

Commentary

California Courts Disagree on Effect of 1994 Letter of Credit Legislation

by Douglas P. Snyder

Last year we reported that the California legislature had passed Senate Bill 1612, effective September 16, 1994, which was designed to change the holding of the California Court of Appeal in *Western Security Bank, N.A. v. Superior Court*, 21 Cal. App. 4th 156 (1993), regarding the enforcement of letters of credit given as credit enhancement for a loan secured by real property. The *Western Security Bank* case had created great uncertainty regarding the utility of letters of credit to enhance mortgage loans and the proper course to follow for an existing transaction.

With respect to commercial loans, the 1994 statute states that a draw on a letter of credit by a mortgage lender will not violate California's "one-action" rule if the draw occurs before foreclosure, or violate the anti-deficiency laws if the draw satisfies a deficiency after non-judicial foreclosure. In either situation, the issuer bank must honor a proper draw request from the mortgage lender and the borrower will be responsible to reimburse the issuer following payment. The law states that it "clarifies prior law" and we concluded that these rules would apply to pre-existing loans.

Two recent decisions in different Court of Appeal Districts have interpreted the new law and its effect on pre-existing loans – **with different results**. In *1111 Prospect Partners, L.P., v. Superior Court*, 95 Daily Journal D.A.R. 12830 (September 26, 1995), under direction from the California Supreme Court to rule in accordance with the 1994 statute, the Court of Appeal in the Fourth Appellate District held that the lender's draw on a letter of credit **before foreclosure** does not violate the one-action rule and does not jeopardize the lender's security interest in real property. No California case had addressed this issue. The Court found this to be the law before the 1994 statute, and stated that it was confirmed by the 1994 statute as a clarification of existing law.

Three days later the Court of Appeal in the Second Appellate District ruled in *Western Security Bank, N.A. v. Beverly Hills Business Bank*, 95 Daily Journal D.A.R. 13210 (September 29, 1995), the same case as was captioned *Western Security Bank, N.A. v. Superior Court* in 1993. This Court was also under instruction from the California Supreme Court to rule in accordance with the 1994 statute. To the surprise of most real estate practitioners, the Court reiterated its original holding that **following non-judicial foreclosure** and presentment of a letter of credit to satisfy part of the loan deficiency resulting from the foreclosure bid, the issuer of the letter of credit has the **option** to honor the letter of credit. The issuer may honor the letter of credit and seek reimbursement from the borrower, or it may refuse to pay the lender and leave the lender with the loan deficiency. If the letter of credit is paid and the borrower reimburses the issuer, the borrower can sue the lender to recoup the money because the lender committed a "fraud" in presenting the letter of credit violation of California's anti-deficiency laws.

The *Western Security Bank* Court held that the 1994 statute did **not** simply clarify prior law, rather the 1994 statute **changed** the law as announced in the Court's 1993 decision. For the 1994 statute to be applied retroactively to pre-existing loans, the California legislature must expressly make this statement.

Parties to mortgage loan transactions which were credit enhanced with letters of credit issued prior to September 16, 1994 should act cautiously and seek legal advice. Transactions entered into after September 16, 1994 should be governed by the 1994 statute.

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