes. The primary difference between the Commercial Code and the real property statutes is that the real property foreclosure rules are more extensively prescribed, while the Commercial Code rejects such detailed regulation and requires a creditor to comply only with an overriding "commercial reasonableness" standard in enforcing its remedies (see, *e.g.*, Comm C §9504(1)).

#### Remedies Under Commercial Code

Under Comm C §§9501-9508, the creditor may either sue the debtor directly on the debt or seek recourse against the personal property collateral. Comm C §§9501(4)(a), 9503-9504. If the creditor seeks recourse against the collateral, the creditor can sell the property either judicially (§9501(4)(a)) or nonjudicially (§9504). The debtor cannot reinstate the debt and has only a limited right to redeem after default and before the creditor has either disposed of the collateral, entered into a contract for its disposition, or kept the collateral in satisfaction of the debt. Comm C §9506.

In order to redeem, the debtor must pay the full amount of the obligation. Comm C §9506. If a sale occurs and the proceeds are not sufficient to pay the indebtedness, the creditor can obtain a deficiency judgment unless the sale was not "commercially reasonable" or otherwise was not conducted in accordance with proper notice procedures. Comm C §9504.

#### Real Property Remedies

In contrast, a creditor with real property security cannot sue directly on the debt, but rather must first foreclose on the collateral. CCP §726. The debtor can rein-

state the debt under CC §2924c(e) until five business days before the foreclosure sale. If the sale is conducted judicially, the debtor has a three-month or one-year right of redemption after the sale. CCP §729.030. Moreover, there are substantial limitations on the availability of a deficiency judgment against the debtor (e.g., CCP §§580a, 580b, 580d, and 726(b)).

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***“Before the legislature adopted Comm C §9501(4), a creditor who had both real and personal property collateral would be faced with inconsistent remedies systems.”***

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Before the legislature adopted Comm C §9501(4), a creditor who had both real and personal property collateral would be faced with the inconsistent remedies systems described above.

### History of Mixed Collateral Statute

Code of Civil Procedure §726 contained the first treatment of mixed collateral financing. Before 1963, that section provided that there could be only one form of action on any debt secured by a mortgage on real or personal property (i.e., a creditor was required first to foreclose on both types of collateral before seeking to collect the debt personally from the debtor or the debtor's unencumbered assets). In 1963 (effective in 1965 with California's adoption of the Commercial Code), the legislature amended CCP §726 to delete the reference to personal property, and enacted Comm C §9501(4), which provided:

If the security agreement covers both real and personal property, the secured party may proceed under this chapter as to the personal property or he may proceed as to both the real and the personal property in accordance with his rights and remedies in respect of the real property in which case the provisions of this chapter do not apply.

The oft-expressed goal of the legislation, as stated by the Committee that drafted the 1985 amendments to the statute, was

to minimize the interference with the rights and remedies of the secured party vis-à-vis the personal property collateral arising from the fact that the secured party also holds real property collateral, while at the same time not expanding the rights and remedies of the secured party vis-à-vis the real property collateral simply because he also holds personal property collateral.

*Report of the Uniform Commercial Code Committee of the State Bar of California on Proposed Amendment to California Uniform Commercial Code §9501(4) (Dec. 7, 1984) 36 UCLA L Rev 69, 72 (Oct. 1988).*

In 1985, because of numerous unanswered questions raised by §9501(4) and the questions raised after the statute's interpretation in *Walker v Community Bank* (1974) 10 C3d 729, 735, 111 CR 897, about whether omitted personal property was subject to the one-action rule, the legislature substantially amended §9501(4), and the one-paragraph rule became a complicated provision containing seven paragraphs and twelve subparagraphs. In 1992, additional amendments were adopted to clarify the 1985 statute, to address issues raised by *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201 (discussed below), and to set forth the provisions of the Commercial Code that apply to a unified sale. Stats 1992, ch 1095.

### Real Property Foreclosure Rules

In order to understand the interaction between the Commercial Code rules and the real property statutes in the mixed collateral setting, it is necessary first to discuss generally the relevant major real property rules. As stated above, a primary goal of the mixed collateral statute was to reconcile the enforcement scheme regarding obligations secured by personal property with that governing obligations secured by real property. It also sought to establish whether certain basic real property—and, to a lesser extent, personal property—provisions are applicable to mixed collateral. The specific real property rules are (1) the one-action/security-first principles contained in CCP §726; (2) the antideficiency provisions of CCP §§726(b), 580a, 580b, and 580d; and (3) CC §2924c, governing reinstatement. A complete discussion of those statutes is beyond the scope of this article and the treatment here is only as detailed as necessary to understand the mixed collateral statute.

#### One-Action Rule

Code of Civil Procedure §726 provides that foreclosure is the only form of action for the recovery of debt or enforcement of a right secured by a mortgage on real property. The section requires that a creditor with such security interest must foreclose on that collateral before seeking recovery from the debtor or the debtor's unpledged assets. As such, the section contains both a one-action rule and a security-first rule. The section can be the basis of either (1) an affirmative defense, which would permit the debtor to require that the secured creditor who commences an action on the obligation include in the action all real property that is collateral for the obligation, or (2) a sanction, which would prevent the creditor who did not include the real property from foreclosing on the omitted real property following the conclusion of that action. *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 997, 275 CR 201.

### Antideficiency Laws

Another set of real property laws that must be understood in connection with the mixed collateral statute are the antideficiency laws, particularly CCP §§580a, 580b, 580d, and 726(b). Section 9501(4) specifically refers to these statutes and defines their applicability in a mixed collateral scenario.

#### Code of Civil Procedure §580a

Code of Civil Procedure §580a, the "fair value" rule, applies to deficiency judgments which may be sought after a nonjudicial foreclosure. The statute requires that a hearing be held to determine the fair market value of the foreclosed real property, and limits the creditor's deficiency judgment to the difference between the outstanding debt and the established market value (not to exceed the difference between the debt and the sale proceeds). To a certain extent, the section has become moot because of the later enactment of CCP §580d, which prohibits deficiency judgments after nonjudicial foreclosures. However, CCP §580a has been held to apply to junior creditors who seek a deficiency judgment after purchasing property at a nonjudicial sale held by a senior creditor. *Walter E. Heller W., Inc. v Bloxham* (1985) 176 CA3d 266, 273, 221 CR 425; *Citrus State Bank v McKendrick* (1989) 215 CA3d 941, 946, 263 CR 781.

#### Code of Civil Procedure §726(b)

Code of Civil Procedure §726(b) is the fair value rule governing judicial foreclosures. The statute limits the creditor's right to a deficiency judgment to the lesser of the difference between (1) the unsatisfied debt and the established fair value of the property, or (2) the unsatisfied debt and the foreclosure sale price.

#### Code of Civil Procedure §580b

Code of Civil Procedure §580b prohibits a deficiency following foreclosure on a purchase money obligation in two standard transactions: (1) seller financing taken in the sale of any type of real property, commercial, residential, or otherwise; and (2) financing from a third party lender given in connection with the purchase of an owner-occupied residential property of one to four units. When a transaction does not fit within one of the two standard types, the courts look at the specific facts of the case to see whether the purposes of CCP §580b would be met by applying its prohibitions. *Spangler v Memel* (1972) 7 C3d 603, 610; *Roseleaf Corp. v Chierghino* (1963) 59 C2d 35, 41, 27 CR 873; *Union Bank v Anderson* (1991) 232 CA3d 941, 946, 283 CR 823.

#### Code of Civil Procedure §580d

Code of Civil Procedure §580d prevents a creditor from obtaining a deficiency after a nonjudicial foreclosure.

#### Reinstatement

Civil Code §2924c permits the debtor with a loan secured by real property to reinstate the debt until five business days before the foreclosure sale by paying only the amount of the obligation in default.

### Provisions of the Mixed Collateral Statute

#### Foreclosure Options

Commercial Code §9501(4)(a) gives the mixed collateral creditor three foreclosure alternatives.

#### Separate Sales

Commercial Code §9501(4)(a)(i) permits the creditor to proceed, in any sequence, (1) in accordance with the secured party's rights and remedies in respect of real property as to the real property security, and (2) in accordance with the Commercial Code as to the personal property or fixtures. This subparagraph establishes the right of a creditor holding mixed collateral to conduct separate foreclosure sales on the real property and the personal property in accordance with the laws governing each.

#### Unified Sale

Commercial Code §9501(4)(a)(ii) allows the creditor to conduct a unified sale of both the real and personal property, in which case the sale will be governed by real property law rules. The sale can cover some or all of the real property together with some or all of the personal property. The sale can be judicial or nonjudicial. When a unified sale is conducted, only three of the Commercial Code remedy provisions apply: (1) The application of proceeds must be in accordance with the parties' agreement; (2) the value of the personal property must be included in the fair market value of the property sold for purposes of determining the right to a deficiency judgment under CCP §726(b) or §580a; and (3) a good-faith-purchaser test applies for the creditor or other purchaser at the sale to insulate them from the consequences of noncompliance with the procedures for sales of real property. Comm C §9501(4)(a)(ii)(A).

Subparagraph (a)(ii) also provides that there is no irrevocable election to proceed by unified sale until actual disposition, and then only as to property so sold. Accordingly, the creditor can stop proceeding with a uni-

fied sale and instead proceed with separate foreclosures, or stop foreclosing altogether.

### Combination of Separate and Unified Sales as to Personal Property

Commercial Code §9501(4)(a)(iii) permits the creditor to proceed in any sequence as to part of the personal property under the separate personal property foreclosure option, and as to the remaining personal property under the unified foreclosure option.

#### "Treaty"

Commercial Code §9501(4)(b)(i) establishes what has been called the treaty between the personal property and real property bodies of law. With important exceptions described in Comm C §9501(4)(c) (discussed below), the following significant provisions of real property law do not apply to personal property in a nonunified foreclosure sale, or to the obligation:

- CCP §726;
- acceleration or reinstatement;
- prohibition on deficiency judgments;
- limits on rights to proceed as to the collateral;
- limitations on deficiency based on the fair value rules;
- security-first rules.

Accordingly, these real property law principles will not affect a secured party's right regarding either personal property that was not included in a unified sale or the obligation, even if the creditor also holds real property collateral.

►**EXAMPLE:** A creditor who has mixed collateral does not elect to conduct a unified sale. The creditor forecloses on the real property nonjudicially and then on the personal property nonjudicially. Is this permissible?

Answer: Yes. The creditor is not precluded by CCP §726 from pursuing the personal property. Commercial Code §9501(4)(b)(i) excludes the personal property from the property covered by the one-action rule, which requires the creditor to include all collateral in the sale. Subparagraph (b)(i) also clarifies that the failure of the mixed collateral creditor to comply with any of the real property rules described in subparagraph (b)(i) does not result in a loss of the obligation. Thus, failure to comply with the real property laws affects only the creditor's remedies as against the real property. The obligation remains alive for purposes of enforcing it against the personal property collateral.

►**EXAMPLE:** A creditor whose debt is secured by mixed collateral forecloses judicially against real property and later seeks a deficiency judgment. Can the debtor require the inclusion of the personal property?

Can the creditor recover against the personal property after recovering as against the real property?

Answer: The debtor cannot require the inclusion of the personal property because CCP §726 does not apply to the omitted personalty. The creditor can recover as against the personal property after recovery against the real property collateral.

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***"Even if an obligation became unenforceable under the real property rules because a creditor did not first resort to its security, the obligation remains enforceable against personal property and fixtures under the Commercial Code."***

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#### No Loss of Obligation

Commercial Code §9501(4)(b)(ii) expands upon subparagraph (b)(i) by specifically addressing the security-first aspect of CCP §726. Subparagraph (4)(b)(ii) states that, notwithstanding failure to comply with the security-first rules, the creditor will not lose its right to enforce its outstanding debt against personal property. This provision addresses dicta in *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, which indicated that, under certain scenarios, a CCP §726 violation may result in loss of the obligation as well as loss of the security (see discussion below). Accordingly, even if an obligation became unenforceable under the real property rules because a creditor did not first resort to its security, the obligation remains enforceable against personal property and fixtures under the Commercial Code.

►**EXAMPLE:** Following default by the debtor, and before it takes any other action, a mixed collateral bank lender unilaterally sets off the obligation against the debtor's bank account, in which the bank has no security interest. May the bank foreclose on its real property collateral? May it foreclose on its personal property collateral?

Answer: Pursuant to *Wozab* (but subject to dicta that may ameliorate the result), the creditor cannot foreclose on the real property collateral because it violated the security-first aspect of CCP §726 in setting off against the bank account before foreclosing on its real property security. Under subparagraph (b)(ii), the bank could proceed against the personal property collateral.

#### Exceptions to "Treaty"

Commercial Code §9501(4)(c) contains limitations on the broad statement in Comm C §9501(4)(b) that real property provisions do not apply to personal property or

to the obligation if the lender is not proceeding in a unified sale.

#### Application of Code of Civil Procedure §580b

Commercial Code §9501(4)(c)(i) provides that subparagraph (b) does not limit the application of CCP §580b (purchase money antideficiency protection). It is interesting to note that CCP §580b itself specifically refers to the mixed collateral situation, and is the only real property antideficiency statute that does so. The statute states that when both a chattel mortgage and a deed of trust have been given to secure payment of the combined purchase price of both real and personal property, no deficiency judgment shall lie under either if no deficiency would lie under the deed of trust. As discussed above, subparagraph (c)(i) preserves the debtor's rights under CCP §580b when the creditor has mixed collateral security. Therefore, if both personal property and real property are purchased in a transaction that fits under CCP §580b, there cannot be a deficiency following the sale of either or both. Subparagraph (c)(i) does not, however, grant purchase money protection if only personal property was purchased, because CCP §580b applies only if both real property and personal property were purchased.

#### Application of Code of Civil Procedure §726

Commercial Code §9501(4)(c)(ii) states that, if the secured party commences an action (presumably an enforcement action against personal property) seeking a monetary judgment on the debt, subparagraph (b) does not prevent the debtor from requiring the creditor to include in that action any interest in real property that secures the debt. If the creditor obtains a monetary judgment on the debt, subparagraph (b) does not prevent the debtor from asserting that the encumbrance on the real property securing the debt and not included in the action is unenforceable. Thus, subparagraph (c)(ii) reaffirms the affirmative defense and sanction aspects of CCP §726 if the creditor brings an action on the debt.

A "monetary judgment on the debt" is defined in Comm C §9501(4)(f) as a judgment for the recovery from the debtor of all or part of the principal amount of the secured obligation, including contractual interest thereon. The definition does not include a judgment that provides only for other relief (whether or not that other relief is secured by the collateral), such as one or more forms of nonmonetary relief and monetary relief ancillary to any of the foregoing, such as attorney fees and costs incurred in seeking the relief.

►**EXAMPLE:** A creditor with a loan secured by mixed collateral files a judicial action on the note to enforce its lien against the personal property, and seeks a deficiency judgment. Can the creditor later proceed against

the real property? Can the creditor recover a deficiency judgment?

Answer: The debtor can require the creditor to include the real property in the action. If the creditor does not, the sanction effect of CCP §726 would preclude the creditor from foreclosing on the real property because the creditor's first action sought a monetary judgment on the debt. By virtue of Comm C §9501(4)(b), the creditor may be able to recover a deficiency judgment (unless CCP §580b precludes it, as discussed above).

►**EXAMPLE:** A creditor with a loan secured by mixed collateral files a judicial action that solely seeks claim and delivery to obtain possession of the personal property and such relief is granted. Is the creditor prohibited from later proceeding against the real property?

Answer: No. The creditor has not recovered a "monetary judgment on the debt," but rather only non-monetary relief. The creditor could also recover its attorney fees and costs in seeking such possession and be able to proceed later against the real property.

Commercial Code §9501(4)(e) also addresses the concept of monetary judgment on the debt. That provision states that, if the creditor brings an action that is not for a monetary judgment on a debt, it can later bring an action for a monetary judgment on the debt.

#### Application of Reinstatement Rules

Commercial Code §9501(4)(c)(iii) has two aspects, one of which is among the most controversial parts of the statute. It provides that, except to the extent that a secured party is proceeding as to personal property in a unified sale, the reinstatement rules of CC §2924c do not apply to the secured party's right to proceed against personal property and fixtures.

►**EXAMPLE:** A creditor whose loan is secured by mixed collateral conducts separate foreclosure sales of the real property and the personal property. Is the creditor required to delay its foreclosure sale against the personal property during the reinstatement period set forth in CC §2924c?

Answer: No. This is a fairly uncontroversial aspect of subparagraph (c)(iii). Report of the Uniform Commercial Code Committee of the State Bar of California on Proposed Amendment to California Uniform Commercial Code §9501(4), published as Appendix I to Hirsch, Arnold, Rabin & Sigman, *The U.C.C. Mixed Collateral Statute—Has Paradise Really Been Lost?* 36 UCLA L Rev 1, 69 (1988).

►**EXAMPLE:** Suppose the facts are the same as in the preceding example. During the reinstatement period, the debtor reinstates under CC §2924c. May the creditor continue with its sale of the personal property?

Answer: Yes. This has been one of the most controversial aspects of the subparagraph. In criticism, some have argued that, if the debt is reinstated as to the real property, it should be reinstated for all purposes. 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 Cal L Rev 185, 201 (1987). To prohibit the creditor from going forward<sup>†</sup> with the personal property foreclosure, however, would go against one of the goals in enacting §9501(4), *i.e.*, to protect the creditor's remedies against the personal property collateral from interference that arises only because the creditor also has real property collateral. Although not expressly prohibited from continuing with the personal property sale, however, the lender should consider the foregoing arguments, the possibility that a commercial reasonableness requirement may later be held to apply to its election to conduct separate sales (especially if the collateral comprises an integrated operation) (see discussion below), and any potential lender liability claims that may be made based on the continuation of the personal property sale.

►**EXAMPLE:** A mixed collateral creditor first conducts a separate personal property foreclosure and plans to proceed with a real property foreclosure. Sufficient proceeds are realized from the personal property foreclosure to reinstate the debt vis-à-vis the real property. Is reinstatement accomplished?

Answer: This question is not answered in the statute. In view of the fact that there is no clear authority on this issue, the creditor probably should carefully consider whether to go forward with the real property foreclosure.

#### Application of Code of Civil Procedure §580d

Commercial Code §9501(4)(c)(iv) provides that Comm C §9501(4)(b) does not deprive the debtor of the protection of CCP §580d against a deficiency judgment following a sale of the real property collateral pursuant to a power of sale in a deed of trust or mortgage. This is fairly straightforward. Read together, subparagraphs (b) and (c)(iv) imply that a mixed collateral creditor can foreclose its interest in the personal property collateral after foreclosing nonjudicially on the real estate collateral, but that the creditor cannot obtain a deficiency judgment after the sale of the personalty.

►**EXAMPLE:** A creditor with mixed collateral conducts a nonjudicial foreclosure sale on the personal property and then brings an action to foreclose judicially on the real property and to recover a deficiency. Is this action permissible?

Answer: Yes. Code of Civil Procedure §580d would not bar a deficiency judgment because it is inapplicable to the personal property foreclosure under Comm C §9501(4)(b), although the right to a deficiency may be prohibited by CCP §580b or limited by CCP §726(b). The effect of the creditor's failure, if any, to comply with the personal property sale requirements is not addressed by the statute; see discussion below.

#### Application of Fair Value Rules

Subparagraph (c)(vi) states that paragraph (b) does not deprive the debtor of CCP §580a protection after a real property foreclosure. Accordingly, §9501(4) has no effect on the borrower's ability to obtain a fair value hearing following foreclosure on real property only. Also, although the debtor does not have a right to a fair value hearing after the separate sale of personalty because of subparagraph (b), it has such a right under CCP §726(b) after a unified judicial sale of realty and personalty, and under CCP 580a after a unified nonjudicial sale of realty and personalty.

#### Wozab Conduct Issues

In *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, a bank had set off against the outstanding obligation the debtors' funds in a bank account that the debtors maintained at the bank. The bank had no security interest in the account. The debtors argued that the bank's actions violated the one-action rule, thus invalidating both the bank's lien on the debtors' real property that was security for the loan, and the obligation as a whole.

The *Wozab* court held that the bank's action did not violate the one-action aspect of CCP §726, but instead violated the security-first rule. As such, the bank lost its security interest in the real property. This issue was moot, however, because the bank had reconveyed the real property to the debtors at their request. The court held that loss of the obligation was not the appropriate sanction. The court also stated in dicta that a creditor who promptly returns seized assets on which it has no lien, and against which it inadvertently offset the debt, might not be penalized at all except for the debtors' consequential damages. If the creditor refuses the borrowers' demand to release the seized asset, however, the creditor risks forfeiture of both its security and the entire underlying obligation.

Commercial Code §9501(4)(c)(vii) is intended to address these issues raised by *Wozab*. It provides that if the secured party violates the security-first principle of CCP §726, paragraph (b) does not prevent the creditor from correcting the violation, or prevent the debtor from either requiring the creditor to correct the violation or asserting the subsequent unenforceability of the encumbrance on any interest in real property securing the obli-

gation, or the unenforceability of the obligation, except to the extent that the obligation is preserved by Comm C §9501(4)(b)(ii), for enforcement against personal property collateral.

### **Personal Property Sale Proceeds**

Commercial Code §9501(4)(d) provides that proceeds from a personal property foreclosure will not cure any nonmonetary default. The proceeds also will not cure any monetary default (even though they will, to the extent of the proceeds, satisfy the secured obligation) so as to adversely affect the creditor's ability to proceed against any remaining personal property collateral. All proceeds are to be applied to the secured obligation in accordance with the parties' agreement and the law.

►**EXAMPLE:** A creditor's loan is secured by real property and multiple items of personal property. The note contains an acceleration clause. The debtor misses a payment. May the creditor sell each of the items of the personal property even after having collected proceeds sufficient to pay the delinquent payment? Will the total sales proceeds from sale of the personal property be applied to reduce the debt? Will the proceeds collected cure the default so as to prohibit the creditor from proceeding against the real property collateral?

Answer: The creditor can continue to sell the personal property even after proceeds have been realized in an amount equal to the delinquent payments without having such application cure the monetary payment default. The total amount of proceeds would reduce the indebtedness. The question of whether the total amount would also have to be applied to cure any default regarding real property collateral is unanswered. It would appear that it would have to be so applied so that the creditor would be precluded from proceeding with the real property foreclosure.

### **Good Faith Purchaser**

Subparagraph (g) sets forth the requirements for being a good faith purchaser who will take free of all claims, interests, or title defects that may arise out of the creditor's failure to comply with the real property foreclosure rules in a unified sale. A purchaser will be a good faith purchaser unless (1) the purchaser is the creditor and its failure to comply occurred other than in good faith; or (2) the purchaser is other than the creditor and, at the time of real property foreclosure, the purchaser knew about the noncompliance and knew that the noncompliance occurred other than in good faith.

Even if the purchaser at the foreclosure sale is not considered a good faith purchaser, a subsequent purchaser for value who acquires an interest in the real property from the purchaser at that foreclosure takes that

interest free from any claim or interest of another person, or any defect in title, based on that noncompliance, unless at the time of acquiring the interest the subsequent purchaser knew about the noncompliance and was aware that it had occurred other than in good faith. Comm C §9501(4)(g).

### **Personal Property Included in Fair Value Calculations**

Commercial Code §9501(4)(h) states that the personal property or fixtures included in a unified sale are considered to be included in the determination of the value of the real property sold for purposes of applying the fair value rules of CCP §580a or §726(b).

### **Aspen Enters., Inc. v Bodge**

Section 9501(4) recently received its first direct judicial interpretation in *Aspen Enters., Inc. v Bodge* (1995) 37 CA4th 1811, 44 CR2d 763. *Aspen* dealt solely with §9501(4)(a) regarding a creditor's enforcement options. Bodge had purchased a retail tire outlet from Aspen and had given Aspen a note secured by part of the store inventory and residential real property. After Bodge defaulted, Aspen sued for breach of the note and obtained a writ of possession. Aspen repossessed part of the inventory pursuant to the writ. Aspen later amended its complaint to add a cause of action for judicial foreclosure. Aspen inventoried the tires repossessed, generated computer invoices giving Bodge credit for the items at the prices Bodge originally paid for them (about \$7400), and sent the (credit) invoice to Bodge. Aspen segregated the tires in its warehouse before resolution of Bodge's challenges to the writ of possession, but thereafter returned the tires to its inventory where they were commingled with other tires in Aspen's inventory.

Because the obligation was approximately \$103,000, there was a deficiency due after the repossession of the tires. Bodge contended that Aspen was precluded from obtaining the deficiency because it had failed to conduct a sale or give notice of sale as required by Comm C §9504. Aspen countered in part that the deficiency was not barred, because Aspen had elected a unified sale by amending its complaint to include a cause of action for judicial foreclosure such that the sale was governed by real property rules, which did not require any notice under the Commercial Code.

In rejecting Aspen's argument, the court held that, although there were no published cases, the overall statutory scheme "suggests" that the unified foreclosure option under Comm C §9501(4)(a)(ii) was intended to be available only when the collateral consists of "closely related" elements of real property and personal property, such as business premises plus the fixtures and inventory located on the business premises. The court also



held that, because a creditor's sale of personal property collateral must be conducted in a commercially reasonable manner pursuant to §9504, the unified sale election can only be made when it is commercially reasonable to do so. It concluded that a sale of retail tire inventory combined with a residence was not commercially reasonable because the likely purchasers of either would probably not want to purchase the other. The court also interpreted the language of subparagraph (4)(a)(ii) (which states that there is not an irrevocable election of a unified sale until the actual disposition of the property) to mean that the mere filing of a "unified" complaint does not constitute a unified sale. The court therefore found that real property rules did not apply. The court, however, went on to find that the creditor was entitled to recover a deficiency under the Commercial Code rules governing personal property foreclosures because the creditor had effectively complied with the Comm C §9504 debtor-notification rules.

*Aspen's* unified sale discussion appears to be dictum because *Aspen's* disposition of the tires had not been completed pursuant to a unified sale under Comm C §9501(4)(a)(ii). The creditor already had disposed of the tires and had not recorded a notice of default under the real property statute (CC §2924) or notice of sale (CC §2924f) before the disposition. Thereafter, it was too late for *Aspen* to conduct a unified sale that included the tires.

The court's decision, however, appeared to be based solely on an interpretation of the statute that was clearly erroneous. The court's statements are inconsistent with the express language of the statute, although some justification may exist in the legislative history or foreclosure practices prior to the ruling.

#### **"Closely Related" Requirement**

Section 9501(4) does not, by its express terms, require that real property and personal property collateral be "closely related" in order for the creditor to elect the unified sale option, and none of the reports issued in connection with the enactment or amendment of the statute note that such a requirement exists.

►**NOTE:** The author's informal polling of the foreclosure departments of several title companies and independent trustees after the *Aspen* decision indicated that creditors seldom request to conduct a unified sale of unrelated assets, either before or after *Aspen*. Some poll respondents concluded that, before *Aspen*, they would not have honored the request and some indicated that they might have proceeded because there was no express statutory proscription.

#### **Commercial Reasonableness and Election of Options**

Section 9501(4)(a) also does not expressly require a creditor's election of enforcement options to be commercially reasonable. The initial version of the legislation, which resulted in the substantial amendment of §9501(4) in 1985 (SB 1305 (Beverly)), did contain such a requirement, but it was later deleted. In 1992, when the statute was again amended, the legislature again considered and rejected a commercial-reasonableness standard. See Report of the Assembly Subcommittee on the Administration of Justice on AB 2734 (Peace), as amended April 20, 1992, in connection with hearing on May 5, 1992, and Report of Uniform Commercial Code Committee of the Business Law Section of the State Bar of California regarding the Technical Amendments Bill to Section 9501(4) of the California Commercial Code and Related Statutes, as approved by the Committee at its September 6, 1991 Meeting. At the time of the 1985 amendments, however, Morris Hirsch, Vice Chair of the UCC Committee which drafted the bill, indicated in a July 26, 1985, letter to the Legislative Consultant to the Assembly Judiciary Committee that the deletion of the commercial-reasonableness standard was intended to leave existing law unchanged without indicating what the existing law was. Hirsch, Arnold, Rabin & Sigman, *The U.C.C. Mixed Collateral Statute—Has Paradise Really Been Lost?* 36 UCLA L Rev 1, 81 (1988). This also was evidently the intent of the UCC Committee in connection with the 1993 amendments. Thus, it may not be accurate to conclude that the lack of an express commercial-reasonableness requirement in the bill necessarily means that none exists.

As noted above in the discussion of subparagraph (a)(ii), however, the 1992 amendments specifically set forth the provisions of the Commercial Code that applied to a unified sale (§9501(4)(a)(ii)(A)), and commercial reasonableness was not one of them. Those amendments also made provisions of the Commercial Code governing the rights of a good faith purchaser inapplicable to personal property that was part of a unified sale. However, these amendments do not address the threshold issue of whether the creditor's initial election of how to proceed is itself subject to a commercial-reasonableness requirement.

#### **Unanswered Questions**

Some of the questions unresolved by the mixed collateral statute arise because the statute does not address the consequences of the creditor's failure to comply with the rules governing personal property sales when the creditor elects the separate foreclosure option and forecloses first against the personal property. As stated in the history of the statute, the statute is based on an assumption that the

real property foreclosure rules are more rigid than the body of personal property law. Mixed collateral under CCP §726, as it existed before adoption of Comm C §9501(4), and the version of 9501(4) in effect until 1985, was governed primarily by real property law. The 1985 and 1992 amendments to §9501(4) have been concerned primarily with how real property rules applied to the mixed collateral situation and limited the effect of the personal property rules. *Aspen* and other recent cases have raised issues, not directly addressed by §9501(4), about the consequences of failing to comply with the Commercial Code rules.

►**EXAMPLE:** Suppose the facts are the same as in *Aspen* except that the creditor conducts an actual nonjudicial sale of the personal property without proper notice. After the personal property sale, the creditor seeks to judicially foreclose on the real property and seek a deficiency judgment. Is this permissible?

Answer: This answer is not specifically addressed in §9501(4). What, for example, is the effect of Comm C §9504(2), which mandates compliance with certain notice and commercial-reasonableness provisions, failure to comply with which may cause the creditor to lose the right to a deficiency and/or the right to additional collateral? This issue begins to be addressed in *Connolly v Bank of Sonoma County* (1986) 184 CA3d 1119, 229 CR 396, a case in which the court held that, for purposes of the Commercial Code personal property remedies, a guarantor was a debtor and entitled to notice of a sale. In that case, the creditor had collateral consisting of aircraft and business equipment owned by the corporate debtor. The Connollys guaranteed the debt and secured the guaranty with their personal residence. Following a sale, without notice to the guarantors, of the corporate debtor's aircraft and business equipment, the court held that the bank could not recover on the guaranty or foreclose on the guarantors' personal residence. The *Connolly* court reasoned that such action would have constituted the recovery of a deficiency to which the bank was not entitled because it had failed to notify the guarantors of the sale of the personal property collateral. The bank argued that the residence was actually intended to secure the primary loan to the corporate debtor rather than the guaranty so that the bank could foreclose under Comm C §9501(4)(a), which allows sequential enforcement against real and personal property mixed collateral. The court, however, found that the residence was intended to secure the guaranty, not the loan, so the transaction was not a mixed collateral transaction. Accordingly, the court did not need to reach the issue of the effect of the

noncomplying personal property sale on any additional collateral for the loan.

The issue of noncomplying personal property sales was also suggested in *Aspen*, although the court did not need to reach a conclusion because it found that the creditor had effectively complied with the Commercial Code notice provisions. If the court had not reached this conclusion, however, the creditor presumably would have lost its right to the almost \$103,000 deficiency due to the effect of Comm C §9504(2)(b) (prohibition against deficiency for failure to comply with debtor-notification and commercial-reasonableness rules) and cases interpreting that section. Nothing in §9501(4) would seem to alter this result.

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***"The statute does not address the consequences of the creditor's failure to comply with the rules governing personal property sales when the creditor elects the separate foreclosure option and forecloses first against the personal property."***

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The Commercial Code also considers the effect of the failure of a sale to be commercially reasonable (apart from whether notice was given). In certain cases the failure to comply with commercial reasonableness requirements may give rise to the loss of the creditor's right both to a deficiency and to other collateral. Comm C §9504(2)(c)-(f). It does not appear that this would be the result if the sale was improperly noticed but was otherwise commercially reasonable. Comm C §9504(2)(e).

Challenging questions can be raised as to whether the sanction can also include loss of real property collateral. The Commercial Code does not govern rights in real property (Comm C §9104(j)) and its definitions of security interest and collateral clearly contemplate personal property only (Comm C §§1201(37), 9105(c)), but the issue is not expressly addressed in §9501(4).

### Conclusion

The legislature hoped to reconcile inconsistent remedy schemes and provide flexible options to creditors by adopting the mixed collateral statute and in large part it has done so. Section 9501(4), however, still remains confusing to many attorneys and their clients and may not have addressed all of the variations on the theme. Perhaps the lesson to mixed-collateral lenders and their counsel is "be careful." Then again, to lenders accustomed to dealing with real property collateral alone, that lesson should already be second nature.