

Commentary

Legislature Overrides Court to Allow Enforcement of Letters of Credit

by Douglas P. Snyder

On September 16, 1994, Governor Wilson signed into law Senate Bill No. 1612, which overrides the California Court of Appeal holding in Western Security Bank, N.A. v. Superior Court, 21 Cal. App. 4th 156 (1993), and allows real estate lenders to enforce a letter of credit held as additional security for a mortgage loan after the lender's non-judicial foreclosure sale of the mortgaged property. In our 1993 Summary of Legal Developments, we reported on this case (previously captioned Western Security Bank v. Beverly Hills Business Bank), holding that a bank which has issued a letter of credit to a real estate lender need not honor its credit following the lender's non-judicial foreclosure of the property. In April of this year the California Supreme Court granted its review of this case, and the case is still pending before the Supreme Court.

The holding in Western Security Bank was based on the anti-deficiency rule of Section 580d of the Code of Civil Procedure, which prohibits a personal judgment against the borrower following a non-judicial foreclosure. This rule does not protect guarantors if the guarantor has waived its statutory rights to reimbursement from the borrower, the exercise of which is viewed as a violation of the anti-deficiency rule. If the guarantor has the right to pursue the borrower, the effect of the anti-deficiency rule is that the non-judicial foreclosure "destroys" the reimbursement rights of the guarantor, and the lender may not collect on its guaranty. In Western Security Bank, the Court held that letter of credit issuers, who insist on a reimbursement rights against their customer, were similar in nature to guarantors. A non-judicial foreclosure by the lender destroyed the issuer's reimbursement rights and, therefore, the lender could not enforce the letter of credit. This was true even though, unlike guaranties, letters of credit benefit from the "independence principle" that the letter of credit is independent of the underlying transaction it supports (the real estate loan in this context), and the issuer normally must pay on the credit regardless of the circumstances in the underlying transaction (the non-judicial foreclosure). It is this independence principle which gives letters of credit their great value when issued by a creditworthy bank – the beneficiary of the credit need not worry about defenses raised by its borrower, absent fraud apparent from the face of the letter of credit.

In response to the outcry from the banking industry that letters of credit were being undermined, the California legislature passed Senate Bill 1612. The new law reaffirms the independence principle of letters of credit found in Section 5114 of the California Commercial Code and removes letter of credit enforcement from the limitations imposed by the anti-deficiency laws. A draw on a letter of credit will not jeopardize the real estate lender's security in the property under the "one-action" rule. The anti-deficiency laws will not be violated by the presentment of a letter of credit for payment after the lender has held a non-judicial foreclosure of the property. The issuer will be obligated to honor the credit in those circumstances and is entitled to seek reimbursement from its customer following payment.

The legislature made an exception for purchase money loans made to individuals to buy an owner occupied residence where the letter of credit is later issued to avoid default on the loan. In these circumstances, where the borrower is not personally liable under Section 580b of the Code of Civil Procedure, the new law states that the letter of credit is not enforceable.

Senate Bill 1612 became effective immediately when signed on September 16, 1994, and states that it clarifies prior law. Thus, the legislature intends that these rules apply to pre-existing loans.

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