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## RECENT CASE

REAL ESTATE SECURED TRANSACTIONS—SUBORDINATED SOLD-OUT JUNIOR LIENOR OF COMMERCIAL PROPERTY AS AN EXCEPTION TO THE ANTI-DEFICIENCY STATUTES—*Spangler v. Memel*, 7 Cal. 3d 603, — P.2d —, — Cal. Rptr. — (1972).

An owner of residential property located in a commercial zone sought to realize a profit by selling the property to real estate developers contemplating a commercial use. By the terms of the agreement of sale, the purchaser made a down payment and executed a note for the balance secured by a deed of trust which the vendor agreed to subordinate to liens held by a bank giving a large construction loan. As consideration for the vendor's subordination agreement, each individual comprising the partnership purchasing the property gave a written guaranty of joint and several liability for the note and waived the protection of the anti-deficiency statutes.<sup>1</sup> The partnership transferred the property to another enterprise composed of the same people plus one additional person, which obtained an agreement for construction loans from a bank up to \$2,000,000.

Upon receiving a portion of the sum available, the transferee-developer constructed a commercial office building which was never a commercial success. When the developers failed to meet payments on the bank loan, the bank brought an action to foreclose, joined the seller, purchased the property at the sale, and because the loan was for construction and not purchase money, obtained a deficiency judgment against the individual developers. The vendor cross-complained against the original purchasers to enforce the personal guaranty of joint and several liability and agreement to waive protection under the anti-deficiency statutes. Cross-defendants appealed from a judgment against them for the amount of the note. The issue before the California Supreme Court was whether section 580(b),<sup>2</sup> prohibiting deficiency judgments against the giver of a purchase money deed of trust, is applicable to a sold-out junior lienor.<sup>3</sup>

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1. CAL. CIV. PRO. CODE §§ 580(a), 580(b), 580(d), 726 (West 1955).

2. *Id.* at 580(b).

3. Cross-defendants claimed section 580(b), as construed in *Brown v. Jensen*, 41 Cal. 2d 193, 259 P.2d 425 (1953), barred cross-complainant's at-

Sections 580(a), 580(b), 580(d) and 726 of the California Code of Civil Procedure<sup>4</sup> all have as their purpose, in part, limiting or prohibiting deficiency judgments in transactions involving mortgages and deeds of trust. Section 580(b) is intended, specifically, to prevent creditors from buying at their own foreclosure sales at deflated prices, thus realizing double recoveries by holding the debtors liable for large deficiencies.<sup>5</sup> As amended in 1963, section 580(b) provides that no deficiency judgment will lie for the holder of a purchase money mortgage or deed of trust upon default by the purchaser.<sup>6</sup>

Of particular significance in *Spangler* is the court's conclusion that "when in the sale of real property for commercial development, the vendor pursuant to the agreement of sale, subordinates his purchase money lien to the lien securing the purchaser-developer's construction loan and thereafter, loses his security interest after sale or foreclosure under the senior lien, section 580b should not be applied to bar recovery by the junior vendor lienor of the unpaid balance of the purchase price of the property."<sup>7</sup> Although the court has diluted its effect by past holdings,<sup>8</sup> the *Spangler* holding constitutes a clear inroad into the rigid prohibitory language of section 580(b), which says in no event shall the vendor obtain a deficiency judgment against a purchase-money mortgagor or trustor.<sup>9</sup> This ruling warrants critical

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tempt to obtain a deficiency judgment. Brown held that 580(b) applies to sold-out junior lienors. Cross-complainant urged that *Brown v. Jensen* was impliedly overruled in *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963), to the extent that 580(b) does not apply to sold-out junior lienors seeking to recover the purchase price.

4. CAL. CIV. PRO. CODE §§ 580(a), 580(b), 580(d), 726 (West 1955).

5. *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 40, 378 P.2d 97, 99, 27 Cal. Rptr. 873, 875 (1963).

6. CAL. CIV. PRO. CODE § 580(b) (West 1955) reads as follows: "No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale, or under deed of trust, or mortgage, given to the vendor to secure payment of the balance of the purchase price of real property, or under a deed of trust, or mortgage, on a dwelling for not more than four families given to a lender to secure payment of a loan which was in fact used to pay all or part of the purchase price of such dwelling occupied, entirely or in part, by the purchaser. (As amended Stats. 1963, c. 2158, p. 4500, § 1.)"

7. *Spangler v. Memel*, 7 Cal. 3d 603, 614, — P.2d —, — Cal. Rptr. — (1972). Whereas the trial court gave recovery to the cross-complainant on estoppel and detrimental reliance grounds, the California Supreme Court "took the bull by the horns" when it ignored the trial court reasoning and separately concluded that 580(b) did not apply in the context of the case before it.

8. See, e.g., *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963), wherein judgment was on notes secured by property other than the property purchased; a variation from the standard purchase money security which involves the retention of interest in the land sold.

9. CAL. CIV. PRO. CODE § 580(b) (West 1955). In *Spangler*, the court quotes from its opinion in *Brown v. Jensen*, 41 Cal. 2d 193, 198, 259 P.2d

consideration.<sup>10</sup>

The court stated that 580(b) applies automatically to sold-out juniors only in the standard purchase money situation.<sup>11</sup> Where, however, the transaction is a variation from the standard purchase money mortgage or deed of trust transaction, it should be determined whether the application of 580(b) subserves the purposes of the statute.<sup>12</sup>

The court emphasized that the purpose of 580(b) is to prevent inflation and overvaluation of land values and discourage precarious land promotion schemes.<sup>13</sup> Placing the risk of inadequate security on the vendor accomplishes this purpose while giving the vendee a clue as to the true market value of the property. The Court stated that 580(b) attempts to discourage land sales that are unsound and to prevent the aggravation of depressed land values that would result if defaulting purchasers lost their land and were burdened with personal liability.<sup>14</sup>

In a standard purchase money transaction, the purchaser continues the same or similar use of the property, thus the present security value of the property is a reliable indicator of its actual fair value. However, where the vendor subordinates his security interest to the purchaser's construction loan in contemplation of considerable improvements upon the property, the present security value is not a reliable indicator of the ultimate value of the property. Rather, the ultimate value is determined by the success of the contemplated change in use of the property. A junior depends

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425, 427 (1953), as follows: "The section states that in *no event* shall there be a deficiency judgment, that is, whether there is a sale under the power of sale or sale under foreclosure, or no sale because the security has become valueless or is exhausted.

10. The court states that since *Brown v. Jensen*, 41 Cal. 2d 193, 259 P.2d 425 (1953), "all subsequent decisions by this court on the applicability of section 580b have assumed that this section by its terms applies to sold-out junior lienors and have gone on to determine whether the particular purchase money situation in question fell within the purposes of section 580b." *Spangler v. Memel*, 7 Cal. 3d 603, 610, — P.2d —, — Cal. Rptr. — (1972). But, application of *Roseleaf* to the facts in point convinced the Court that the purpose of the statute was better subserved by not applying 580(b). *Spangler* is distinguishable from *Roseleaf*, however, because the note involved was secured by the property purchased whereas, in *Roseleaf*, the notes upon which the action was based were secured by property other than the property purchased.

11. *Spangler v. Memel*, 7 Cal. 3d 603, 610-611, — P.2d —, — Cal. Rptr. — (1972). The California Supreme Court approved *Brown* with limitations thus disposing of the confusion over the validity of *Brown* in light of *Roseleaf*.

12. Whereas the court makes explicit statements regarding statutory purpose, it makes no reference to the legislature's own intent, but rather relies entirely on its own statements in prior cases.

13. *Spangler v. Memel*, 7 Cal. 3d 603, 612, — P.2d —, — Cal. Rptr. — (1972).

14. *Id.* See *Bargioni v. Hill*, 59 Cal. 2d 121, 123, 378 P.2d 593, 28 Cal. Rptr. 321 (1963).

on the ultimate value of the property as sufficient and adequate to cover the senior lien and his own. Thus, a markedly different situation arises constituting a variation from the standard purchase money transaction.

The court's final conclusion is that "the purpose of preventing overvaluation in this context is best subserved by not applying section 580b."<sup>15</sup> In this context, the true market value depends on the success of the commercial development; the success of the commercial development depends on the loans to construct the project; the availability of loans depends upon the lender receiving senior security interest in the property. "Consequently a vendor who wishes to receive a purchase price reflecting the commercial potential of the project must be willing to subordinate his security interest to that of the construction lender."<sup>16</sup> Therefore, the court reasoned, since success depends greatly on the competence and diligence of the purchaser-developer, he, rather than the vendor, should bear the risk of failure.

By its holding in *Spangler*, the court enabled the vendor to escape the consequence of losing both his land and the purchase price. Although the court has provided relief in circumstances where it did not previously exist, the question remains whether it is advisable to change present security practices to take advantage of the newly established remedy. The answer is probably that, under ordinary circumstances, it is still sound judgment not to subordinate to prior liens for commercial improvements greatly in excess of the fair market value of the property. Whereas the owner can now recover a deficiency judgment on a purchase money deed of trust under the circumstances of *Spangler*, that judgment may be worthless. If the construction lender forecloses and obtains a significant deficiency judgment, as in *Spangler*, the developer will probably be insolvent and unable to pay the additional deficiency judgment in favor of the vendor. Therefore, the seller contemplating subordinating to the developer-purchaser's construction loans should proceed with no less caution than if 580(b) applied to bar deficiency judgments against the developer-purchaser.

If the developer is sufficiently reputable and well established so that there is no question that he will be solvent after the construction lender's deficiency is satisfied, then perhaps the *Spangler* ruling will warrant a deviation from present practice. Another alternative for the seller who wishes to realize the commercial potential of his property by selling to a developer is to obtain a

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15. *Spangler v. Memel*, 7 Cal. 3d 603, 613, — P.2d —, — Cal. Rptr. — (1972).

16. *Id.*

guaranty from a reputable and solvent third party. In that case, 580(b) is inapplicable to the independent action against the guarantor who is not the purchaser.<sup>17</sup> However, unless these special circumstances appear, owners are advised not to subordinate their security to construction lenders for commercial development of the property even in light of the California Supreme Court's holding in *Spangler*.

Application of 580(b) has been changed under special circumstances involving subordination to commercial development construction lenders. However, 580(b) is still automatically applied to sold-out juniors in the standard situation. Furthermore, the impact of the *Spangler* ruling is not likely to produce significant changes in the protection of a vendor's security interest in his land or alter the likelihood of his recovery of the purchase price upon default by the purchaser.

*Stephen D. Quinn*

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17. CAL. CIV. PRO. CODE § 580(b) (West 1955).