Note

Western Security Bank v. Beverly Hills Business Bank: The Vanishing Utility of Letters of Credit in Real Estate Transactions

A lender in California is subject to significant limits upon the manner in which it can foreclose upon real property security, including preclusion of a deficiency judgment after a nonjudicial foreclosure, a one-action rule, and a security-first requirement. These restrictions on lender recourse have made it increasingly difficult for California lenders to attain any measure of credit enhancement. In Western Security Bank v. Beverly Hills Business Bank, *a California appellate court held that section 580(d) of the California Code of Civil Procedure, the anti-deficiency statute precluding a deficiency judgment after a nonjudicial foreclosure, barred a creditor's draw on a letter of credit post-nonjudicial foreclosure. The court left unanswered the potentially more important question of whether section 726(a) of the California Code of Civil Procedure, the section embodying the one-action rule and security-first requirement, would apply to a pre-foreclosure draw on a letter of credit resulting in loss of the lender's real property security. This Note concludes it would, considers the implications this will have upon the use of letters of credit in California real estate financing, and proposes that the California Legislature resolve this issue by exempting letters of credit from the anti-deficiency requirements.*

INTRODUCTION

In California, a complex statutory framework limits the process by which creditors can proceed against debt secured by real property. Two interrelated limits are embodied in sections 580(d)[1] and 726(a)[2] of the California Code of Civil Procedure. Section 580(d) precludes a creditor proceeding by nonjudicial foreclosure from obtaining a deficiency judgment.[3] Section 726(a) allows only one form of action by the creditor for the enforcement of a debt secured by a mortgage or deed of trust. As a result, a secured creditor can bring only one lawsuit to collect its debt.[4] A corollary to the one-action rule is the security-first principle,[5] which requires a secured creditor to proceed against his security in its entirety before pursuing a borrower's personal estate. The combination of these provisions gives protection to a defaulting borrower. Conversely, these provisions hinder a lender's attempts to collect the full amount of the debt owed.[6]

These statutes place limits upon the credit enhancement options

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1. CAL. CIV. PROC. CODE § 580(d) (West 1994). Section 580(d) reads in pertinent part:

> No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property . . . in any case in which the real property . . . has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.

Id.

2. CAL. CIV. PROC. CODE § 726(a) (West 1994). Section 726(a) reads in relevant 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." *Id.*

3. *See, e.g.*, Roseleaf Corp. v. Chierighino, 59 Cal. 2d 35, 43-44, 378 P.2d 97, 102, 27 Cal. Rptr. 873, 877-78 (1963).

4. *See, e.g.*, Security Pac. Nat'l Bank v. Wozab, 51 Cal. 3d 991, 997, 800 P.2d 557, 560, 275 Cal. Rptr 201, 204 (1990); *see also infra* part II.B.

5. *See, e.g.*, Darren Conley, Comment, *The Sanction for Violation of California's One-Action Rule*, 79 CAL. L. REV. 1601, 1608 (1991). *See generally infra* part II.B; *see also* ROGER BERNHARDT, CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE 187-88 (2d ed. 1990).

6. In California, certain forms of debt secured by real property provide the lender recourse against the borrower personally while other forms are treated in a manner similar to non-recourse debt regardless of the parties' desire for the lender to be able to recover a deficiency judgment. A deficiency judgment is recovery of the excess of the face value of the debt over the amount obtained from the sale of the property at foreclosure. According to California Code of Civil Procedure section 580(b), a lender cannot obtain a deficiency judgment after a foreclosure of real property that secures a purchase-money loan. CAL. CIV. PROC. CODE § 580(b) (West 1994). *See also* BERNHARDT, *supra* note 5, at 204. A purchase-money loan is defined as either (1) a loan in which the seller provides the funds to the buyer, or (2) a loan provided by a third party with the money being used to pay all or part of the purchase price of a dwelling of not more than four units occupied entirely or in part by the purchaser. *Id.* Because a deficiency judgment is not available under purchase-money loans, these loans are similar to non-recourse debt. The intricacies of the rules governing purchase-money loans are beyond the scope of this Note. Debt secured by real property, either partially or in total, that is not a purchase-money loan is assumed to provide recourse against the borrower personally. This recourse is limited by the patchwork of rules explored in this Note.

available to California lenders. Examples of attempts to obtain collateral in combination with real property that have been thwarted by section 580(d) are guarantees,[7] mortgage insurance,[8] and now, letters of credit.[9] Courts continue to expand these debtor protection statutes. During years of inflation and increasing property values, these sections lay dormant. But in the midst of a stagnant economy and falling property values the anti-deficiency policies awake from their hibernation and receive extensive judicial attention.

A recent credit enhancement of choice is the "standby" letter of credit. Its attraction lies in the perception that a letter of credit is "as good as cash."[10] The use of letters of credit has expanded to the point that, on December 31, 1992, the amount of "standby" letters of credit issued by U.S. banks was $162.4 billion, of which $20.1 billion was issued by California banks.[11] However, the recent California appellate court decision in *Western Security Bank v. Beverly Hills Business Bank*[12] calls into question the continued utility of letters of credit as additional security when used in combination with real property. The problems and questions created by the *Western Security Bank* opinion are of such a significant nature that the California Real Property Journal deemed *Western Security Bank* the

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7. Union Bank v. Gradsky, 265 Cal. App. 2d 40, 71 Cal. Rptr. 64 (1968).

8. Commonwealth Mortgage Assurance Co. v. Superior Court, 211 Cal. App. 3d 508, 259 Cal. Rptr. 425 (1989).

9. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 25 Cal. Rptr. 2d 908 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994).

10. *See* Amicus Brief for the California Banker's Association at 6, Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 25 Cal. Rptr. 2d 908 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994) (No. S037504) (prepared for the California Supreme Court urging review of *Western Security Bank*) [hereinafter CBA Brief]:

> The letter of credit is an extremely important tool of domestic and international commerce. Its unique attributes of speed, certainty of payment, efficiency, precision and cost effectiveness facilitate hundreds of billions of dollars of commerce annually that, in the absence of letters of credit, otherwise would not occur or would occur only with increased expense and risk to the parties. This important role as a facilitator of commerce is made possible by the special rules of letter of credit law.

Id. at 6-7 (footnotes omitted).

11. Federal Deposit Insurance Corporation's Statistics on Banking (June 1993). See also Peter J. Gregora, *Letters of Credit in Real Property Finance Transactions*, CAL. REAL PROP. J., Spring 1991, at 1, 1, which states, "There are no readily available statistics indicating the extent to which letters of credit are used in *real estate transactions*, but anecdotal evidence and personal experience indicate that the use of letters of credit has become quite common in real estate [financing]." *Id.* (emphasis added).

12. 26 Cal. App. 4th 1441, 25 Cal. Rptr. 2d 908 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994).

1993 case with the largest impact on California real property law.[13]

In part I, this Note examines how letters of credit are currently used in real estate financing. Part II discusses the mechanics of sections 580(d) and 726(a) and how these statutes interact to limit lender recourse. Part III discusses the *Western Security Bank* opinion and its effect on the general letter of credit doctrine. Part IV considers whether the interpretation that the *Western Security Bank* court gave to the rules relating to standby letters of credit significantly undermines the usefulness of such letters in real estate financing and concludes that it does. Part V considers possible judicial and legislative solutions to the problems posed by *Western Security Bank*, determines that the Legislature is the most likely source for a reevaluation of the rules articulated in *Western Security Bank*, and proposes legislation exempting letters of credit from the anti-deficiency statutes. Part VI is a brief conclusion.

I. THE USE OF STANDBY LETTERS OF CREDIT IN REAL ESTATE TRANSACTIONS

To completely understand the implications of the *Western Security Bank* decision, it is helpful to first explore the manner in which letters of credit are currently used in financing real estate transactions. In such a transaction, a letter of credit is typically used as a readily accessible source of payment of a portion of the debt in addition to the security of the real property underlying a deed of trust.[14] The basic letter of credit relationship involves three different parties and three contractual relationships. The three parties are referred to as the customer or borrower (the party obligated to reimburse the issuer if the letter of credit is drawn upon), the beneficiary or lender (the party with the right to draw on the letter of credit), and the issuer (typically a bank who issues the letter of credit). The contractual relationships can be called: (1) the reimbursement contract (obligating the customer/borrower to the issuer), (2) the letter of credit contract (obligating the issuer to the beneficiary/lender), and (3) the

13. Barry P. Jablon, *The "Top Ten,"* CAL. REAL PROP. J., Winter 1994, at 11, 11.

14. Letters of credit can be used in a variety of ways. For the sake of simplicity and to facilitate an understanding of how the most common type of letter of credit relationships will be affected by *Western Security Bank*, this Note is limited to the most basic manner in which letter of credit relationships are structured in real estate transactions. This is by no means the sole manner in which letters of credit are used as security by real estate lenders. In addition, this Note only discusses the manner in which letters of credit are used in the real estate context and does not explicitly consider the use of letters of credit in commercial sales transactions. For consideration of the various uses of letters of credit, see generally JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS ¶ 1.10 (1984); BROOKE WUNNICKE & DIANE B. WUNNICKE, STANDBY LETTERS OF CREDIT §§ 2.2, 2.3, 2.8 (1989).

financing contract (obligating the customer/borrower to the beneficiary/lender).[15] Although these relationships are necessarily interrelated, the value of a letter of credit is derived from treating these three contracts, and their underlying obligations, as completely independent.[16] This treatment is referred to as the "independence principle"[17] and is vital to the value of letters of credit as security enhancement devices.

In the real estate context, a letter of credit relationship is formed when a borrower approaches the issuer, typically a bank, and requests that the issuer promise to pay a certain amount to the lender in the event the lender presents documents stating that the borrower is in default. The issuer then requires the borrower to promise to reimburse the issuer if it pays on the letter of credit. This promise is the basis of the reimbursement contract. The reason for the creation of the letter of credit relationship is the underlying financing transaction. The beneficiary has a right to draw on the letter of credit only if it presents the issuer with a document stating the borrower is in default on this financing agreement. The issuer's obligation to pay is not triggered by the borrower's actual default, but merely by the lender's written representation of the default.[18] Because the enforcement of the issuer's obligation does not depend upon the underlying financing transaction, these obligations are considered "independent" of one another. The independence of these transactions shifts risk from the lender to the issuer of the letter of credit and the borrower.[19]

The distinct nature of the letter of credit obligations has resulted in the cardinal rule of letter of credit law: the independence principle. Many of the advantages letters of credit have over other credit devices emanate directly from this doctrine. As a result, uncertainty surrounding what this doctrine requires undermines the usefulness of letters of credit.

The independence principle obligates the issuing bank to review only the documents presented for facial compliance.[20] The bank is

15. Gregora, *supra* note 11, at 2.
16. *Id.* at 2, 3.
17. *Id.* at 3.
18. The written representation by the beneficiary must strictly conform to the requirements specified in the letter of credit contract. *See, e.g.*, Paramount Export Co. v. Asia Trust Bank, Ltd., 193 Cal. App. 3d 1474, 1480, 238 Cal. Rptr. 920, 924 (1987) ("Documents nearly the same as those required are not good enough.").
19. Gregora, *supra* note 11, at 2.
20. *See* Mercantile-Safe Deposit & Trust Co. v. Baltimore County, 309 Md. 668, 526 A.2d 591 (1987); Gerald T. McLaughlin, *Standby Letters of Credit and Guaranties:*

not required to investigate the facts that underlie these documents. Accordingly, the issuing bank's promise to pay on receipt of these documents is not contingent on the truth or falsity of the facts stated in the documents, which ensures that the lender will receive prompt payment. This guarantee of prompt payment regardless of disputes in the underlying contract has resulted in letters of credit being commonly considered "as good as cash."[21] The certainty of letter of credit payments eliminates significant risks a lender would otherwise assume.

The independence principle encourages lenders to loan money supported by a letter of credit because it reduces the two central risks a lender normally faces.[22] The first is the borrower's inability to repay the underlying debt. The issuer has essentially added its credit to that of the borrower. Because the issuer is generally a bank, the risk of the issuer's insolvency is slight; the financial consequences of a borrower's default will now be borne by the issuer to the extent of the letter of credit amount. Upon payment to the lender under the letter of credit, the issuer will typically have a right to reimbursement from the borrower. However, in many cases this reimbursement right (especially if unsecured) will be of little solace to the issuer because the borrower's inability to repay the lender usually indicates a similar inability to satisfy reimbursement obligations.[23]

The second risk shifted away from the lender is the loss of use of the letter of credit funds during a dispute concerning the underlying financing transaction.[24] One commentator describes this reduction in the lender's risk in the following way: "[T]he beneficiary is entitled to payment from the issuer under the letter of credit even though the customer [borrower] vigorously (and perhaps correctly) contends that the beneficiary has no right to payment under the underlying contract."[25] The practical significance is that the lender will have this money during the time in which the underlying contract is disputed. Thus, any delay in the resolution of the dispute will in no way hinder the lender's financial position.

Letters of credit have become increasingly popular due to the guaranteed payment mechanism created by the independence principle and the resulting diminishing of the lender's risk. Bending the strict rules embodied in the independence principle will impair this

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An Exercise in Cartography, 34 WM. & MARY L. REV. 1139, 1142-43 (1993); Gregora, *supra* note 11, at 4.

21. *See supra* note 10.

22. *See* Michael Stern, *The Independence Rule in Standby Letters of Credit*, 52 U. CHI. L. REV. 218, 222 (1985); Gregora, *supra* note 11, at 2-3.

23. Of course this would not be the case if a borrower defaulted for reasons other than financial infirmities.

24. Gregora, *supra* note 11, at 3.

25. *Id.*

risk shifting mechanism and severely lessen the utility of letters of credit as financing devices. The danger of a breakdown in the independent treatment of letter of credit obligations is especially acute when the independence principle collides with strong public policies, such as those embodied in California's anti-deficiency legislation.

II. CALIFORNIA'S ANTI-DEFICIENCY LEGISLATION

California's anti-deficiency scheme is a product of the Great Depression and the legislative distaste for foreclosures and forfeitures that occurred during that era for reasons beyond the debtors' control.[26] John R. Hetland and Charles A. Hansen aptly describe the development and motivation behind this legislation: "The [legislature had in mind the] unsavory visage of the mustachioed mortgagee in a top hat, ready to foreclose the family homestead, . . . resulting in a system that is generously hedged about with debtor protections and potential pitfalls for the unwary secured creditor."[27] Two protections created by this Depression Era legislation are sections 580(d) and 726(a).

A. Section 580(d): No Deficiency Judgment After a Nonjudicial Foreclosure

California Code of Civil Procedure section 580(d) provides that a deficiency judgment cannot be obtained on a note secured by real property after a trustee's nonjudicial foreclosure.[28] This provision

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26. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1453-54, 25 Cal. Rptr. 2d 908, 920 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994) (quoting John R. Hetland & Charles A. 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, 187-88 (1987)).

27. Hetland & Hansen, *supra* note 26, at 188-89. A footnote accompanying this text in the Hetland & Hansen article provides an enlightening view of the explicit favoritism provided borrowers over lenders by the California courts:

> [The court] in Freedman v. The Rector, 37 Cal. 2d 16, 230 P.2d 629 (1951), arguably California's most influential antiforfeiture decision[,] . . . referred to the creditor (a land contract vendor) as . . . [the villain] whom the law (characterized as a disinterested "Pontius Pilate") would allow to keep his "pound of flesh if he can carve it for himself." *Id.* at 21, 230 P.2d at 632 (quoting from Ballantine, *Forfeiture for Breach of Contract*, 5 MINN. L. REV. 329, 341 (1921)). Although the *Freedman* court does not use the name, the Ballantine article calls the creditor "Shylock," *id.* at 347, and the *Freedman* court's reference to a "pound of flesh" echoes this allusion.

Hetland & Hansen, *supra* note 26, at 188-89 n.17.

28. CAL. CIV. PROC. CODE § 580(d) (West 1994). *See generally* BERNHARDT,

was enacted in 1940 to place nonjudicial foreclosure on a parity with judicial foreclosure.[29] In *Western Security Bank*, the court accurately describes the differences between judicial and nonjudicial foreclosure:

> In a judicial foreclosure, the beneficiary or trustee . . . [obtains a judgment directing] the sale of the property and application of the proceeds of sale to the amount due on the debt . . . [T]he judgment may also contain a provision for allowance of deficiency and proceedings to determine the amount of deficiency . . . . Because judicial foreclosure permits recovery of a deficiency, the property must be sold subject to the debtor's right of redemption.
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> In a nonjudicial foreclosure, the trustee exercises the power of sale given him or her by the deed of trust . . . .
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> [T]he nonjudicial foreclosure is less expensive and more quickly concluded than a judicial foreclosure and *the debtor has no right of redemption.*[30]

Section 580(d) seeks to equalize judicial and nonjudicial foreclosure by focusing on the tradeoff between the borrower retaining his statutory redemption rights[31] and the lender obtaining a deficiency judgment. If the lender desires a deficiency judgment, she must institute a judicial foreclosure and the sale will be subject to statutory redemption rights. If she wishes an expedited sale resulting in nonredeemable title, section 580(d) will eliminate her right to a deficiency judgment.[32] Section 580(d) is complemented by section 726(a) — the one-action rule.

B. Section 726(a): The One-Action Rule and Security-First Corollary

The one-action rule of section 726(a) is motivated by the legislative desire for creditors to proceed against all of a borrower's debt first and in a single action. In *Security National Bank v. Wozab*,[33] the California Supreme Court held that an "action" for section 726(a) purposes means a "proceeding in a court of justice."[34] The

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supra note 5, at 197-203.

29. Roseleaf Corp. v. Chierighino, 59 Cal. 2d 35, 44, 378 P.2d 97, 102, 27 Cal. Rptr. 873, 878 (1963).

30. *Western Sec. Bank*, 26 Cal. App. 4th at 1454-55, 25 Cal. Rptr. 2d at 914 (footnotes omitted).

31. In California, a borrower is provided a redemption period after judicial foreclosure during which time the borrower can regain title by repurchasing the property at the price for which it was sold during the judicial sale. The time the borrower is allowed to redeem depends upon whether the proceeds from the sale were greater or less than the secured indebtedness. If the sales proceeds satisfied the entire indebtedness, the borrower is allowed three months to redeem the property. Where the sales proceeds are less than the indebtedness, and therefore the borrower is subject to a deficiency judgment, the borrower is allowed one year to redeem. CAL. CIV. PROC. CODE § 729.030 (West 1994).

32. *Roseleaf*, 59 Cal. 2d at 43-44, 378 P.2d at 102, 27 Cal. Rptr. at 877-78.

33. 51 Cal. 3d 991, 800 P.2d 557, 275 Cal. Rptr. 201 (1990).

34. *Id.* at 998, 800 P.2d at 561, 275 Cal. Rptr. at 205. This "proceeding in a court of justice" language is taken directly from California Code of Civil Procedure section 22.

one-action rule would be severely limited if this were the only situation in which pre-foreclosure recourse triggered anti-deficiency protections. Acknowledging the undesirability of so limiting the one-action rule, *Wozab* recognized the California judiciary has developed a security-first corollary[35] that does not include the "action" requirement.[36] Roger Bernhardt provides the following summary of why the security-first requirement is a necessary expansion of the one-action rule:

> Because [section 726(a)] bars an independent action on the note, the only method by which a [lender] may recover from a [borrower's] personal estate is by a deficiency judgment after a foreclosure sale has failed to produce enough to satisfy the debt. Thus, [section 726(a)] is a security-first rule as well as a one-action rule . . . .
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> 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 [borrower] 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.*[37]

Stated simply, a creditor must first bring an action on, and exhaust all of the mortgaged security for, a debt before recovering from the debtor personally. If the creditor does not follow this procedure and the borrower raises an objection, the court will compel the creditor to seek recourse from the mortgaged security before seeking a personal deficiency judgment.[38] If the borrower does not raise an objection the lender will lose his security, but be entitled to retain the proceeds from the improper action.[39]

By requiring lenders to proceed against all of a borrower's real

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CAL. CIV. PROC. CODE § 22 (West 1994).

35. The reference to the security-first requirement as a corollary to the one-action rule is borrowed from Darren Conley's Comment analyzing the sanction aspect of section 726(a). *See* Conley, *supra* note 5, at 1608.

36. *Wozab*, 51 Cal. 3d at 998-99, 800 P.2d at 561, 275 Cal. Rptr. at 205.

37. BERNHARDT, *supra* note 5, at 187-88 (emphasis added).

38. Walker v. Community Bank, 10 Cal. 3d 729, 734, 518 P.2d 329, 332, 111 Cal. Rptr. 897, 900 (1974). In the context of an informal "action," i.e., a banker's setoff, the borrower will not be able to raise an affirmative defense because this is not a "proceeding in a court of justice." *Wozab*, 51 Cal. 3d at 998, 800 P.2d at 561, 275 Cal. Rptr. at 205; *see also* Conley, *supra* note 5, at 1615. However, the borrower can object to an informal "action" instituted prior to foreclosing on the real property security and if the lender does not return the proceeds it will be precluded from further foreclosure on the real property security interest *and will also lose the right to collect the remainder of the debt. Wozab*, 51 Cal. 3d at 1006, 800 P.2d at 566, 275 Cal. Rptr. at 210.

39. *See* Hetland & Hansen, *supra* note 26, at 206 n.78; Conley, *supra* note 5, at 1603.

property first and in one action, section 726(a) ensures that the borrower will not be subject to multiple actions, and that the real property security will be the primary source for satisfaction of the borrower's obligation.[40] Section 726(a) also prevents a lender from skirting the limits of section 580(d) by obtaining a deficiency judgment prior to a nonjudicial foreclosure.[41] Importantly, these policies seek to uphold the parties' expectations that the security will be looked to first to satisfy the debt and the borrower will not be subjected to multiple actions. The full effect of sections 726(a) and 580(d) can be illustrated by considering how they interact with one another.

C. The Interaction of Sections 580(d) and 726(a): Lender's Disappearing Options

To better understand how sections 580(d) and 726(a) complement one another, consider the following hypothetical. A small local bank lends a commercial borrower $5,000,000 to purchase and develop a shopping center in an upscale neighborhood. The bank takes back a note secured by a deed of trust on the shopping center. Everything is going well (the tanning booth shop and hair care products store have moved in) until the local country club closes down after the back nine is designated a wildlife preserve by the state and thus condemned. The politically proper well-to-do country club members and neighbors of the shopping center are all for nature so they do not wield their substantial political power to save their country club. Instead, they find a country club in a different part of town, with its own shopping center, and move.

In the above situation, the borrower may go into default and the bank will contemplate how to recover the debt owed. Assume the bank discovers that the borrower has $250,000 sitting in one of the bank's demand deposit accounts. The bank will probably consider three possibilities: (1) institute judicial foreclosure proceedings to recover the entire debt, (2) foreclose on the deed of trust and begin nonjudicial foreclosure proceedings, or (3) setoff the borrower's demand deposit account and then institute either a nonjudicial or judicial foreclosure.

If the bank chooses judicial foreclosure it will be able to obtain not only the amount for which the shopping center is sold, but a deficiency judgment against the borrower in the amount the debt exceeds the proceeds of the foreclosure sale.[42] Although judicial

40. *Walker*, 10 Cal. 3d at 735, 518 P.2d at 333, 111 Cal. Rptr. at 901.

41. *See, e.g.*, John R. Hetland, *Deficiency Judgment Limitations in California — A New Judicial Approach*, 51 CAL. L. REV. 1, 35 n.158 (1963).

42. Due to section 580(a) of the California Code of Civil Procedure, the amount of

foreclosure may seem like the perfect solution to the bank's problems, the bank could encounter several difficulties. For example, the borrower may have other real estate investments that are deteriorating. In other words, the bank may realize time is of the essence; a deficiency judgment will mean little if the borrower has nothing to recover against. Because judicial foreclosure is slow and costly, resorting to judicial foreclosure in this situation will probably leave the bank with a deficiency judgment against a borrower who is judgment-proof.

The bank's next option is nonjudicial foreclosure. Nonjudicial foreclosure does not suffer from the turtle syndrome encountered in judicial foreclosure. It can be done quickly and probably concluded before the borrower's funds are depleted. But expediency has a price. Due to the limitations of section 580(d), a deficiency judgment cannot be obtained after a nonjudicial foreclosure. Consequently, the bank's recovery will be limited to the proceeds from the sale of a shopping center adjacent to a wildlife preserve. It would not be surprising, especially in the current California real estate market, to discover the bank will be the only party willing to purchase the property. Thus, the bank will be facing the possibility of obtaining this wildlife shopping center in exchange for the borrower's $5,000,000 loan.

Finally, the bank could setoff the $250,000 that the borrower has in one of their demand deposit accounts. But once again, this will create problems for the bank. Due to the rule articulated in *Wozab*, if the bank decides to take this course of action, the borrower will have a choice of responses. If the borrower demands the return of the funds, the bank can either comply and be forced to proceed

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the deficiency will be further limited to the excess, if any, of *either* the amount of the shopping center proceeds *or* the *fair market value* of the center at the time of the sale, whichever is greater, over the face value of the debt. CAL. CIV. PROC. CODE § 580(a) (West 1994). Section 580(a), in conjunction with section 726(b),

> require[s] that any deficiency judgment must be based upon proceedings commenced within three months after the foreclosure sale and be computed on the basis of the fair market value of the secured property at the time of the sale; in other words, any deficiency must be promptly sought and be limited to the difference between the amount of the foreclosure judgment and the fair value of the security.

Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1454 n.4, 25 Cal. Rptr. 2d 908, 913 n.4 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994) (citing Citrus State Bank v. McKendrick, 215 Cal. App. 3d 941, 263 Cal. Rptr. 781 (1989); Walter E. Heller Western, Inc. v. Bloxham, 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985); Rainer Mortgage v. Silverwood, Ltd., 163 Cal. App. 3d 359, 209 Cal. Rptr. 294 (1985)).

against the shopping center first, or refuse and lose not only the shopping center security, but also the right to pursue the balance of the underlying debt.[43] If the borrower does not demand the return of the funds the bank will have lost its real property security.[44]

In light of its predicament, the bank's ultimate course of action will probably be determined by whether the wildlife shopping center is now worth more than $250,000. The bank will be left with either (1) the $250,000 proceeds in the demand deposit account,[45] (2) the wildlife shopping center,[46] or (3) the wildlife shopping center and a deficiency judgment which may be worthless.[47]

This hypothetical simply illustrates what was stated earlier: "*A California . . . [borrower] who signs a note does not promise unconditionally to pay the note, but rather promises any deficiency that remains if a sale of the encumbered property does not satisfy the note.*"[48] This general rule should be expanded to include the requirement that this deficiency can only be obtained if the sale of the property is completed through judicial foreclosure. As considered above, when time is of the essence these rules may effectively preclude the lender from obtaining any deficiency at all.

In *Western Security Bank*, the court encountered a direct conflict between the anti-deficiency provisions and the independence principle of letter of credit law discussed in part I. The result, although not surprising, will have dramatic implications upon the manner in which real estate financing is practiced and, more importantly, upon the availability of such financing.

III. *Western Security Bank v. Beverly Hills Business Bank:* A Case of Forced Judicial Misdirection

A. Facts and Procedural History

On October 10, 1984, Beverly Hills Business Bank (Bank) loaned $3,250,000 to Vista Place Associates (Vista), a limited partnership,

43. *See supra* notes 38-40 and accompanying text.

44. *See Walker*, 10 Cal. 3d at 733-34, 518 P.2d at 520-21, 111 Cal. Rptr. at 899-900; Roseleaf Corp. v. Chierighino, 59 Cal. 2d 35, 38-39, 378 P.2d 97, 98-99, 27 Cal. Rptr. 873, 874-75 (1963).

45. If the improper bank setoff is used and the bank refuses to return the funds when the borrower demands that they do so, the right to collect the remainder of the debt, and consequently to proceed against the security, will be lost. *See supra* notes 38-40 and accompanying text.

46. If nonjudicial foreclosure is used a deficiency judgment will be prevented by section 580(d). *See supra* note 28 and accompanying text.

47. If judicial foreclosure is used the lender can obtain a deficiency judgment. But note the problems associated with judicial foreclosure discussed *supra* notes 31-32 and accompanying text.

48. BERNHARDT, *supra* note 5, at 187-88 (emphasis added).

to finance the purchase of a shopping center. Vista's three general partners (the Vista partners) all signed a promissory note and the loan was secured by a "Deed of Trust and Assignment of Rents."[49]

Due to financial difficulties, Vista defaulted on the loan. On February 1, 1987, the Bank and Vista entered into a loan modification agreement that enabled Vista to continue to operate the shopping center and repay the debt. Under the terms of this modification agreement the three Vista partners each obtained an unconditional, irrevocable standby letter of credit issued by Western Security Bank (Western) in favor of the Bank in the amount of $125,000, for a total of $375,000. The modification agreement documented the underlying financial transaction and also provided that the Bank was entitled to use the letters of credit if Vista defaulted again or the loan was not fully paid at maturity.[50]

In December 1990, the Bank declared Vista to be in default on the modified loan. The Bank began nonjudicial foreclosure proceedings. The Bank then filed an action against Vista seeking specific performance of the rents and profits provisions of the deed of trust as well as appointment of a receiver.[51] On June 11, 1991, the Bank and Vista's attorneys entered into a letter agreement in settlement of the specific performance lawsuit. This agreement provided in pertinent part:

> [Vista will] not take any legal action to prevent [Bank's] drawing upon [the letters of credit] after the Trustee's sale of the Vista Place Shopping Center . . . provided that the amount of the draw by [Bank] does not exceed an amount equal to the difference between [Vista's] indebtedness and the successful bid of the Trustee's Sale.[52]

Vista further agreed that after the Bank drew on the letters of credit, it would not take any legal action against the Bank with respect to the draw.

On June 13, 1991, the Bank concluded its nonjudicial foreclosure on the shopping center. The Bank was the only bidder and purchased

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49. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1449, 25 Cal. Rptr. 2d 908, 910-11 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994).

50. *Id.* at 1450, 25 Cal. Rptr. 2d at 911. The Vista partners each promised to reimburse Western if the letters were ever drawn upon. Separate promissory notes of $125,000 were given to Western by each of the Vista partners to secure the reimbursement agreement. *Id.*

51. *Id.*

52. *Id.* (alteration in original).

the property for $2,744,109.84, leaving a $505,890.16 unpaid deficiency on the entire debt of $3,250,000.[53] The Bank then delivered the three letters of credit to Western and demanded payment of $375,000. That same day, Vista's attorney provided Western with written notice that any attempt by Western to seek reimbursement from the Vista partners would be barred by section 580(d). Finding itself in the middle of competing claims with respect to the letters of credit, Western refused to honor the Bank's demand for payment and sought declaratory relief in the form of (1) a declaration that it was not obligated to accept or honor the Bank's tender of the letters of credit, or alternatively, (2) a declaration that, if it was required to honor the letters, the Vista partners were obligated to reimburse Western despite section 580(d).[54]

The trial court held that the Bank was entitled to recover from Western the sum of $375,000, plus interest, and that Western was not barred from seeking reimbursement from the Vista partners. Western filed an appeal from this judgment and the Vista partners filed a cross appeal.[55]

B. The Appellate Court's Decision

The court of appeal reversed, holding that the draw upon the letters of credit after the nonjudicial foreclosure was a violation of section 580(d) because this draw was the equivalent of a deficiency judgment.[56] It then attempted a precarious balancing of the independence principle and the policies upon which section 580(d) is based. The court decided the best way to reconcile these two provisions was to treat the Bank's draw upon the letters of credit after a nonjudicial foreclosure as "fraud in the transaction" under California Commercial Code section 5114(2)(b),[57] thus fitting it into an exception to the independence principle. As a result, the court allowed Western to either honor the transaction and seek reimbursement from the Vista partners or refuse to honor the letters of credit.[58] If Western honored the letters of credit and obtained reimbursement, the Vista partners could recover from the Bank the amount the Vista partners reimbursed Western.[59]

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53. *Id.*
54. *Id.* at 1451, 25 Cal. Rptr. 2d at 911.
55. *Id.*, 25 Cal. Rptr. 2d at 911-12.
56. *Id.* at 1465, 25 Cal. Rptr. 2d at 921.
57. *Id.* California Commercial Code section 5114(2)(b) reads in pertinent part: "[A]n issuer acting in good faith *may* honor the draft or demand for payment despite notification from the customer of *fraud*, forgery, or other defect not apparent on the face of the documents." CAL. COM. CODE § 5114(2)(b) (West 1994) (emphasis added).
58. *Western Sec. Bank*, 26 Cal. App. 4th at 1465, 25 Cal. Rptr. 2d at 921-22.
59. *Id.* at 1465 n.15, 25 Cal. Rptr. 2d at 921-22 n.15. "[I]t seems clear that had

C. *The Damage* Western Security Bank *Inflicts Upon Letter of Credit Law*

The *Western Security Bank* decision threatens the vitality of the independence principle by significantly expanding the "fraud in the transaction" exception. This unjustified expansion resulted from the court (1) relying upon precedent that is no longer viewed as the proper interpretation of "fraud in the transaction," (2) ignoring the existing body of law interpreting California as adhering to a narrow reading of "fraud in the transaction" and closely guarding the sanctity of the independence principle, (3) incorrectly determining that interpreting "fraud in the transaction" as "fraud in the credit transaction" would create a "meaningless redundancy"[60] in the California Commercial Code, and (4) inaccurately characterizing the Bank's conduct as fraudulent.

In *Western Security Bank*, the only case the court cites in support of its expansive interpretation of "fraud in the transaction" is *Sztejn v. J. Henry Schroder Banking Corp.*[61] To the court's credit, *Sztejn* is considered the origin of the "fraud in the transaction" exception. In *Sztejn*, the beneficiary of a letter of credit was to draw upon it once he tendered invoices demonstrating shipment of fifty crates of bristles. Instead, the beneficiary sent fifty crates of garbage. The court allowed the letter of credit customer to enjoin the beneficiary from drawing upon the letter of credit.[62] This holding, if it were still followed by courts to the letter, does lend credence to *Western Security Bank*'s expansive reading of "fraud in the transaction." However, in relying upon *Sztejn* as the modern definition of "fraud in the transaction," the court ignored over fifty years of precedent that has systematically limited *Sztejn* to its facts.

Today, contrary to the *Western Security Bank*'s representations, *Sztejn* is viewed as an extreme definition of "fraud in the transaction." For this reason it is rarely followed. One commentator accurately describes the subsequent judicial treatment and the problems with the *Sztejn* view in the following way:

Western chosen to honor the Bank's demand, the Vista defendants would have no recourse against Western and would be liable on their reimbursement notes; *their remedy would have been limited to an appropriate action against the bank.*" *Id.* (emphasis added).

60. *Id.* at 1464 n.14, 25 Cal. Rptr. 2d at 921 n.14.
61. 177 Misc. 719, 722, 31 N.Y.S.2d 631, 634-35 (Sup. Ct. 1941).
62. *Id.* at 721-22, 31 N.Y.S.2d at 633-35.

> Commentators have generally sought to limit *Sztejn* to *fraudulent documentary compliance* (as opposed to [fraud in the underlying sales contract]). A broad reading of *Sztejn* would certainly jeopardize the principle that the documents and not the . . . [underlying sales contract] are all a bank must review, *a principle indispensable to the continued utility of the letter of credit.*[63]

The court's reliance upon a fifty-year-old holding that represents the minority view is even more disturbing because there is an active interpretation of California law that the court failed to recognize. The closest the court comes to considering this precedent is in footnote 14 when it refers in passing to *Federal Deposit Insurance Corp. v. Bank of San Francisco.*[64] The court describes *Bank of San Francisco* as an example of "some authority to the contrary" of its interpretation of "fraud in the transaction."[65] In light of the detrimental impact created by the court's expansion of this exception, it is appropriate to consider the "authority to the contrary" the court elected to ignore.

The first in a series of federal cases to consider the "fraud in the transaction" exception under California law was *Agnew v. Federal Deposit Insurance Corp.*[66] *Agnew* interpreted California law to be more restrictive regarding the enjoining of an issuer's payments than even the Uniform Commercial Code:

> The California legislature could not have spoken more clearly. The commercial viability of letters of credit depends on their ability to provide assurance of payment. Consequently, to enjoin the issuing banks from paying the letters of credit would directly contradict the intent of the legislature and erode the certainty that should accompany letter of credit transactions.[67]

Five years later, in *Bank of San Francisco,*[68] mentioned above, the Ninth Circuit interpreted "fraud in the transaction" under California law, and relying heavily upon *Agnew*, came to the same conclusion regarding its meaning. *Bank of San Francisco* brought the federal interpretation of the California "fraud in the transaction" exception into clear focus when it explained why in that case the issuer's refusal to honor the letter of credit was improper: "For the [issuer] to prevail . . . the terms 'fraud in the transaction' must mean 'fraud in the underlying transaction.' . . . Such an interpretation undermines the institution of letters of credit; it invites uncertainty and litigation in the place of assured payment."[69]

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63. Paul R. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 720 n.23 (1973) (emphasis added).
64. 817 F.2d 1395 (9th Cir. 1987).
65. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1464 n.14, 25 Cal. Rptr. 2d 908, 921 n.14 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994).
66. 548 F. Supp. 1234 (N.D. Cal. 1982).
67. *Id.* at 1238 (citations omitted).
68. 817 F.2d 1395 (9th Cir. 1987). *See supra* notes 64-65 and accompanying text.
69. *Id.* at 1399.

The final act of this trilogy was *Trans Meridian Trading, Inc. v. Empresa Nacional de Commercializacion* (hereinafter *TMTI*).[70] In *TMTI*, the Ninth Circuit again relied heavily upon *Agnew* in holding that an issuer could not be enjoined from honoring a letter of credit simply by virtue of a dispute in the underlying transaction.[71]

Admittedly, *Bank of San Francisco* is the only case of the three that explicitly dealt with the degree of fraud in the transaction necessary to *allow* the issuer to refuse to honor a letter. Both *Agnew* and *TMTI* evaluated the fraud necessary to allow a borrower to *enjoin* an issuer from payment. Nonetheless, this line of cases is best viewed as indicating that, contrary to the characterization of the *Western Security Bank* court, California law provides a narrow interpretation of "fraud in the transaction" and a robust existence of the independence principle. Even assuming an overly narrow reading of *Agnew* and *TMTI* that might allow them to be distinguished entirely, the lucid teachings of *Bank of San Francisco* cannot be ignored: "[Interpreting 'fraud in the transaction' to mean 'fraud in the underlying transaction'] undermines the institution of letters of credit; it invites uncertainty and litigation in the place of assured payment."[72]

California courts are committed to a strict adherence to the independence principle. This is exemplified by *Lumbermans Acceptance Co. v. Security Pacific National Bank*,[73] the only California case to previously address this issue. The *Lumbermans* court stressed the importance of the independence principle: "An issuer 'must honor a draft or demand for payment which complies with the terms of the relevant credit *regardless of whether the goods or documents comply to the underlying contract for sale . . . between the customer and the beneficiary.*'"[74] Because *Lumbermans* does not explicitly interpret "fraud in the transaction," the *Western Security Bank* court limited its use to illustrating that letters of credit embody the independence principle and thus can be distinguished from guarantees and sureties.[75]

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70. 829 F.2d 949 (9th Cir. 1987).
71. *Id.* at 955.
72. *Bank of San Francisco*, 817 F.2d at 1399.
73. 86 Cal. App. 3d 175, 150 Cal. Rptr. 69 (1978).
74. *Id.* at 178, 150 Cal. Rptr. at 71 (quoting CAL. COM. CODE § 5114(1); Asociacion De Azucareros De Guatemala v. United States Nat'l Bank of Oregon, 423 F.2d 638, 641 (9th Cir. 1970))(emphasis added).
75. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 1441, 1459-60, 25 Cal. Rptr. 2d 908, 918 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994).

By utilizing *Lumbermans* in such a limited way, the court entirely misses the point. The independence principle requires that the underlying transaction be completely separate from the letter of credit transaction. The court's reading of "fraud in the transaction" as "fraud in the underlying transaction" necessarily allows the status of the underlying transaction to creep in to the issuer's decision upon whether to honor a draw upon a letter of credit. Therefore, in contrast to the court's treatment of its holding as consistent with *Lumbermans*, the *Western Security Bank* interpretation of "fraud in the transaction" is irreconcilable with the *Lumbermans* court's deference to the independence principle.

The *Western Security Bank* court seemed to realize precedent was not on their side. To counter this, the court resorted to some questionable interpretation tactics. It stated that interpreting "fraud in the transaction" as "fraud in the credit transaction" creates a "meaningless redundancy" in the California Commercial Code.[76] In footnote 14 of the *Western Security Bank* opinion, the court attempted this misdirection:

> The term "fraud in the transaction" includes a deception of the debtor. While there is some authority to the contrary [citing *Bank of San Francisco*] we believe that this term applies to "fraud in the *underlying* transaction" (i.e., fraud on the debtor). There is no California law on this point, but we have no trouble concluding that if the term were limited to "fraud in the *credit* transaction" (i.e., fraud on the issuer) it would be nothing more than a meaningless redundancy. *It is difficult to imagine a fraud on the issuer that would not involve the use of a forged or fraudulent document*; however, these two possibilities are already expressly included in California Uniform Commercial Code section 5114, subdivision (2). Thus, the final phrase, "or there is fraud in the transaction," must have been added for some other purpose [namely to include fraud in the underlying transaction].[77]

The "redundancy" the court relies on is based upon the court's difficulty in imagining "a fraud on the issuer that would not involve the use of a forged or fraudulent document . . . ."[78]

The court's finding of a redundancy is flawed for two reasons. The first problem with this interpretation is that it incorrectly equates "fraud in the credit transaction" with "fraud on the issuer." "Fraud in the credit transaction" covers not only cases where there is fraud upon the issuer, but also where there is conduct that constitutes fraud of a nature that vitiates the entire underlying transaction, regardless of its effect upon the issuer.[79] One court describes these situations as being based upon "wrongdoing of the beneficiary [that]

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76. *Id.* at 1464 n.14, 25 Cal. Rptr. 2d at 921 n.14.
77. *Id.* (third emphasis added).
78. *Id.*
79. *See* Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 361-62, 336 A.2d 316, 325-26 (1975) (requiring egregious fraud); Trans Meridian Trading, Inc. v. Empresa Nacional de Comercializacion, 829 F.2d 949, 955-56 (9th Cir. 1987) (utilizing

has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served."[80] In such cases, the beneficiary's fraud must consist of "outrageous conduct which shocks the conscience of the court."[81] Therefore, the egregiousness of the fraud is the determining factor, not upon whom the fraud was perpetrated.

The second problem with the redundancy alleged by the *Western Security Bank* court is "fraud in the credit transaction" is not limited to cases involving forged or fraudulent documents. Black's Law Dictionary defines fraud as: "An intentional perversion of the truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right."[82] In the context of letters of credit, fraud is present not only when there is fraudulent or forged documents, but in other situations as well.

Examples where fraud in a letter of credit transaction would not involve fraudulent or forged documents include when someone other than the beneficiary attempts to draw on the letter of credit, or the beneficiary enters into the letter of credit agreement while planning at the time of its formation to later make an improper draw.[83] A fraudulent letter of credit transaction requires intentional misrepresentations that induce the formation or payment of the letter of credit. Courts also require egregious conduct — " 'active intentional fraud' or 'evil intent'."[84] This requirement ensures that the "fraud in the transaction" exception does not swallow the independence principle. Therefore, *Western Security Bank* is incorrect when it says that it is difficult to imagine a situation where "fraud in the credit transaction" would not involve forged or fraudulent documents.

The *Western Security Bank* court incorrectly defines "fraud in the transaction." But even under its unjustifiably expansive reading of

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an active intentional fraud standard similar to *Intraworld* test); GATX Leasing Corp. v. DBM Drilling Corp., 657 S.W.2d 178, 183 (Tex. Ct. App. 1983) (applying the *Intraworld* test to a standby letter of credit); *see generally* William M. Hensley, *Lenders and Bankers Beware: Second District Uses Section 580d to Impale Letter of Credit Draws and Enforces Unduly Broad View of "Fraud in the Transaction" Exception*, CAL. REAL EST. REP., Jan. 1994, at 7, 12.

80. *Intraworld*, 461 Pa. at 359, 336 A.2d at 324-25.

81. Edward L. Symons, *Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief*, 54 TUL. L. REV. 338, 348 (1980).

82. BLACK'S LAW DICTIONARY 660 (6th ed. 1990).

83. *See* Stern, *supra* note 22, at 232.

84. Trans Meridian Trading, Inc. v. Empresa Nacional De Comercializacion, 829 F.2d 949, 956 (9th Cir. 1987) (citations omitted).

the exception, the Bank's conduct did not establish the requisite fraud. The court initially states that the fraudulent conduct is based on what it terms the lender's "implicit representation that the letters would not be presented for payment after a nonjudicial foreclosure."[85] The court reasoned that "[t]he Bank's subsequent conduct in nonetheless presenting the letters following such a foreclosure effectively worked a fraud upon the Vista partners."[86] This indicates that the "fraud in the transaction" was created by the Bank reneging upon its implicit representation not to present the letters of credit for payment after a nonjudicial foreclosure. However, the court continued:

> The Bank's effort to recover payment on the standby letters *after* it had concluded a nonjudicial foreclosure constituted the imposition of indirect liability upon the Vista partners which clearly conflicts with the legislative policy and purpose behind the enactment of section 580d. In our view such conduct amounted to a "fraud in the transaction" within the meaning of Commercial Code section 5114, subdivision (2).[87]

This assertion bases the "fraud in the transaction" upon the Bank's imposition of indirect liability on the Vista partners after nonjudicial foreclosure. The rationale seems to be that this violates the legislative policy behind section 580(d), amounting to a "fraud." The court's argument leaves unanswered the question of what aspect of the bank's conduct created this "fraud." Was it the breach of the implied representation or violation of the legislative purpose behind section 580(d)? If either of these two aspects of the Bank's conduct constituted "fraud in the transaction" the court's decision was correct. However, both of the characteristics of the Bank's conduct proffered by the court were insufficient to trigger this exception.

The court's creation of and reliance upon an implied promise by the Bank not to draw on the letters after the nonjudicial foreclosure was completely unjustified. The Bank attempted to guarantee that it would be able to draw on the letters of credit in this manner by obtaining a written assurance from the Vista partners that they would not take legal action to enjoin the Bank from drawing after a nonjudicial foreclosure.[88] In addition, the Vista partners promised not to seek recourse from the Bank after the draw. Therefore, not only did the Bank fail to represent it would not draw upon the letters of credit after a nonjudicial foreclosure, it explicitly included provisions to allow it to do so without being subject to legal sanctions. The Vista partners agreed to these terms and thus could not have

85. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1464, 25 Cal. Rptr. 2d 908, 921 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994).

86. *Id.*

87. *Id.* at 1465, 25 Cal. Rptr. 2d at 921.

88. *Id.* at 1450, 25 Cal. Rptr. 2d at 911.

reasonably believed the Bank was impliedly promising not to act in this manner. Even assuming the court was justified in inferring this representation, the Bank's later draw in no way approaches the "intentional perversion of the truth" included in the traditional definition of fraud.[89]

The court's assertion that violation of the legislative purpose behind section 580(d) was sufficient to establish fraud barely merits consideration. Fraud would have little independent meaning if its scope included every violation of legislative policy and purpose. One of the clearest rules of letter of credit law is that "fraud in the transaction" will not be triggered by a bona fide dispute concerning the underlying transaction.[90] As evidenced by the public reaction following the *Western Security Bank* decision,[91] the Bank was not alone in the belief that drawing on a letter of credit after a nonjudicial foreclosure would not violate section 580(d). The court's decision that the Bank's draw was in violation of section 580(d) in no way creates an intent to deceive at the time of the draw by the Bank.[92] Therefore, violating section 580(d) was not sufficient to taint the transaction with fraud, especially because the Bank had no knowledge that its conduct would create this violation.

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89. *See* BLACK'S LAW DICTIONARY 660 (6th ed. 1990); *see supra* text accompanying note 82.

90. *See, e.g.*, Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 361, 336 A.2d 316, 325 (1975) (stating that an injunction is justified only if lender has no bona fide claim to payment); Airline Reporting Corp. v. First Nat'l Bank of Holly Hill, 832 F.2d 823, 828 (4th Cir. 1987) (holding that an injunction will be justified if the lender has an active intent to defraud and there is no colorable basis for the underlying contract for the lender to call the letter of credit); Itek Corp. v. First Nat'l Bank of Boston, 730 F.2d 19, 25 (1st Cir. 1984) (deciding that an injunction will only be granted if a lender's claim for payment has absolutely no basis in fact).

91. *See, e.g.*, Steven J. Coté, *Appellate Court Denies Lenders by Confirming Prior Decision That Anti-Deficiency Rule Bars Draw Down of Letter of Credit Following Nonjudicial Foreclosure*, CAL. REAL EST. REP., Jan. 1994, at 1; Hensley, *supra* note 79; Dennis B. Arnold, Credit Enhancement: An Elusive Illusion 8-22, Presentation to the Finance Lawyers Conference and the Real Property Section of the Los Angeles County Bar Association (November 4, 1993) (on file with author); Jablon, *supra* note 13, at 11 (choosing *Western Security Bank* as the 1993 case with the largest impact on California real property law).

92. *See* CBA Brief, *supra* note 10, at 12:

> [*Western Security Bank*] leads to the inevitable conclusion that any alleged violation of public policy in the underlying transaction would constitute a fraud by the beneficiary even if prior law had never addressed the public policy issue. The fraud exception has been construed so broadly by the Court of Appeals that it devours the independence principle.

Id.

In sum, the *Western Security Bank* decision is an improper application of "fraud in the transaction" as it exists under current law. The court misapplied this doctrine by (1) relying on outdated precedent, (2) ignoring current judicial interpretations, (3) incorrectly asserting that the "fraud in the credit transaction" view creates a redundancy under the California Commercial Code, and (4) inaccurately characterizing the Bank's conduct as fraudulent. Therefore, Justice Kitching, dissenting in *Western Security Bank*, was correct when she stated that "[the] Bank's presentation of the letter of credit to . . . [the issuer] after a nonjudicial foreclosure [was not] akin to a fraudulent act and [I] see no indication that is what the legislature intended."[93] Unfortunately, the detrimental implications *Western Security Bank* will have upon the use of letters of credit in real estate financing is not limited to this doctrinal damage. If section 726(a) limits are placed on pre-foreclosure draws, the utility of letters of credit will be further undermined.

IV. The Vanishing Utility of Letters of Credit in Real Estate Transactions: "Good as Cash" But in Lieu of the Real Property Security

In *Western Security Bank*, the court was careful to skirt the question of whether section 726(a) would apply to pre-foreclosure draws on letters of credit. Relegating the issue to a footnote, the court recognized that:

> The Bank was, of course, free to make a demand upon the defendants' standby letters after the debt went into default but *prior* to the nonjudicial foreclosure. Had it done so, there would be *no conflict with section 580d.* It is the attempt to enforce the letters *following the nonjudicial foreclosure* sale which presents the problem.[94]

The court was suspiciously silent about whether this would be a violation of section 726(a), resulting in a loss of the lender's additional security. The court also observed that "[r]eal property lenders who rely on standby letters in the future will have to consider the alternatives of judicial foreclosure or the making of pre-foreclosure demands on the letters."[95] Again, the court made no mention of section 726(a), but the court implicitly warned lenders to compare the alternatives of judicial foreclosure with pre-foreclosure demands before taking action.[96] The upshot seems to be that the court was not ready

93. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1470, 25 Cal. Rptr. 2d 908, 925 (1993) (Kitching, J., dissenting), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994).

94. *Id.* at 1463 n.11, 25 Cal. Rptr. 2d at 920 n.11 (second emphasis added).

95. *Id.* at 1466, 25 Cal. Rptr. 2d at 922.

96. In MDFC Loan Corp. v. Greenbrier Plaza Partners, 21 Cal. App. 4th 1045, 26 Cal. Rptr. 2d 596 (1994), a decision subsequent to *Western Security Bank*, the appellate court again ignored the issue of whether a pre-foreclosure draw on a letter of credit

to pass on this issue, but wanted lenders to be aware of the pitfalls which logically follow from the *Western Security Bank* decision. In light of the court's foreshadowing, the next section considers whether section 726(a) applies to pre-foreclosure letter of credit draws.

A. Does Section 726(a) Apply to Pre-Foreclosure Draws?

As discussed previously, section 726(a) embodies a one-action rule and a security-first corollary. Generally, the one-action rule only applies to judicial "actions."[97] Letter of credit draws clearly do not fit into this category. However, *Security Pacific National Bank v. Wozab*[98] held that an informal "action," in that case a bank setoff, violates the security-first corollary to the one-action rule.[99] Under *Wozab*, a draw upon a letter of credit should also be an informal "action" that violates the security-first corollary because it results in a multiplicity of suits against the borrower.[100] In addition, allowing

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violated section 726(a). Instead, citing *Western Security Bank*, the *MDFC* court simply stated that "no conflict with Section 580d arises where a real property lender draws on a letter of credit *before* nonjudicially foreclosing on the property." *Id.* at 1056 n.3, 26 Cal. Rptr. 2d at 603 n.3 (citing *Western Sec. Bank*, 26 Cal. App. 4th at 1463 n.11, 25 Cal. Rptr. 2d at 920 n.11).

97. *See supra* notes 33-36 and accompanying text.

98. 51 Cal. 3d 991, 800 P.2d 557, 275 Cal. Rptr. 201 (1990).

99. *Id.* at 999, 800 P.2d at 562, 275 Cal. Rptr. at 206. For a general discussion of *Wozab* and the security-first corollary, see *supra* notes 33-41 and accompanying text.

100. The *Wozab* court held that a banker's setoff was an informal "action" that violated the security-first corollary to the one-action rule. *Wozab*, 51 Cal. 3d at 999, 800 P.2d at 562, 275 Cal. Rptr. at 206. The sanction imposed was a loss of the bank's security upon the note. Draws on letters of credit should not be treated any differently. Two distinctions between a banker's setoff and a letter of credit draw that could be offered to rationalize allowing a preforeclosure draw despite the *Wozab* decision are: (1) a draw can be viewed as a proceeding against "security," a bank setoff cannot, and (2) a letter of credit draw will require the borrower to meet his reimbursement obligation but this will be a payment to the third party issuer, conversely, the bank's setoff is a direct collection by the lender. However, both of these distinctions were implicitly refuted by the *Western Security Bank* opinion.

The first of the above distinctions is based upon the *Western Security Bank* court's statement that the letter of credit was "security." Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1452, 25 Cal. Rptr. 2d 908, 910 (1993) (stating that the letter of credit was given to the lender as *additional security*); *Id.* at 183, 25 Cal. Rptr. 2d at 923 (describing the letter of credit as "*additional security* for repayment of the loan"). However, the court used the term "security" too loosely. If the court was saying that the letter of credit was additional "security" for the purposes of the anti-deficiency legislation, *Western Security Bank* would have been a case based on a section 726(a) violation, not a section 580(d) violation. The nonjudicial foreclosure would have been an informal "action," thus triggering the security-first corollary and resulting in a loss of the remainder of the security. *See* Conley, *supra* note 5, at 1608. The letter of credit would have been the security lost if it were actually security under the anti-deficiency legislation. Because *Western Security Bank* was decided under section 580(d), the

letters of credit to be drawn on prior to a nonjudicial foreclosure would undermine the policy behind section 580(d) by giving the lender the equivalent of a deficiency judgment prior to a nonjudicial foreclosure.

One of the central policies embodied in section 726(a) is that borrowers should not be subjected to a multiplicity of lawsuits.[101] When a lender draws on a letter of credit the issuer will typically enforce its reimbursement right against the borrower. In most real estate financing situations, the letter of credit amount will only be for a portion of the total debt. Consequently, after a pre-foreclosure draw, the borrower will not only have the lender pursuing her for the amount of the debt not obtained from drawing on the letter of credit, but will also have the issuer pursuing her for reimbursement. As the *Western Security Bank* court recognized, "It makes no difference to . . . [a borrower's] purse whether the recovery is by the original creditor in a direct action . . . or whether the recovery is in an action . . . for *reimbursement* of the same sum."[102] Providing that pre-foreclosure draws on letters of credit do not violate section 726(a) would permit the lender to bring multiple actions against the borrower — precisely what section 726(a) was enacted to avoid.

Additionally, in the context of *non*judicial foreclosures, it is essential to treat post-foreclosure and pre-foreclosure draws the same in order to ensure the "strong public policies" *Western Security Bank* recognized as underlying the antideficiency legislation are upheld. As John R. Hetland puts it: "§ 580d . . . make[s] it clear that the creditor would waive the balance of his security by . . . [recovering from the borrower prior to a nonjudicial judgment]. Otherwise, by reversing the order, the creditor could get what 580d prohibits, a

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court was treating the letter of credit not as security, but as a personal deficiency judgment.

The second distinction was eviscerated by *Western Security Bank* because the court treated the enforcement of the reimbursement obligation as equivalent to the lender's proceeding against the security. As a result, it is of little consequence that a banker's setoff is a direct collection from the borrower while a letter of credit draw (borrower pays the letter of credit issuer and not the lender) is an indirect collection.

An interesting side note is that even if letters of credit could be viewed as additional security, the result reached would be the same as that in *Western Security Bank* (loss of the right to collect on the letter of credit) because section 726(a) requires not only that a lender exhaust the security upon a note before seeking a deficiency judgment, but it also requires that all of the security be proceeded against in one-action. If a letter of credit being used in combination with real property is security, a proceeding against the letter effectively exhausts the lender's one-action against security. Consequently, although the lender has proceeded against "security-first," he has not proceeded against it in total and, thus, will forfeit the amount that remains.

101. Walker v. Community Bank, 10 Cal. 3d 729, 735, 518 P.2d 329, 333, 111 Cal. Rptr. 897, 901 (1974).

102. *Western Sec. Bank*, 26 Cal. App. 4th at 1456, 25 Cal. Rptr. 2d at 915 (citing Union Bank v. Gradsky, 265 Cal. App. 2d 40, 46, 71 Cal. Rptr. 64, 69 (1968)) (emphasis added).

personal judgment and extrajudicial sale of the security . . . ."[103] If a lender were allowed to make a draw before a *non*judicial foreclosure without being subject to the imposition of the one-action/security-first sanction, she would be receiving an advance nonjudicial foreclosure deficiency judgment.[104] From a policy perspective, there is little substantive difference if a letter of credit draw is made before or after a nonjudicial foreclosure. The result is the same — the borrower has lost the real property security without the benefit of a fair value hearing or the right of redemption. Since the issuer will pursue the borrower for reimbursement, the borrower is effectively forced to pay a pre-foreclosure deficiency to the issuer. Because *Western Security Bank* treats a letter of credit draw as the equivalent of a deficiency judgment, such a draw runs afoul of the anti-deficiency statutes whether made before or after a nonjudicial foreclosure.

A pre-foreclosure draw upon a letter of credit results in an imposition of the one-action/security-first sanction: loss of additional real property security. This is the result that must be reached because a pre-foreclosure draw subjects the borrower to multiple actions and allows the lender to obtain the equivalent of a pre-nonjudicial foreclosure deficiency judgment. The application of the restrictions of section 726(a) restrictions will eviscerate the usefulness of letters of credit when used as security in combination with real property.

B. The Vanishing Utility of Letters of Credit

Placing the limits of sections 580(d) and 726(a) on letters of credit eliminates most of their utility as credit enhancers when used in combination with real property security. To illustrate why this is so, reconsider the hypothetical involving the bank that gave a loan secured by the wildlife shopping center.[105] Assume that in addition to the shopping center the bank obtained a $1,000,000 letter of

103. Hetland, *supra* note 41, at 35 n.158. "[I]f a creditor chooses to secure an obligation with an interest in real property, he does so at a significant price. That price includes the following limitations on the creditor's rights and remedies: (1) No personal (deficiency) judgment against a debtor is allowed without first exhausting the security; . . ." Hetland & Hansen, *supra* note 26, at 194. *See also* Pacific Valley Bank v. Schwenke, 189 Cal. App. 3d 134, 234 Cal. Rptr. 298 (1987); Bank of Am. v. Daily, 152 Cal. App. 3d 767, 199 Cal. Rptr. 557 (1984).

104. If this were held not to violate section 726(a), pre-foreclosure letter of credit draws would become the " 'artifice of choice' to avoid . . . [section 580(d)'s] limitations." *Western Sec. Bank*, 26 Cal. App. 4th at 1463, 25 Cal. Rptr. 2d at 920.

105. For a discussion of the shopping center hypothetical see *supra* part II.C.

credit it could draw upon by presenting drafts stating that the borrower was in default. If the borrower defaults on the underlying loan and is experiencing difficulties similar to the borrower in the original hypothetical, the bank might attempt one of the following courses of action: (1) draw on the letter of credit and then institute either nonjudicial or judicial foreclosure proceedings on the shopping center, (2) institute a nonjudicial foreclosure proceeding and after the property is sold draw upon the letter of credit to obtain a deficiency equal to the excess of the debt over the proceeds from the nonjudicial sale, or (3) institute a judicial foreclosure proceeding and use the letter of credit to recover any deficiency that is remaining.

Each of these options has consequences similar to those encountered in the shopping center loan hypothetical. First, as discussed previously, a pre-foreclosure draw should subject the lender to a section 726(a) loss of remaining security sanction. Second, according to *Western Security Bank*, a draw on the letter of credit after a nonjudicial foreclosure will be barred by section 580(d). Third, a bank desiring expediency because of a borrower's deteriorating financial condition will not have its needs satisfied by a time-consuming judicial foreclosure. In addition, a letter may be worthless in the context of judicial foreclosure because *Western Security Bank*'s assertion that letters of credit can be drawn on after the conclusion of a judicial foreclosure proceeding does not comport with commercial reality:

> The *Western Security* Court . . . suggests that a lender/beneficiary could wait to draw on a letter of credit until after it judicially forecloses without violating Section 580d. As a practical matter, however, this is not an option. Letters of credit generally are short in duration, requiring yearly renewal. *A letter of credit normally will expire prior to the completion of a judicial foreclosure action, leaving the lender/beneficiary with nothing to draw on.*[106]

In sum, judicial foreclosure will provide the best chance for a lender to collect on both its letter of credit and real property security. If the letter of credit term expires while waiting for judicial foreclosure to be concluded, the lender will have to choose whether to collect the letter of credit amount *or* look to the proceeds of the judicial sale of the real property security; it will not have the benefit of both. Therefore, in most cases, the letter of credit will serve not as a

106. Amicus Brief for the Irvine Company at 8 n.8, Western Sec. Bank v. Beverly Hills Business Bank, 21 Cal. App. 4th 156, 25 Cal. Rptr. 2d 908 (1993) (No. B066488) (prepared pursuant to California Rule of Court 14(b) urging the California Supreme Court to grant review of the *Western Security Bank* decision) [hereinafter Irvine Brief] (emphasis added); Dennis B. Arnold, Western Security Bank, *Part Deux: The Empire Strikes Out*, CAL. REAL PROP. J., Winter 1994, at 30, 31 (noting that a judicial foreclosure prior to drawing upon a letter of credit simply ignores the reality that letters of credit are typically short-term instruments which will often expire during the pendency of a judicial foreclosure proceeding).

credit enhancer to be used to collect the debt in combination with real property security, but will merely provide the lender with a choice of recourse — collect upon either the letter of credit or the real property. In most cases, because letters of credit are generally issued for a fraction of the total debt amount, the lender will proceed against the real property because it should provide a superior source of funds. The net result is that letters of credit will be of diminished value when used for credit enhancement in combination with real property security.

More generally, the result in *Western Security Bank* also impinges upon the central strength of letters of credit in allowing transacting parties to economically customize who will assume specific risks.[107] Letters of credit are a method to customize risks at minimal costs because (1) the lender gains from the mechanical and expedient payment,[108] (2) the administrative expenses involved are relatively low due to the automatic nature of payment,[109] (3) the issuer will often be able to avoid the duplicative expenses of investigating and monitoring the underlying contract because it will be familiar with the transaction and the customer's creditworthiness,[110] and (4) the risk of litigation can be shifted from the lender to the borrower.[111]

Treating letters of credit in accord with the *Western Security Bank* opinion will increase their cost, eliminate the benefit they provide in shifting risks, and provide the analytical basis for making pre-foreclosure draws a violation of the security first corollary of the one-action rule. The cost of letters of credit will rise because the issuer will feel obligated to consider the status of the underlying transaction to insure she will not incur liability for improperly honoring the draft. Additionally, the *Western Security Bank*'s expansion of the "fraud in the transaction" exception makes it more likely litigation will occur before a letter of credit is honored.[112] This undermines the risk shifting mechanism of letters of credit by increasing the risk to the lender that funds will be tied up during a valid dispute. Finally, as discussed above, because *Western Security Bank*

107. *See* Stern, *supra* note 22, at 222-24.

108. Joseph D. Becker, *Standby Letters of Credit and the Iranian Cases: Will the Independence of the Credit Survive?*, 13 UCC L.J. 335, 339 (1981).

109. Leo H. Garman, *Standby Letter of Credit and Guarantees: Do We Understand What We're Doing?*, J. COM. BANK LENDING, Apr. 1978, at 3.

110. *See* Stern, *supra* note 22, at 225.

111. *See supra* notes 22-25 and accompanying text.

112. "[T]he standby letter of credit reduces the probability of judicial involvement, thus enabling the parties to evaluate the risks involved with a standby letter of credit more accurately." Stern, *supra* note 22, at 224-25 n.41.

precludes draws after a nonjudicial foreclosure, it provides the rationale that logically leads to a loss of real property security under section 726(a) if letters are drawn upon before foreclosure. As a result, borrowers and lenders will have their current access to the financial soundness of banking institutions, through the use of letters of credit as credit enhancers in combination with real property, eliminated.[113]

The *Western Security Bank* court chose to vindicate the anti-deficiency legislation at the expense of the vitality of letters of credit as currently used in real estate financing. This result should not be allowed to stand. Instead, action must be taken to insure that letters of credit continue to play their important role in fueling real estate financing.

V. Searching For a Solution

As discussed above, the *Western Security Bank* opinion suffers from serious deficiencies. To prevent further aggravation of the illness currently afflicting the California real estate market it is essential that letters of credit retain their usefulness. Accordingly, this part considers possible judicial and legislative solutions.

A. Can the Independence Principle Be Saved Without Departing from Judicial Precedent?

The weakness of the *Western Security Bank* decision lies in its attempt to square the public policies underlying the anti-deficiency legislation with the independence principle upon which letters of credit are based. The court recognized that one of these two provisions must yield to the other:

> If we conclude that . . . [when a beneficiary of a letter of credit draws upon such letter after a nonjudicial foreclosure] an issuer has no alternative but to honor the payment demand then we effectively have subordinated the antideficiency legislation to the need for commercial certainty upon which the independence principle is predicated. On the other hand, if we hold that an issuer, on the facts before us, cannot properly honor a request for payment on standby letters, then we have done the opposite. *We cannot . . . completely vindicate both of these competing statutory policies.*[114]

The court purported to avoid this quandary by reconciling section

113. Letters of credit allow parties to take advantage of the financial soundness of banking institutions that would not otherwise be available because banks are precluded from issuing alternative credit enhancement tools such as guarantees or performance bonds. *See, e.g.*, Henry Harfeild, Bank Credits and Acceptances 163-65 (5th ed. 1974); Richard A. Lord, *The No-Guaranty Rule and the Standby Letter of Credit*, 96 Banking L.J. 46-47 (1979).

114. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1463, 25 Cal. Rptr. 2d 908, 920 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994) (emphasis added).

580(d) with the independence principle so as to give effect to the apparent intent of the legislature.[115] However, as previously mentioned, in the process the court mangled the independence principle by resorting to an overexpansive reading of "fraud in the transaction."[116] The *Western Security Bank* opinion has resulted in substantial criticism.[117] However, what these critics have failed to sufficiently articulate is a way in which the court could have escaped from the dilemma described above without sacrificing either the independence principle or section 580(d) as previously interpreted by the California judiciary.[118]

In *Western Security Bank*, the Bank's best argument for drawing upon the letter of credit post-foreclosure was to characterize the draw not as a deficiency judgment, but rather as an attempt to recover from the issuer under an obligation separate and distinct from that of the underlying notes secured by the deed of trust. The Bank argued that its draw was not a deficiency judgment, but instead a contract recovery under its agreement with the Vista partners. However, this argument ignored prior California cases which provided a more expansive interpretation of section 580(d). The court was bound by this line of cases giving a broad construction to the definition of deficiency judgment.

In *Union Bank v. Gradsky*,[119] a California appellate court held

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115. The court stated: "We must therefore seek a way to reconcile . . . [these two statutory policies]. It is the duty of courts, when reasonably possible, to harmonize [statutory provisions] so as to give effect to the apparent intent of the legislature." *Id.* (citing Stowe v. Merrilees, 6 Cal. App. 2d 217, 220, 44 P.2d 368, 369 (1935)) (second alteration in original).

116. *See* CBA Brief, *supra* note 10, at 12.

> What the Court of Appeal did in this case was to achieve a result that the Court thought attractive by marshaling the "fraud" exception to the independence principle. But the resulting consequence of that decision is to seriously broaden the definition of fraud in real property secured transactions . . . . Instead of clarifying the law, the Court of Appeal has introduced great uncertainty.
>
> The elevation of a breach of a representation newly implied in law to the level of fraud also raises troublesome issues outside the letter of credit context. Is the beneficiary liable for punitive damages? What other consequences flow from a finding of fraud? The Court of Appeal has opened a Pandora's box.

Id.

117. *See supra* note 91.

118. The *Western Security Bank* court itself may have been implicitly recognizing potential harm it had inflicted upon the independence principle when it stated that it had "reconcile[d] these competing statutory provisions and policies without doing *undue damage* to either." *Western Sec. Bank*, 26 Cal. App. 4th at 1466, 25 Cal. Rptr. 2d at 922 (emphasis added).

119. 265 Cal. App. 2d 40, 71 Cal. Rptr. 64 (1968).

that a lender could not collect from a guarantor of a promissory note secured by real property after foreclosing nonjudicially upon the real property securing the debt. *Gradsky* pointed out that "[i]f . . . the guarantor . . . can successfully assert an action . . . against [the borrower] for reimbursement, the obvious result is to *permit the recovery of a 'deficiency' judgment* against the [borrower] following a nonjudicial sale of the security under a different label."[120] *Gradsky* clearly stands for the proposition that section 580(d) does not permit any liability, either direct or indirect, to be imposed upon a borrower after a nonjudicial foreclosure.[121]

Even if the court had ignored *Gradsky*, it would have been faced with precedent even more difficult to distinguish. In *Commonwealth Mortgage Assurance Co. v. Superior Court*,[122] another California appellate court opinion, a couple purchased three condominium units with a loan secured by promissory notes. The bank who provided the loan required the couple to obtain mortgage guarantee insurance policies to secure payment on the notes.[123] The couple signed indemnity agreements promising to reimburse the mortgage insurer for any funds paid out under the policy. The couple defaulted on the notes and the bank foreclosed nonjudicially on the real property. The bank then collected on the mortgage insurance and the mortgage insurer brought an action on the indemnity agreement.[124] The court held that section 580(d) precluded the mortgage insurer's enforcement of the indemnity agreements.[125]

The *Commonwealth* court relied heavily on *Gradsky* to reach the same result. The court stated: "[W]e find the facts herein substantially similar . . . to those in [*Gradsky*] and conclude that the indemnity agreements herein are nothing more than *attempts to recover a deficiency* in violation of the antideficiency statute."[126] Later in its opinion, the *Commonwealth* court sounded what was probably the death knell of any chance that letters of credit could be distinguished from indemnity agreements:

> The question we must now address is whether the execution of the indemnity agreements by . . . [the borrowers] sufficiently distinguishes their situation from the debtor in *Gradsky*. We conclude it does not. The instant indemnity agreements *add nothing to the liability . . . [the borrower's] already incurred as principal obligors on the notes . . . . To splinter the*

120. *Id.* at 45-46, 71 Cal. Rptr. at 68-69 (emphasis added).
121. *Id.* at 46, 71 Cal. Rptr. at 69. "The Legislature clearly intended to protect the debtor from personal liability following a nonjudicial sale of the security. No liability, direct or indirect, should be imposed upon the debtor following a nonjudicial sale of the security." *Id.*
122. 211 Cal. App. 3d 508, 259 Cal. Rptr. 425 (1989).
123. *Id.* at 512, 259 Cal. Rptr. at 426.
124. *Id.*
125. *Id.* at 517, 259 Cal. Rptr. at 430.
126. *Id.* at 515, 259 Cal. Rptr. at 428 (emphasis added).

> *transaction and view the indemnity agreements as separate and independent obligations . . . is to thwart the purpose of section 580d by a subterfuge, a result we cannot permit.*[127]

Gradsky and *Commonwealth* left the *Western Security Bank* court with little room to maneuver. An alternative that would have left the independence principle intact would have been to distinguish these cases by characterizing them as grounded in subrogation law. This, however, would not be a principled distinction because the indemnity obligation in *Commonwealth* provided a contract to base collection upon and thus subrogation law was not directly in issue, and *Gradsky* and *Commonwealth* both contain sweeping language that clearly prevents the imposition of *any* personal liability, either direct or indirect, regardless of the application of the subrogation doctrine, following a nonjudicial sale of security. As the *Western Security Bank* court accurately stated:

> *Gradsky* and *Commonwealth* reflect the strong judicial concern about the efforts of secured real property lenders to circumvent section 580d by the use of financial transactions between debtors and third parties which involve post nonjudicial foreclosure debt obligations for the borrowers. Their common and primary focus is on the lender's requirement that the debtor make arrangements with a third party to pay a portion of all of the mortgage debt remaining after a foreclosure, i.e., to pay the debtor's deficiency.[128]

The court could not vindicate the policies underlying the independence principle while acknowledging the "judicial concern about . . . efforts . . . to circumvent section 580d."[129] The *Western Security Bank* court chose to leave anti-deficiency protections unscathed at the expense of what may be the continued vitality of the independence principle. The only options open to the court were either to ignore these cases or distinguish them on overly technical grounds.[130]

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127. *Id.* at 517, 259 Cal. Rptr. at 429-30 (citation omitted) (emphasis added).

128. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1457, 25 Cal. Rptr. 2d 908, 916 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994).

129. *Id.*

130. The dissent in *Western Security Bank* argued that the sections could be reconciled without resort to the "fraud in the transaction" exception by allowing the lender to draw on the letter of credit and by providing that the borrower can seek disgorgement from the lender based on the section 580(d) violation. *Western Sec. Bank*, 26 Cal. App. 4th at 1471, 25 Cal. Rptr. 2d at 925-26 (Kitching, J., dissenting). Although requiring the issuer to honor the draw would have been preferable to the majority's decision because it would not label the draw as "fraud," as a practical matter this approach would still impose a "temporary" deficiency judgment on the borrower. The result of allowing a lender to draw on the letter of credit after a nonjudicial foreclosure would be the issuer seeking immediate reimbursement from the borrower. These funds would be sought at a time when the borrower is most likely in dire financial trouble. Any judgment against the borrower for the reimbursement funds would aggravate the borrower's financial position

As discussed above, California courts have traditionally been unsympathetic to proposed limits on the application of the judicially evolved anti-deficiency doctrine, especially where these limits would restrict the prior holdings of well-established cases such as *Gradsky* and *Commonwealth*.[131] Consequently, it will probably be left to the Legislature to solve the problems posed by the *Western Security Bank* decision.

B. A Legislative Proposal: Exempt Letters of Credit from the Anti-Deficiency Statutes

In *Western Security Bank*, the court recognized that its resolution of the clash between the letter of credit doctrine and the anti-deficiency legislation was insufficient and that the ultimate solution would have to be provided by the Legislature:

> To the extent that this result will present problems for real estate lenders with respect to the way they now do business, . . . it is a matter which should be addressed to the Legislature. We have been presented with two important but conflicting statutory policies. Our reconciliation of them in this case may not prove as satisfactory in another factual context. *It is therefore a matter which should receive early legislative attention.*[132]

The California Legislature should accept the court's invitation to solve this statutory conflict. The Legislature should amend the California Commercial Code to provide that letters of credit used in commercial real estate financing can be drawn upon irrespective of proceedings to foreclose on real property securing the same obligation. This amendment would not conflict with the policies of the anti-

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and could also adversely affect other creditors, especially if the issuer's reimbursement obligation is secured. In addition, in many cases the borrower would have to expend funds in the form of legal fees to secure disgorgement from the lender. Following the dissent's approach would not infringe upon the independence principle, but in substance, would impose the equivalent of a deficiency judgment upon the borrower. Consequently, it is very unlikely that the courts will adopt this approach in the future. However, note that by allowing the issuer the option of funding the draw, the *Western Security Bank* holding will often result in this "temporary" deficiency judgment being imposed upon the borrower. This is another indication of the inconsistencies embraced by the *Western Security Bank* majority.

131. Ironically, *Western Security Bank* hurts borrowers — the parties which the anti-deficiency legislation was enacted to help:

> The Court's decision puts at risk literally billions of dollars in real property secured loans that presently rely on letters of credit as additional credit support. In general, letters of credit must be renewed yearly. Thus, as the present outstanding letters of credit expire, lenders will require borrowers to put up other forms of security. For many borrowers, this will mean pledging needed working capital. Those borrowers that are unable to provide such additional security will default on their loans. Clearly, the Court's decision hurts the very persons the anti-deficiency laws were intended to protect . . . ."

Irvine Brief, *supra* note 106, at 8-9.

132. Western Sec. Bank v. Beverly Hills Business Bank, 26 Cal. App. 4th 1441, 1466, 25 Cal. Rptr. 2d, 908, 921 (1993), *review granted*, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994) (citation omitted) (emphasis added).

deficiency legislation because the transactions in which letters of credit are used typically involve commercial borrowers who are not at a significant disadvantage in bargaining power. Such an amendment would also bring the treatment of letters of credit in line with the treatment of other instruments governed by the Commercial Code and concurrently used as partial security in real estate transactions.

1. The Policy of the Anti-Deficiency Legislation

The anti-deficiency legislation is the product of the "need, during the Great Depression of the 1930's, to halt the wholesale destruction of the small landowner class."[133] It arose from the "legislative abhorrence of the all too common foreclosures and forfeitures occurring during that era for reasons beyond the control of the debtors."[134] The objective was to protect residential borrowers with a disadvantage in borrowing power from a loss of not only most or all of their personal wealth, but also the basic necessities such as shelter and the means of earning a livelihood.

The original legislation did not distinguish between commercial and residential borrowers and, with one exception, the current statutes also do not distinguish between the two. This exception, section 580(b), provides support for the proposed amendment. Section 580(b) prevents a deficiency where the security consists of a structure of no more than four units occupied in whole or in part by the borrower (in essence, residential borrowers).[135] Thus, the anti-deficiency statutes support the policy of protecting residential borrowers with limited bargaining power, while limiting the protection provided to sophisticated commercial borrowers.

Three additional reasons support the argument that the legislative policies embodied in the anti-deficiency legislation are not applicable to most real estate transactions involving letters of credit. First, letters of credit are normally not used in transactions involving parties which the anti-deficiency legislation was enacted to protect. Typically, letters of credit are issued to relatively large commercial borrowers. These borrowers are not the residential homeowners the

133. BERNDARDT, *supra* note 5, at 185.
134. Hetland & Hansen, *supra* note 26, at 188.
135. CAL. CIV. PROC. CODE § 580(b) (West 1991). *See generally* Roseleaf Corp. v. Chierighino, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963); Brown v. Jensen 41 Cal. 2d 193, 259 P.2d 425 (1953); Palm v. Schilling, 199 Cal. App. 3d 63, 244 Cal. Rptr. 600 (1988).

Legislature deemed worthy of protection from loss of the necessities of life.[136] Accordingly, the Legislature should recognize that the distinction between commercial and residential borrowers is relevant with respect to the interaction of letters of credit and the anti-deficiency legislation.[137]

Secondly, borrowers in transactions that include a letter of credit do not need, nor do they necessarily deserve, the protections provided by the anti-deficiency legislation. Because letters of credit are used by commercial borrowers, the transactions in which they are used do not suffer from the unequal bargaining positions typically encountered in residential financing.

Third, letters of credit do not undermine the parties' expectations. The anti-deficiency legislation is an attempt to uphold the expectations of parties to a credit transaction that is secured by real property by requiring that the lender resort to the real property for primary recourse. When sophisticated parties with equal bargaining power voluntarily enter into an agreement to allow the lender to recover on a letter of credit if the borrower defaults, they have formed their expectations in a way that is not advanced, but instead frustrated, by the anti-deficiency statutes. Therefore, the policies that underlie the anti-deficiency legislation are inapplicable to real estate financing transactions that include letters of credit.

2. *The Precedent for Exempting Letters of Credit from the Anti-Deficiency Legislation*

Precedent supports the amendment this Note proposes. The conditions surrounding *Western Security Bank* are similar to those which resulted in the "mixed collateral" amendments to the California Commercial Code. The "mixed collateral" amendments were prompted by California courts subordinating division 9 of the California Commercial Code to the anti-deficiency legislation. Similarly, *Western Security Bank* subordinated division 5 of the Commercial Code to the anti-deficiency rules.

Before 1986, when a single obligation was secured by both real and personal property, creating the "mixed collateral" problem, the real property enforcement scheme which embodies the anti-deficiency legislation was exclusively applied. This was the procedure the courts chose despite the fact these obligations were also secured

136. Irvine Brief, *supra* note 106, at 3 n.2 ("Letters of credit are virtually never used in real estate transactions involving private homeowners.").

137. Real estate law consistently treats commercial borrowers differently than residential borrowers. *See, e.g.*, CAL. CIV. PROC. CODE § 580(b) (West 1994). *See generally* HARRY D. MILLER & MARVIN B. STARR, CALIFORNIA REAL ESTATE 122-28 (2d ed. 1989).

by personal property subject to division 9 of the California Commercial Code.[138]

In 1985, the California Legislature amended California Commercial Code section 9501(4).[139] This amendment allows real and personal property to be pursued in whichever order the lender chooses without impairing the other form of security. In enacting this amendment, the Legislature overruled the previous judicial determination that the real property enforcement scheme would provide the exclusive rules in the "mixed collateral" problem. This amendment essentially provides that personal property security will be governed solely by the rules of the California Commercial Code, and real property security by the "elaborate and interrelated set of anti-deficiency and foreclosure statutes."[140]

Letters of credit are covered by California Commercial Code division 5.[141] Therefore, as in the "mixed collateral problem," in the context of letters of credit there are two financing instruments (the letter of credit and the real property security), each with a distinct set of rules governing their use. By applying the anti-deficiency rules to letters of credit the judiciary has allowed these statutes to trump the Commercial Code rules regarding letters of credit.[142] The Legislature should take action, just as they did with the "mixed collateral" amendments, to insure that the requirements of division 5 of the Commercial Code are not ignored.

Comparing the "mixed collateral" amendments to a potential amendment providing special treatment for letters of credit illustrates that letters of credit are even more deserving of an exemption from the real property foreclosure rules. By allowing lenders to draw on letters of credit and proceed against personal property in a manner unfettered by the anti-deficiency rules, the parties' expectations

138. CAL. COM. CODE §§ 9102-9508 (West 1994). *See generally* Hetland & Hansen, *supra* note 26, at 185-86; Morris W. Hirsch et al., *The U.C.C. Mixed Collateral Statute — Has Paradise Really Been Lost?*, 36 UCLA L. REV. 1, 2-5 (1988).

139. CAL. COM. CODE § 9501(4) (West Supp. 1987) (amendments effective January 1, 1986).

140. Hetland & Hansen, *supra* note 26, at 185.

141. CAL. COM. CODE §§ 5101-5117 (West 1994).

142. Note that *Western Security Bank* attempts to take this tack by applying the California Commercial Code's rules in conjunction with the anti-deficiency limits. This is done by holding that a draw violates section 580(d) and thus constitutes "fraud in the transaction" under California Commercial Code section 5114(2)(b). *See* CAL. COM. CODE § 5114(2)(b) (West 1994). However, as discussed above, the use of the "fraud in the transaction" exception was simply misdirection used by the court to obscure its actual holding: Section 580(d) applies despite the conflicting rules governing the letter of credit doctrine. *See supra* part III.C.

are upheld. Unlike letters of credit, personal property security is typically used in both residential and commercial lending transactions. Therefore, the transactions which include personal property involve many residential borrowers with markedly unequal bargaining power. As discussed above, these are the parties that the anti-deficiency legislation was intended to protect. Exempting letters of credit from the anti-deficiency statutes would have no effect on these parties.

The Legislature should amend the California Commercial Code to exempt letters of credit from the anti-deficiency legislation.[143] Subjecting letters of credit to these statutes simply provides protection to large commercial borrowers who can take care of themselves.

CONCLUSION

Western Security Bank impairs the usefulness of letters of credit by expanding the "fraud in the transaction" exception to the extent that it threatens to swallow the independence principle, and by providing the rationale for subjecting pre-foreclosure draws to section 726(a) limits. *Western Security Bank* creates an uncertainty in the place of the guaranteed and mechanical payment that letters of credit are meant to provide. This Note proposes that the California Legislature should end this uncertainty by enacting an amendment to the California Commercial Code providing that letters of credit be governed solely by division 5 of the Commercial Code. Accordingly, draws would not be limited in any way by the anti-deficiency statutes. Exempting letters of credit from the anti-deficiency legislation would not undermine the general policies upon which these statutes are based because letters of credit are typically used by commercial

143. An alternative solution would be to allow draws upon letters of credit used in combination with real property security only when the lender proceeds against the real property in a judicial foreclosure action. Under this rule a letter of credit beneficiary could draw on the letter either (1) pre-foreclosure on the condition that the beneficiary only proceed against the property in a later judicial foreclosure, or (2) post foreclosure as long as the foreclosure was done judicially. This would only change current law with regard to pre-foreclosure draws, assuming they are held to violate section 726(a), because drawing post judicial foreclosure is currently acceptable (but note the problem of the letter expiring due to its short-term nature). This treatment would ensure letters of credit retain some of their commercial utility while not allowing them to be used as a vehicle to impose a deficiency judgment, either pre- or post-nonjudicial foreclosure, upon a borrower who is denied the right of redemption and a fair value hearing. However, as discussed in this part, letter of credit draws do not threaten the legislative policies behind the anti-deficiency statutes. Therefore, exempting letters of credit altogether from the anti-deficiency legislation is the superior treatment. The Legislature has enacted Commercial Code division 5 to govern letters of credit. Real property is governed by the anti-deficiency rules and foreclosure statutes. Accordingly, a real estate financing transaction which includes both a letter of credit and real property security should be treated similar to the "mixed collateral problem" — allow the statutory section which governs the instrument determine how the instrument can be proceeded against.

borrowers and in transactions that do not involve overreaching. Moreover, allowing lenders to draw on letters of credit does not frustrate, but instead upholds, the intention of parties to real estate financing.

This Note's proposed amendment would not be unprecedented; the rules that *Western Security Bank* established to govern letters of credit are similar to the judicial treatment of personal property security before the "mixed collateral" amendments. Because letters of credit are generally used only by commercial borrowers, whereas personal property security is often used by residential borrowers, there are more weighty policy reasons for exempting letters of credit from the anti-deficiency rules than there were for providing the personal property exemption created by the enactment of California Commercial Code section 9501.

Denying California borrowers the option of using letters of credit in the financing and restructuring of real property loans serves only to exacerbate the current real estate downturn. Letters of credit are especially important during a time of depressed real estate prices because they may provide the only viable means to support continued development and allow necessary refinancing.[144] The legislative amendment proposed in this Note ensures that letters of credit are not rendered useless; the California real estate market cannot afford any further aggravation of its currently anemic condition.

ADDENDUM

On September 15, 1994, Governor Pete Wilson approved urgency legislation to amend section 2787 of the Civil Code, to add sections 580.5 and 580.7 to the Code of Civil Procedure, and to amend section 5114 of the Commercial Code.[145] The most significant features of this legislation are:

1. Section 2787 of the Civil Code is amended to state that a letter of credit is not a suretyship obligation.
2. Section 580.5 is added to the Code of Civil Procedure to provide that drawing upon a letter of credit supporting an obligation which is also secured by a mortgage or deed of trust upon real property does not constitute (i) an action within the meaning of subdivision (a) of section 726, (ii) a money judgment for a deficiency or a deficiency judgment within the meaning of section

144. Irvine Brief, *supra* note 106, at 3.
145. 1994 Cal. Adv. Legis. Serv. 611 (Deering).

580a, 580b, and 580d, or subdivision (b) of Section 726, or (iii) a violation of sections 580a, 580b, 580d, or 726.

3. Section 580.7 is added to the Code of Civil Procedure to preclude the enforcement of a letter of credit if (i) the customer is a natural person, (ii) the letter of credit is issued to the beneficiary to avoid a default of the existing loan, (iii) the existing loan is secured by a purchase money deed of trust or purchase money mortgage on real property containing one to four residential units, at least one of which is owned and occupied or was intended at the time the existing loan was made, to be occupied by the customer, and (iv) the letter of credit is issued after the effective date of this section.

The stated intent of the Legislature in approving this enactment was to

> confirm the independent nature of the letter of credit engagement and to abrogate the holding in *Western Security Bank* . . . [and] to confirm the expectations of the parties to a contract that underlies a letter of credit, that the beneficiary will have available the value of the real estate collateral and the benefit of the letter of credit without regard to the order in which the beneficiary may resort to either.[146]

The urgency legislation is effective on September 15, 1994; non-urgency legislation will become effective January 1, 1995.

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146. *Id.*