LENDER'S CHOICE OF FORECLOSURE LAW

By Gordon L. Gerson, ESQ.

National lenders love California sunshine and real estate, but hate its laws relating to foreclosures and enforcement of deficiencies.

Deficiency judgments have seldom been allowed out west. But now comes a case by a California court that allows a lender to enforce a non-California choice-of-law provision allowing the lender to seek a deficiency judgment following foreclosure sale of commercial property in California.

In what may be viewed in years to come as a watershed case for national lending practices, a Califonia appellate court held in Guardian Savings & Loan Association v. MD Associates, 64 Cal. App. 4th 309 (1998) that the choice-of-law provision in a promissory note calling for application of Texas law was enforceable so as to permit a payee to seek a deficiency judgment following the foreclosure sale.

Background

Lenders with portfolios of loans nationwide have their own 80/20 Rule for California lending. That is, while 20% of every good loan portfolio is in California, real estate loans, 80% of all legal foreclosure problems and collection of indebtedness issues arise in connection with California loans.

California's anti-deficiency legislation is the result of Depression Era politics. The state legislature desired to protect borrowers and place the risk of inadequate security on lenders. As a result of statutes and a series of cases, certain principles are sacrosanct to California lending practices:

- A deficiency judgment may not be obtained following foreclosure of a purchase-money security interest in real property.
- Anti-deficiency provisions of California law may not be contractually waived as a condition of the encumbrance of real property.
- A deficiency judgment may not be obtained following a non-judicial foreclosure sale.
- A general partner of a limited partnership or a guarantor of the debt of another is entitled to the same anti-deficiency protection as the borrower.

And the list goes on with each rule threaded together by the concept that lenders have superior bargaining power and must bear an equitable allocation of risk when lending. The cases in this area are a minefield for California lawyers, and have the effect of a winter white-out for non-California lawyers and underwriters attempting to lend without full grasp of the concepts.

New Law for Sophisticated Borrowers.

In Guardian, as part of a complex real estate transaction involving the purchase of an office building in San Francisco, a Texas joint venture of two individuals was formed to purchase the property. Guardian S & L provided 100% of the financing for the purchase. The promissory note included a choice-of-law provision adopting Texas law. Guardian S & L sought and succeeded in obtaining a motion for summary judgment that the two individuals of the joint venture should be personally liable on a deficiency judgment following foreclosure sale. While California Code of Civil Procedure Section 580b bars a deficiency judgment following foreclosure of purchase-money security interest, Texas law imposses no similar provision. The court held among other matters that "California's policy of equitable risk application did not apply to a transaction between sophisticated Texas domiciliaries, and the interest of Texas in assuring justified expectations of parties to an agreement that had maximum force when the agreement was negotiated, as here, between Texas domiciliaries."

It is noteworthy how the court arrived at its decision. The court relied upon Ned-Lloyd Lines BV v. Superior Court, 64 Cal. App. 4th 316 (1992) which held a choice-of-law provision choosing Hong Kong law to be fully enforceable in a contract dispute in California. In Ned-Lloyd the court, while engaging in a lengthy analysis of California decisions and the Restatement Second of Conflict Laws, restated that California has strong policy considerations favoring the enforcement of freely negotiated choice-of-law provisions. The court in Guardian also adopted the following analytical approach for determining in what instances California's foreclosure law or another state's foreclosure law should govern out of state lending transactions:

(1) Whether the law of the chosen state has a substantial relationship to the parties or their transactions; or

(2) Whether there is any other reasonable basis for the parties' choice-of-law.

(3) "If neither of [the foregoing] tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice-of-law. If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a fundamental policy of California. If there is no such conflict, the court shall enforce the parties' choice-of-law. If, however, there is a fundamental conflict with California law, the court must then determine whether California has a "materially greater interest than the chosen state in the determination of the particular issue…"

While both facts and judicial analysis of the Guardian case are set forth here in an extremely abbreviated manner, the message is clear: California law need not govern the country in today's lending environment - particularly with respect to commercial purchase-money lending.