California Code of Civil Procedure Section 580b Revisited: Freedom of Contract in Real Estate Purchase Agreements

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Section 580b of the California Code of Civil Procedure makes purchase-money deeds of trust in California "nonrecourse" by prohibiting any deficiency judgment following foreclosure. In Spangler v. Memel, *the California Supreme Court created an exception to the antideficiency rule of section 580b where the seller subordinated the buyer's purchase-money deed of trust to a construction loan deed of trust which was subsequently foreclosed, leaving the seller without security. An analysis of* Spangler *suggests that it was a misconceived attempt to protect sellers as a "class" from certain risks of real estate development, even though sellers of developable property often reap a benefit in higher prices by sharing in such risk. The decision was based on a number of fictions and rationalizations that are inconsistent with the real world of commercial real estate transactions. Cases which have followed and extended* Spangler *have continued to rely on poorly analyzed statements in the case and have created confusion and unpredictablity in the law relating to purchase-money deeds of trust. More principled and predictable decisions would be based on the negotiated agreements of the parties, including contractual waivers of section 580b protection when they are agreed to.*

INTRODUCTION

Every practitioner and student of the law has seen examples of court-created exceptions to statutory rules. Courts sometimes create

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exceptions to statutes based on the judges' perceptions of the requirements of justice in particular circumstances. Jurisprudentially this can be tricky business, especially when the statute is one that has widespread application in commercial transactions and the exception is based on poorly defined or untestable theories. This Article explores the pitfalls of judicial creation of one such exception to a clear statutory rule of California law regarding financing of real estate purchase and sale transactions.

Section 580b of the California Code of Civil Procedure (580b) establishes the statutory rule that the buyer of real property in California who pays part of the purchase price with a note to the seller secured by a deed of trust or mortgage on the property purchased is not personally liable on the note. The seller must look solely to the real property security for enforcement of the obligation by foreclosure, and no deficiency judgment is permitted. The celebrated collapses of the Denver, Dallas, and Phoenix real estate markets during the mid-1980s, and recent sharp declines in California real property values emphasize the significance of 580b's nonrecourse rule. In *Spangler v. Memel*,[1] the California Supreme Court created an exception to the rule of 580b by holding that 580b does not protect the purchaser from suit for a deficiency judgment where the seller, pursuant to the sale agreement, subordinates the lien of the seller's purchase-money deed of trust to a construction loan obtained by the buyer for commercial development of the property.[2]

A growing number of appellate court decisions have followed and considerably expanded *Spangler*. These include *Long v. Superior Court (Rickert)*,[3] *Roffinella v. Sherinian*,[4] *Ziegler v. Barnes*,[5] and others.

It is the thesis of this Article that *Spangler* and its progeny are based on fictions and represent unwarranted judicial protectionism. The *Spangler* doctrine results in unpredictable and potentially unjust consequences in the real world of real estate transactions. Courts could balance the risks of real property purchase transactions more consistently with the expectations of the parties by respecting the plain language of 580b and the parties' own negotiated agreements (including contractual waivers of 580b), than through a poorly conceived judicial exception to a clear statutory rule. It is not the purpose of this Article to argue whether or not the nonrecourse rule of

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1. Spangler v. Memel, 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr. 807 (1972).
2. *Id.* at 615, 498 P.2d at 1061, 102 Cal. Rptr. at 814.
3. Long v. Superior Court (Rickert), 170 Cal. App. 3d 499, 216 Cal. Rptr. 337 (1985).
4. Roffinella v. Sherinian, 179 Cal. App. 3d 230, 224 Cal. Rptr. 502 (1986).
5. Ziegler v. Barnes, 200 Cal. App. 3d 224, 246 Cal. Rptr. 69 (1988).

580b is itself good policy.[6] However, nonrecourse for secured purchase-money obligations is the existing statutory rule of California. As such, the courts should decide cases in a way that will allow transacting parties to predict the consequences of their agreements with reasonable accuracy when they negotiate in light of that statutory rule.

BACKGROUND

Section 580b and Its Application Prior To Spangler: *The Search for Elusive Purposes*

Before turning to *Spangler* itself, it is necessary to review some earlier guidepost decisions that interpreted the meaning and effects of 580b.

Currently, 580b provides:

> No deficiency judgment shall lie in any event after a sale of real property or an estate for years therein for failure of the purchaser to complete his or her contract of sale, or under a deed of trust or mortgage given to the vendor to secure payment of the balance of the purchase price of that real property. . . .[7]

Section 580b was first enacted in 1933.[8] It was part of a spate of legislation arising from the collapse of real estate values during the Great Depression.[9] Unfortunately, there is virtually no legislative history to aid in interpretation of the statute.

A major question arising from the language of the statute is whether the bar against personal liability arises only if the seller/beneficiary forecloses under the purchase-money deed of trust, or whether it is also operative after foreclosure by the holder of a lien senior to that of the seller. The latter situation typically arises when a property is sold and the seller takes back a second deed of trust behind a third-party lender. The Supreme Court answered this key question in *Brown v. Jensen.*[10]

In *Brown*, the plaintiff seller took back a note secured by a second

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6. It is certainly not universal in the United States. Many other states allow deficiency judgments on purchase-money notes after foreclosure. Indeed, the general rule is personal liability for deficiency. *See, e.g.*, 59 C.J.S. *Mortgages* § 777 (1949 & Supp. 1993). The question is likely to be debated extensively in response to the proposed major reform of California's foreclosure laws. *See infra* notes 120-23 and accompanying text.

7. CAL. CIV. PROC. CODE § 580b (West Supp. 1993).

8. 1933 Cal. Stat. 642.

9. *See generally*, Stefan A. Riesenfeld, *California Legislation Curbing Deficiency Judgments*, 48 CAL. L. REV. 705 (1960) (discussing the background of 580b).

10. Brown v. Jensen, 41 Cal. 2d 193, 259 P.2d 425 (1953).

deed of trust on the sold property. The buyer placed a first deed of trust in favor of Glendale Federal Savings and Loan ahead of the seller's encumbrance at the closing, the proceeds of which presumably were paid to the seller. Glendale Federal foreclosed after the buyer defaulted under its note. Plaintiff seller did not attempt to buy the property at the foreclosure sale to protect her second deed of trust, but afterwards sued on the purchase-money note and obtained a judgment against the buyer.

The buyer pleaded 580b as a bar to the action. The trial court apparently determined that since there had been no "sale" by the seller under her deed of trust, the action by the seller was not one for a "deficiency" and 580b therefore did not apply. The Supreme Court examined the several antideficiency sections, 580a, 580b, and 580d,[11]

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11. Section 580a of the California Code of Civil Procedure attempts to assure that the debtor defendant in an action for a deficiency judgment will receive credit for the fair value of the foreclosed property. It provides,

> Whenever a money judgment is sought for the balance due upon an obligation for the payment of which a deed of trust or mortgage with power of sale upon real property or any interest therein was given as security, following the exercise of the power of sale in such deed of trust or mortgage, the plaintiff shall set forth in his or her complaint the entire amount of the indebtedness which was secured by the deed of trust or mortgage at the time of sale, the amount for which the real property or interest therein was sold and the fair market value thereof at the date of sale and the date of that sale. Upon the application of either party made at least 10 days before the time of trial the court shall, and upon its own motion the court at any time may, appoint one of the probate referees provided for by law to appraise the property of the interest therein sold as of the time of sale. The referee shall file his or her appraisal with the clerk and that appraisal shall be admissible in evidence. The referee shall take and subscribe an oath to be attached to the appraisal that he or she has truly, honestly and impartially appraised the property to the best of his or her knowledge and ability. Any referee so appointed may be called and examined as a witness by any party or by the court itself. The court must fix the compensation of the referee in an amount as determined by the court to be reasonable, but those fees shall not exceed similar fees for similar services in the community where the services are rendered, which may be taxed and allowed in like manner as other costs. Before rendering any judgment the court shall find the fair market value of the real property, or interest therein sold, at the time of sale. The court may render judgment for not more than the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value of the real property or interest therein sold at the time of sale with interest thereon from the date of the sale; provided, however, that in no event shall the amount of the judgment, exclusive of interest after the date of sale, exceed the difference between the amount for which the property was sold and the entire amount of the indebtedness secured by the deed of trust or mortgage. Any such action must be brought within three months of the time of sale under the deed of trust or mortgage. No judgment shall be rendered in any such action until the real property or interest therein has first been sold pursuant to the terms of the deed of trust or mortgage, unless the real property or interest therein has become valueless.

CAL. CIV. PROC. CODE § 580a (West Supp. 1993). Section 580d prohibits a deficiency judgment whenever a mortgage or deed of trust on real property is foreclosed under a power of sale, i.e., nonjudicial foreclosure. Section 580d provides,

> No judgment shall be rendered for any deficiency upon a note secured by deed

and concluded:

> These provisions indicate a considered course on the part of the legislature to limit strictly the right to recover deficiency judgments, that is, to recover on the debt more than the value of the security. Next comes section 580b, here involved, which deals with a special type of security transaction, a trust deed given to secure to the vendor of property the purchase price agreed to be paid by the vendee. That section is necessarily intended to provide a protection for the trustor because if it were intended to cover only the situation where there has been an actual sale of the security under the power of sale in the trust deed, it would be superfluous. Section 580d covers precisely that situation in *all* trust deeds, whether purchase-money or otherwise.[12]

The court then made a curious statement which has perplexed subsequent courts and commentators and created one of the unfortunate fictions underlying *Spangler*. The *Brown* court prognosticated that "[t]he one taking such a trust deed [i.e., securing a note for part of the purchase price] knows the value of his security and assumes the risk that it may become inadequate."[13] The second half of the statement (about assuming the risk of inadequacy) is nothing but a tautological restatement of the rule of 580b itself. The unanalyzed and unsupported fiction resides in the first part of the statement, i.e., that sellers somehow have superior knowledge of "the value of [the] security." This troublesome fiction of the seller's presumed greater knowledge will be discussed further below; however at this point it should be noted that it was not at all essential or even very useful to the decision.

The court went on to conclude that under 580b, the security alone can be looked to by the seller, and if the security is lost through foreclosure of a senior lien, the seller has no recourse against the buyer. "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

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of trust or mortgage upon real property or an estate for years therein hereafter executed in any case in which the real property or estate for years therein has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.

This section does not apply to any deed of trust, mortgage or other lien given to secure the payment of bonds or other evidences of indebtedness authorized or permitted to be issued by the Commissioner of Corporations, or which is made by a public utility subject to the Public Utilities Act (Part 1 (commencing with Section 201) of Division 1 of the Public Utilities Code).

CAL. CIV. PROC. CODE § 580d (West Supp. 1993).

12. *Brown*, 41 Cal. 2d at 197, 259 P.2d at 426-27 (citations omitted).

13. *Id.* at 197, 259 P.2d at 427.

valueless or is exhausted."[14] Thus, the decision in *Brown* stands on a plain reading of the actual words of the statute, specifically the words "in any event."[15] It does not rest on revelation of hidden statutory purpose or theories of the relative knowledge or equities of buyers and sellers.

Except for *Spangler* and the line of subordination cases trailing in its muddy wake, *Brown*'s literal reading of 580b has been consistently followed.[16]

The next major development after *Brown* in the Supreme Court's interpretation of 580b was *Roseleaf Corp. v. Chierighino*.[17] *Roseleaf* presented an unusual and compelling fact situation. The defendant bought a hotel from plaintiff seller. The purchase price included several promissory notes, one of which was secured by the hotel property, while the others were secured by other properties owned by the buyer, all of which were subject to senior liens in favor of third parties. The buyer defaulted on the notes to the seller secured by the other properties but not on the note secured by the hotel property. The senior lien holders on the other properties foreclosed, leaving the plaintiff seller's notes on those properties unsecured.

The seller sued on the notes that had been secured by the foreclosed properties, and the buyer asserted the defense of 580b. Thus, the buyer seeking protection of 580b still had ownership of the property he had purchased from the plaintiff, while the plaintiff held only paper, the security for which had been lost because of the buyer's default on obligations to other lenders secured by property other than the purchased property. Application of 580b would have meant the buyer retained the property without paying the contract purchase price.

The trial court readily perceived the unfairness of allowing the

14. *Id.* at 198, 259 P.2d at 427.

15. *But see* City Consumer Services, Inc. v. Peters, 815 P.2d 234 (Utah 1991), a recent Utah Supreme Court decision in which it was held that Utah's "one form of action" rule, equivalent to section 726 of the California Code of Civil Procedure, did not bar a sold-out junior lienor (not purchase-money) from suing the borrower directly on the note. The court also held that Utah's fair value limitations, equivalent to section 580a of the California Code of Civil Procedure, did not apply to limit the amount recoverable by the sold-out junior creditor.

16. *See, e.g.*, Raub v. Lee, 181 Cal. App. 2d 529, 5 Cal. Rptr. 444 (1960); Lucky Investments, Inc. v. Adams, 183 Cal. App. 2d 462, 7 Cal. Rptr. 57 (1960); Jackson v. Taylor, 272 Cal. App. 2d 1, 180 Cal. Rptr. 342 (1969); and Shepard v. Robinson, 128 Cal. App. 3d 615, 180 Cal. Rptr. 342 (1981). *See also* Clayton Development Co. v. Falvey, 206 Cal. App. 3d 438, 253 Cal. Rptr. 609 (1988) (holding that 580b applied to bar a seller's suit against the buyer after foreclosure by the first trust deed holder where the seller's second was an *equitable* mortgage resulting from an erroneously recorded deed of trust.) In *Falvey*, the clear intention of the parties to create a *secured* purchase-money obligation was honored by the court in spite of a legal description error that prevented the deed of trust from appearing in the subsequent chain of title.

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

buyer to keep the property yet remain protected from a judgment for the unpaid portion of the price. Hence, the trial court awarded judgment for the seller. The Supreme Court affirmed. The court, however, had to struggle a bit with the plain language of 580b which did not then specifically refer to sale under a deed of trust on the *purchased* property. At that time 580b just referred to sale of real property under a deed of trust or mortgage to "secure payment of the balance of the purchase price of real property."[18] A 1989 amendment changed it to read "the purchase price of *that* real property," i.e., the property sold under the mortgage or deed of trust.[19]

To get around the slight vagueness of wording, the *Roseleaf* court resorted to creation of a second unfortunate fiction, adding to the confusion of *Brown*'s "superior knowledge of the seller" fiction. Without stating how it was apparent and without defining what was a "standard" transaction, the court said that "580b was apparently drafted in contemplation of the *standard purchase money mortgage transaction*, in which the vendor of real property retains an interest in the land sold to secure payment of part of the purchase price."[20] The court was not able to cite any legislative history or other basis for the notion that 580b was directed only to "standard" transactions.[21] *Roseleaf*'s fiction of a "standard" purchase-money deed of trust transaction, as opposed to "variations," like *Brown*'s presumption of the seller's superior knowledge of value of the security, is the second major fiction underlying *Spangler* and the continued confusion in applying 580b.

Having created the fiction of the "standard" transaction, the *Roseleaf* court then went on a search for the elusive "purpose" of 580b to complete its rationale for the decision, stating that 580b applies to "[v]ariations on the standard" only if the transactions "come

18. *Id.* at 41 n.4, 378 P.2d at 100 n.4, 27 Cal. Rptr. at 876 n.4.

19. 1989 Cal. Stat. 698 § 12.

20. *Roseleaf*, 59 Cal. 2d at 41, 378 P.2d at 100, 27 Cal. Rptr. at 876 (emphasis added).

21. It must also be noted that the description of the "standard purchase money mortgage transaction" (one in which the seller retains a security interest in the property sold to secure payment of *part* of the purchase price) actually included the *Roseleaf* type transaction since in *Roseleaf part* of the purchase price was secured by a note and deed of trust on the hotel. Indeed, the court's general description of the "standard" transaction includes virtually all purchase-money mortgage transactions. *Id.* The opinion could have stopped at this point by saying that "standard" means the mortgage or deed of trust is on the property sold, thus interpreting the then existing language of 580b to include the missing "that" which was added in 1989 by the legislature. *See supra* note 19 and accompanying text. Alas, the Court apparently felt the need to go on to look for "purpose" instead of being satisfied with mere meaning.

within the *purpose* of that section."[22]

After considering and rejecting several previously suggested "purposes" (including the *Brown* court's suggestion that one taking a purchase-money trust deed "knows the value of his security and assumes the risk"), the court settled on two. First, the court theorized that by placing the risk of inadequate security on the seller, sellers would be "discouraged from overvaluing" their property in sales transactions; this in turn was presumed to discourage "precarious land promotion schemes."[23] Second, the court divined that 580b is intended to prevent aggravation of the economic downturn that would result from declines in property values in a general or local depression if defaulting buyers were burdened with large personal liabilities in addition to loss of their property through foreclosure. The court said, "Section 580b thus serves as a stabilizing factor in land sales."[24]

Neither of these heady economic "purposes" applied to the facts of *Roseleaf*. The buyer still held the property and there was no indication that the property had been overvalued or that there was a depression in the area. The court apparently decided that the Roseleaf-Chierighino transaction was not "standard" because the notes being sued on were secured by property other than the property sold. Because the "purposes" of 580b were unrelated to the facts and the transaction was not "standard," the court concluded that Roseleaf's cause of action was not barred by 580b.

The first of the two "purposes" of 580b suggested by the court is highly doubtful. Human nature suggests that a seller will always try to get the highest price possible even if partly on paper, and a buyer not concerned with personal liability for failure to pay a purchase-money note is certainly not discouraged by the statute from offering a greater price. The seller's risk of not being paid where he takes a second trust deed depends more on the risk of foreclosure of the first than it depends on the size of the second. While the loan to value ratio of total debt secured by the property is certainly one factor affecting that risk, it is not the only one, and may be less significant than other factors such as cash flow of the property, the buyer/borrower's income and other assets, the relative size of the loans in comparison to each other, and perceived trends in real estate values. Thus, 580b is unlikely to discourage overvaluation, and may in fact promote overvaluation in an otherwise hot market because buyers

22. *Roseleaf*, 59 Cal. 2d at 41, 378 P.2d at 100, 27 Cal. Rptr. at 876 (emphasis added).

23. *Id.* at 42, 378 P.2d at 101, 27 Cal. Rptr. at 877 (citing Brainerd Currie & Mark S. Lieberman, *Purchase-Money Mortgages and State Lines: A Study in Conflict-of-Laws Method*, 1960 DUKE L.J. 1, 33-34, 39-40).

24. *Id.*

can increase their offers on paper without fear of personal liability. The macroeconomic effects proposed in *Roseleaf* as the second "purpose" of 580b are equally doubtful. It is not at all clear what empirical data could be used to demonstrate any effect of 580b in preventing "aggravation of [economic] downturn"[25] or contributing to economic stabilization.

In spite of the fact that the *Roseleaf* court rested its decision on the weak pillars of fictional "standard" transactions and speculative micro and macroeconomic "purposes," one can hardly argue convincingly with the result. Whatever the purpose or purposes behind 580b, it would have been unconscionable to permit the defendant to retain the property yet escape paying the agreed contract price for it.[26] It is clear from the plain language of 580b that it protects individual buyers from the economic calamity of loss of the purchased property through foreclosure followed by exposure to personal liability for a deficiency judgment. If the court in *Roseleaf* had eschewed speculation on broad macroeconomic "purposes" and focused on this obviously intended *result*, it could have clarified the meaning of 580b without clouding the discussion with speculative and untestable notions of discouragement of overvaluation and economic stabilization. The legislature could not have meant for a defaulting purchaser to be free to keep the property *and* not pay the agreed price. Therefore, it would have been sufficient for the court simply to decide that 580b could not be asserted as a defense to a suit for the purchase price because the buyer still owned the property, a meaning obviously ratified by the above-mentioned 1989 amendment to 580b.

Shortly after the *Roseleaf* decision, Professor John Hetland (who submitted an amicus brief to the Supreme Court in *Roseleaf*) published an article (Hetland I),[27] in which he criticized *Brown* as an unwarranted extension of 580b. Hetland argued that *Brown* was inconsistent with the purposes and intent of the statutory framework of sections 726, 580a, 580b, and 580d of the Code of Civil Procedure. Professor Hetland extravagantly praised Justice Traynor's decision

25. *Id.*

26. This obvious theme of *Roseleaf* was played again in Goodyear v. Mack, 159 Cal. App. 3d 654, 205 Cal. Rptr. 702 (1984), where some time after the sale, the original purchase-money deed of trust on the property sold was reconveyed and replaced with a note and junior deed of trust on other property belonging to the buyer. Section 580b did not bar suit on the substituted note after foreclosure of a senior lien on the substituted security property, where the buyer still owned the property purchased from the plaintiff, freed of the purchase-money lien by the substitution of collateral.

27. John R. Hetland, *Deficiency Judgment Limitations in California - A New Judicial Approach*, 51 CAL. L. REV. 1 (1963) [hereinafter Hetland I].

in *Roseleaf* as bringing consistency to analysis of those statutes. Reviewing *Roseleaf's* speculations about the purposes of 580b, Professor Hetland asserted that *Roseleaf* "stripped" *Brown's* fiction of the superior knowledge of the seller on which the *Brown* court based extension of 580b to sold-out junior liens. "*Brown* should be dead," he said.[28] In view of *Spangler*, however, and other 580b decisions since, it is clear that Professor Hetland was mistaken in announcing *Brown's* demise.

In a subsequent article (Hetland II),[29] Professor Hetland reaffirmed the assertion that *Brown* was all but overruled by *Roseleaf*. He suggested that *Roseleaf* allowed important predictions to be made with confidence about the future direction of decisions in the antideficiency area. Professor Hetland then made two predictions relevant to the thesis of this Article. First, gazing into a crystal ball with *Roseleaf*-colored glasses, Professor Hetland again (wrongly) predicted that *Brown* was likely to be overruled, and soon. Second, he predicted, indeed even strongly urged, the creation of the rule of *Spangler*.[30]

Hetland's arguments that *Brown* unjustifiably extended 580b and that *Roseleaf* analytically overruled *Brown* are both based on comparison and criticism of the discussions of the purposes of 580b in the two cases. In Hetland I, for example, Hetland cogently attacks the *Roseleaf* postulation that prevention of overvaluation is an underlying purpose of 580b. Hetland is less successful, however, in attacking the notion that a purpose of 580b is to avoid aggravation of declines in property values by protecting buyers from the additional loss of a personal judgment for the unpaid note after foreclosure. To the extent this "purpose" is restated simply as protection of individual buyers from increased loss, *Brown's* holding clearly serves it, since the aggravation of the buyer's loss by a deficiency judgment after foreclosure is the same regardless of whether it is the seller or a senior lien holder who forecloses.

In his analysis attacking *Brown*, Hetland gives insufficient attention to the plain language of 580b which, without straining or extending, clearly includes the foreclosure situation involved in *Brown*. A suit by the seller for the balance of the buyer's secured purchase-money note is barred "in any event . . . under a deed of trust, or mortgage, given to the vendor to secure payment of the balance of the purchase price of real property."[31] Ultimately, *Brown* should be

28. *Id.* at 11.

29. John R. Hetland, *Real Property and Real Property Security: The Well-Being of the Law*, 53 CAL. L. REV. 151 (1965) [hereinafter Hetland II].

30. *Id.* at 162.

31. CAL. CIV. PROC. CODE § 580b (West Supp. 1993).

interpreted to rest on a literal application of the language of the statute, not on the frail analysis of "purpose" which was and is subject to criticism.

Ten years after the *Brown* decision the legislature was presented with the opportunity to amend the language of the statute. Senate Bill 950, introduced in the 1963 session, would have deleted the key words "in any event" from the statute, and so probably would have compelled a change in the *Brown* result. The bill did not pass. Similarly, in the 1989 amendment mentioned above the words "in any event" were retained.[32] Under commonly applied principles of statutory interpretation, it may be presumed that the legislature has therefore approved *Brown*'s interpretation of 580b, and *Brown* cannot be considered an extension of the law.

Although Professor Hetland's prediction that *Brown* would be overruled turned out to be wrong, he did accurately forecast the result of the *Spangler* decision. In Hetland II, Professor Hetland argued that the holding of *Brown*, in conjunction with the provisions of 580a, 580c, and 580d, leaves the individual seller of property as the only lender who is barred from obtaining a deficiency judgment against all buyers "including the most likely deficiency judgment candidate, the *property developer*."[33] Professor Hetland theorized: "To decide, therefore, whether or not a sold-out junior should be able to recover a judgment on the note after a senior has taken all of the security, one has to decide who the buyer and seller are likely to be *and then compare their relative equities*."[34]

This remarkable statement appears to suggest that, notwithstanding the expansive language of 580b and the Supreme Court's decision in *Brown*, interpretation of 580b should be based on speculation as to the likely identity of parties to a transaction, followed by a balancing of the jurists' sympathies for one class of transactional parties against another. Without indicating what "equities" should be considered, Professor Hetland suggests a view of real estate transactions in which hapless sellers are invariably at the mercy of sharp and greedy developers from whom the courts must provide protection. Professor Hetland seems to be instructing the court to ignore the language of the statute and ignore the contract of the parties and instead to decide for the party with the greater relative "equities."

Seven years later, this is exactly what the Supreme Court did in

32. *See supra* note 19 and accompanying text.
33. Hetland I, *supra* note 27, at 160 (emphasis added).
34. *Id.* (emphasis added).

Spangler v. Memel,[35] when Justice Traynor followed the Professor's advice. However, the comparison of the "relative equities" of the seller and buyer in *Spangler* was disguised by repeated murmuring of the fictions that posed as analysis in *Brown* and *Roseleaf*.

SPANGLER v. MEMEL: THE WEIGHT OF FICTIONS TILT THE SCALE

The facts in *Spangler* are important and will be reviewed in some detail. In 1956 Mr. and Mrs. Spangler purchased a lot on Sunset Boulevard in Los Angeles for $43,000. At the time, the property was improved with a single family residence that Mr. Spangler subsequently converted into an office for his advertising business. The property was zoned for commercial use and appreciated in value over the years because of the possibility of commercial office building development on the site.

In 1960 Mr. and Mrs. Spangler listed the property for sale through a real estate broker. Thereafter, Mr. Spangler quit-claimed all of his interest in the property to Mrs. Spangler.

After approximately a month of negotiations, a contract was made between Mrs. Spangler and the purchasers for sale of the property for $90,000, payable as $26,100 in cash, plus a promissory note for $63,900 secured by a purchase-money deed of trust. In the purchase agreement Mrs. Spangler agreed to subordinate her purchase-money deed of trust to construction loans up to the amount of $2,000,000. Obviously, the development of the property contemplated by the parties was quite significant compared to its existing value.

In conjunction with the subordination agreement, each of the buyers individually waived the benefits of 580b in the contract and gave a written personal guarantee of joint and several liability for payment of the $63,900 purchase-money promissory note. These waivers and guarantees were for the specific purpose of protecting Mrs. Spangler against the hazard that her purchase-money deed of trust might become worthless in the future following foreclosure of the construction loan.[36]

Following close of escrow, the buyer transferred the property to a development partnership, which obtained a construction loan of $408,000 in order to construct an office building on the property. Pursuant to the agreement to subordinate, Mrs. Spangler executed a subordination agreement in favor of the construction lender. The partnership proceeded to construct a three-story commercial office

35. Spangler v. Memel, 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr. 807 (1972).

36. No doubt her capable lawyer was cognizant of the *Brown* holding and of the financial risk to the seller inherent in subordination of her deed of trust to a large construction loan.

building on the property. However, in spite of diligent efforts to obtain tenants, the building was never a commercial success and the buyers defaulted under the construction loan. The construction lender foreclosed, and Mrs. Spangler sued for a judgment against the buyers under the purchase-money note and personal guarantees.

The trial court, giving effect to the buyers' negotiated written guarantees and waivers of 580b, granted judgment in favor of the plaintiff for the balance of the note plus interest and costs.

When the case reached the California Supreme Court it summarized the positions of the parties as follows:

> [Buyers] contend that [Seller] is actually attempting to obtain a deficiency judgment in connection with a purchase money deed of trust, that any such recovery is barred by section 580b of the Code of Civil Procedure as construed in *Brown v. Jensen*, and that [Buyer's] guaranty and waiver, being merely an attempt to circumvent the above statute, is illegal and unenforceable. [Seller], on the contrary, urges that *Roseleaf Corp. v. Chierighino* has impliedly overruled *Brown v. Jensen* to the extent that section 580b cannot be applied to sold-out junior lienors seeking recovery of the purchase price.[37]

The court then focused primarily on the argument of whether *Brown* had been overruled and completely ignored the question of whether waiver and release of rights under 580b was enforceable under the circumstances.[38] The court engaged in lengthy review of *Brown* and *Roseleaf* to support its holding "that the application of *Roseleaf* to the facts of this case compels the conclusion that section 580b is here inapplicable."[39]

The seller, of course, had picked up Professor Hetland's argument that *Roseleaf* impliedly overruled *Brown*'s holding that 580b applies to protect the buyer even when the seller's junior lien is "sold out" by foreclosure of a senior encumbrance. The court specifically reaffirmed *Brown* and said it had "never over-ruled or modified"[40] the central holding of *Brown* that 580b "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."[41] The court noted

37. *Spangler*, 7 Cal. 3d at 608-09, 498 P.2d at 1058, 102 Cal. Rptr. at 810 (citations omitted) (footnotes omitted).

38. It is remarkable that this point was never even addressed since effectiveness of the waiver and guaranty was the stated basis of the trial court judgment.

39. *Spangler*, 7 Cal. 3d at 609, 498 P.2d at 1058, 102 Cal. Rptr. at 810.

40. *Id.* at 609, 498 P.2d at 1059, 102 Cal. Rptr. at 811.

41. *Id.* at 609, 498 P.2d at 1058, 102 Cal. Rptr. at 810 (citing Brown v. Jensen, 41 Cal. 2d 193, 198, 259 P.2d 425, 427 (1953)).

that in *Roseleaf* and subsequent cases[42] the court had "assumed without argument or question that section 580b applied by its terms to sold-out junior lienors."[43]

Perhaps because of its concentration on refuting Professor Hetland's and plaintiff's theory that *Brown* was impliedly overruled by *Roseleaf*, the court stepped through the looking glass into the *Roseleaf* fiction of "the standard purchase money transaction" in search of its decision in the case. The court repeated its *Roseleaf* statement that if the transaction "is a variation on the standard purchase money mortgage or deed of trust," then it should be examined to determine whether application of 580b subserves the purposes of section 580b as explicated by us in *Roseleaf* and *Bargioni*."[44] The court said,

> The crux of the matter is, of course, whether a sale of real property for commercial development in which the vendor agrees to subordinate his senior lien under the purchase money deed of trust to the liens of lenders of the construction money for the commercial development is a variation on the standard purchase money mortgage transaction. It seems clear that it is. In the standard transaction the vendor usually sells the property to a purchaser who is going to continue the same or similar use of the property. The present security value of the property, therefore, is a reliable indicator of its actual fair market value. However, in the situation where the vendor agrees to subordinate his lien to the purchaser's construction loan, the purchaser does not intend to continue with the same use of the property but actually intends a different use which contemplates considerable improvement of it. In this latter situation, the present security value of the property, therefore, is *not* a reliable indicator of the ultimate value of the property; that value will be determined by the success of the venture which contemplates a *change* in the use of the property.[45]

Thus the court thought it was "clear" that a potential change in use through commercial development of the property must in itself constitute a variation on a "standard" purchase-money transaction.[46] Why this should be so is far from clear in the dynamic California urban real estate market of recent decades. Real estate development is a significant statewide industry. Indeed, from a real estate practitioner's viewpoint it could be said that real estate transactions in which development or change of use is contemplated by the buyer are very "standard" and normal transactions. The theoretical basis for the court's determination, that change of use or development constitutes "variation" appears to be that where development by the buyer is contemplated, the "security value of the property" doesn't

42. Bargioni v. Hill, 59 Cal. 2d 121, 378 P.2d 593, 28 Cal. Rptr. 321 (1963); Kistler v. Vasi, 71 Cal. 2d 261, 455 P.2d 106, 78 Cal. Rptr. 170 (1969).

43. *Spangler*, 7 Cal. 3d at 610, 498 P.2d at 1059, 102 Cal. Rptr. at 811.

44. *Id.* at 611, 498 P.2d at 1059, 102 Cal. Rptr. at 811.

45. *Id.* at 611, 498 P.2d at 1059-60, 102 Cal. Rptr. at 811-12 (citations omitted).

46. The court glossed over the fact that the house on the property had already been converted to commercial and office use, so it could be argued there really was no change in *use*, even though a new building was built.

provide a reliable indicator of the "actual fair market value."[47]

The court developed this theme further, saying that in the "standard" transaction "the security value of the land gives purchasers a clue as to its true market value."[48] The court presumed that in the "standard" purchase-money mortgage transaction where the purchaser has not been able to meet the value placed on the land by the seller through "normal cash down payment and obtaining from a third party lender a loan for the balance of the purchase price," it is obvious that a loan large enough could not be obtained since the amount of the loan would exceed "the security value."[49] The court suggested that the inability of a buyer to obtain the purchase price from a lender using the land as security "should warn the vendor that he is perhaps overvaluing the land, and that he insists, at his peril, upon his premium price secured by a second trust deed."[50]

This analysis really amounts to a disguised application of Professor Hetland's suggestion, in Hetland II, that balancing "the equities" between buyer and seller should control.[51] Without saying so, the court implicitly revived the discredited *Brown* fiction that in a "standard" transaction, the seller supposedly has superior knowledge of property value and added the idea that the buyer therefore needs "clues" to the value based on the amount of third-party financing he can obtain. The court implies an unexplained ability on the seller's part to fix the value at a premium by somehow imposing a second deed of trust on the buyer who is in the dark about true value. Thus, in the "standard" transaction the equities presumably reside with the hapless buyer. However, in a development subordination transaction, the court said the *seller* does not have a clue to the value of property because of prospective change of use, so the equities suddenly shift from the buyer to the seller.[52]

47. *Spangler*, 7 Cal. 3d at 611, 498 P.2d at 1060, 102 Cal. Rptr. at 812. This theory looks like the obverse of the notion put forward in *Roseleaf* that one of the purposes of section 580b was to place the risk of inadequate security on the seller thus supposedly discouraging the seller from overvaluing the security and discouraging precarious land promotions schemes. If the seller does not have a reliable "indicator" of value how can it be fair to sanction the seller for "overvaluing?" Or to put it another way, is the court saying that the seller is invariably the "greater fool" where the parties contemplate development of the property?

48. *Id.* at 612, 498 P.2d at 1060-61, 102 Cal. Rptr. at 812-13.

49. *Id.*

50. *Id.*

51. *See supra* note 34 and accompanying text.

52. *Spangler*, 7 Cal. 3d at 613, 498 P.2d at 1061, 102 Cal. Rptr. at 813.

The whole line of rationalization expressed in *Spangler* is a simplistic and illusory view of real estate transactions. The notion of "security value," which reverses the balance of equities, is extremely elusive and ill-defined. The value of a real property in a purchase and sale transaction is not a static thing determined or imposed by one side or the other of a transaction. Sellers ask, buyers offer. They either meet at a common negotiated ground of agreed price and terms or no transaction occurs.

Fair market value is that value which is presumed to be determined at arm's length between a willing seller and a willing buyer, both reasonably well informed, and neither subject to conditions of duress. In a dynamic real estate market many factors influence the willingness of a buyer and seller to agree on price and terms and hence affect fair market value. Such factors include existing and potential future uses of the property, perceived direction of changes in the market, availability and cost of financing, governmental restrictions, zoning laws, environmental conditions, tax impacts, terms and conditions for payment, and general economic conditions. What a third-party lender may be willing to lend on a particular piece of property is certainly determined primarily by the market value as perceived by the lender, but is also affected by the income and expenses of the property, the cost and availability to the lender of funds, the conditions of the secondary mortgage market, the terms of the loan, the buyer's intended use of the property, and the risk-averseness of the particular lender involved.

There simply is no empirical basis for the notion, espoused in *Brown* and adopted in *Spangler*, that sellers as a group necessarily have more knowledge of the value of their properties than do buyers, or for the idea that any construct of law is needed to prevent sellers from "overvaluing" their properties. Sellers naturally want the highest price they can get and buyers naturally want the lowest, but who has the most knowledge about value in a given transaction is a function of individual market sophistication, not a function of status as a buyer or a seller.

Similarly, there is no empirical or logical foundation for the Supreme Court's notion that "the security value of the property" is somehow an indicator or a clue to the buyer of the market value, or that it is a deterrent to overvaluation by the seller. "Security value," whatever that means, may be relevant to a third-party lender who puts out hard cash with the expectation of a return on investment and repayment of principal. From a lender's point of view security value is a measure of adequacy of collateral for protection of principal and income repayment and is affected by, among other things, cash flow from the property, the general credit worthiness of the borrower, the length of the loan, and the availability of other collateral and sources of repayment. On the other hand, the concept of "security value" between buyer and seller is largely meaningless. Buyer and seller are interested in price, terms and conditions of payment, and risk. The price and financing terms of a real estate purchase agreement are usually negotiated in dynamic interrelationship. They are affected by many considerations on both sides of the table, such as tax factors, interest rates, timing of performance by either party, the relative negotiating strength of the parties, and all the factors influencing a seller's and buyer's valuation of the property itself.

Having created a fictional scale of knowledge and "clues" to value upon which to weigh the equities, the court in *Spangler* then suggested that where a seller agrees to subordinate his or her purchase-money deed of trust, the risk of failure of the development "is thrust upon the vendor,"[53] which in turn tilts the scale away from the buyer in favor of the seller. To counteract the risk "thrust upon the vendor," the developer buyer needs to have a realistic assessment of the likelihood of success and must therefore be forced, by the threat of personal liability on a sold-out junior purchase-money deed of trust, "to exert his highest efforts" to carry out the project successfully.[54] Therefore 580b protection is denied to the buyer by a court-created equitable exception.

The court's method of analysis in *Spangler* results in several surprising turnabouts. First, in *Roseleaf*[55] and again in *Spangler*[56] the court said one of the purposes of 580b is to discourage sellers from overvaluing their property, yet *Spangler* views the seller as an unwitting victim of uncertain valuation in subordination transactions, thus justifying a decision not to apply section 580b.

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53. *Id.*

54. *Id.* This observation by the court not only overlooks the fact that in the case before it the trial court had found that the developer had made "diligent efforts" to obtain tenants for the building, *Id.* at 606, 498 P.2d at 1056, 102 Cal. Rptr. at 808, but it also overlooks the reality of the marketplace which already places very substantial pressures on any developer-buyer to exert his best efforts to conclude a successful development. Not the least of these pressures are the potential loss of equity investment, loss of projected profits on the transaction, and personal liability on a construction loan guarantee. Once again, the court's analysis is but a reformulation in different words of Professor Hetland's suggestion that sellers as a class require judicial protection from developer buyers as a class.

55. Roseleaf Corp. v. Chierighino, 59 Cal. 2d at 42, 378 P.2d at 101, 27 Cal. Rptr. at 877 (1963).

56. *Spangler*, 7 Cal. 3d at 612, 498 P.2d at 1060, 102 Cal. Rptr. at 812.

Second, it is true that in a subordinated purchase-money transaction the seller often bears a part of the risk of the development in the sense that the full value of the seller's subordinated note and deed of trust may not be realized by the seller unless the development is successful. But the court specifically notes that the market value of property in a contract being sold for development is often substantially influenced by the development potential of the property.[57] This recognition necessarily admits that the seller will very often share in the reward of a successful development through a negotiated contract price that is higher than would have been obtained if the development potential had not been considered by the parties in the purchase.[58] Why is it fair and equitable that a seller should share in the potential benefit of increased value (overvaluation?) but, by a rule of law that section 580b cannot apply to such transactions, remain insulated from the risk?

Third, the court ignores the fact that the purchaser developer often has a substantial cash investment in the project in the form of down payment, option payments, engineering and design fees, processing costs, and the like, and has usually made personal guarantees on the construction loan which may be many times larger than the seller's subordinated second. Compared to these potential losses, does potential personal liability on a note to the seller really add anything to the buyer's motivation to be realistic in assessing the fair market value of the property and the chances for success of the project? The facts of the case presented to the Supreme Court in *Spangler* certainly do not so indicate.[59]

In summary, in *Spangler* the Supreme Court adopted and then enlarged upon the unfortunate and unnecessary fictions created in the *Brown* and *Roseleaf* decisions in order to create an exception to clear statutory language. The decision in *Spangler* closely follows the "equities" balancing approach espoused by Professor Hetland in Hetland II even though the "equities" identified in the decision are extremely speculative and have little connection to the real world of negotiated agreements. The superficial balancing of equities, proposed by Hetland II and adopted by the Supreme Court in *Spangler*, is based on broad-brush assumptions about buyers and sellers as classes of persons rather than on any empirical data about real

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57. *Id.* at 613, 498 P.2d at 1061, 102 Cal. Rptr. at 813.

58. This is particularly true when the seller agrees to subordinate, as is well known in the real estate industry. *See, e.g.*, Leon J. Alexander, *Subdivision Trusts: A Proposed Standard Form*, 5 LOY. L. REV. 487, 492 n.21 (1972) ("A rule of thumb in the subdivision business puts the price of land with a subordination agreement at 125% of the price of land without such an agreement.").

59. As noted in the text following note 36, *supra*, the new construction was successfully completed, and the court specifically acknowledged the buyer's "diligent" efforts to obtain tenants.

transactions.[60] Perhaps most significantly, even though the final balancing of the scale in *Spangler* was based on the risk being "thrust" upon the seller, the court blatantly ignored the fact that the buyer and seller had negotiated and explicitly agreed for themselves on a contractual allocation of the risk inherent in the sellers' subordination.

In spite of its reliance on the fictions created by *Brown* and *Roseleaf*, its deeply flawed reasoning about the nature of transactions in the real estate marketplace, and its refusal to address a key element of the parties' contractual agreement, *Spangler* has been blindly followed and embroidered upon in a number of subsequent appellate decisions.[61]

One of the first appellate decisions to follow *Spangler* was *Long v. Superior Court (Rickert)*.[62] The facts were not in dispute. Plaintiff had been the owner of a single family home in which he also maintained an office. Plaintiff investigated the market and determined that while the property was worth about $150,000 as a single family residence, it could be worth $250,000 if sold for development of five condominiums. Through a broker, plaintiff sought and found a builder with whom he negotiated an agreement to sell the property

60. It is also worth noting that the protection of subordinating sellers that the court sought to achieve is of doubtful utility in practical terms. When the senior lender has foreclosed, the seller's right to sue the failed developer for a deficiency judgment is frequently worthless as far as collectibility is concerned. This point was aptly noted in an otherwise uncritical casenote on *Spangler*. Stephen D. Quinn, Note, *Recent Case*, 13 SANTA CLARA L. REV. 170, 173 (1972).

61. The *Spangler* decision was discussed and criticized at some length in David A. Leipziger, *Deficiency Judgments in California: The Supreme Court Tries Again*, 22 UCLA L. REV. 753 (1975). Professor Leipziger cogently observed that *Spangler* failed to provide "accurate guidance in predicting the outcome of future disputes." *Id.* at 756. Professor Leipziger's analysis of *Spangler* and the 1974 decision of Walker v. Community Bank, 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974), led him to conclude the Supreme Court was moving in the direction of distinguishing between residential and commercial borrowers in the application of sections 580b and 726 of the Code of Civil Procedure. As will be noted *infra*, the authors of the proposed new California foreclosure and antideficiency laws adopted this approach. *Spangler* was also the subject of a student note, Craig M. Thomas, Note, *Application of Antideficiency Statute to Construction-Subordination Agreement*, 61 CAL. L. REV. 536 (1973), which essentially agreed with Hetland's analysis that *Brown* should be considered overruled. *See supra* text accompanying notes 28-29. The writer asserted that "*Spangler* reaches a correct result in shifting the risk of loss to the commercial developer in the subordination context," but noted forthrightly that "the difficulty with the case, however, is not its result but its potential and uncertain application to other fact situations." *Id.* at 546-47. Consistent with one of the principal concerns of this Article, the writer concluded, "*Spangler* has introduced much uncertainty into the world of real estate transactions . . . ." *Id.* at 548.

62. Long v. Superior Court (Rickert), 170 Cal. App. 3d 499, 216 Cal. Rptr. 337 (1985).

for $252,000 to be paid with a cash downpayment of $134,000, plus a note for the balance secured by a deed of trust on the property. The deed of trust was subordinated to a $682,000 construction loan. (The opinion does not indicate whether this occurred at close of escrow or later.) Construction of the project was successfully completed, but the units were not sold in time to pay off the construction loan, and the lender foreclosed.

The plaintiff's broker testified that plaintiff had established his $250,000 asking price on the basis of his belief that five condominium units could be built on the property. The broker testified that plaintiff had told him he "was aware that if the project bombs out, he would lose his money carried back."[63] The trial court apparently accepted this testimony as truthful and ruled that *Spangler* was not applicable to the facts of the case, as the plaintiff had presumably knowingly accepted the risk of loss of his security. The trial court's minute order said, "Here plaintiff Long's conditions of sale substantially protected him since the cash downpayment of $134,000 almost equalled the intrinsic value of the property ($150,000). Moreover, Long actively participated in the project and knowingly assumed the risk."[64]

The court of appeal reviewed the trial court's decision, focusing on the *Spangler* rationale that where a "radical" change in the use and value of the property is contemplated, the "purposes" of 580b are not served and the seller cannot determine the "security value" of the property:

> [t]he pivotal criterion is that the radical change in use and value contemplated by the buyer, at once renders the security value of the subordinated purchase money security uncertain. It also significantly jeopardizes the integrity of the purchase money security by imposing the potential of a noncurable senior deed of trust foreclosure by the construction lender. *Spangler* addresses the question as one of providing the benefit of the bargain and assignment of full risk, not as a mediating of respective losses.[65]

Thus recognizing that the question of risk was central to the result in *Spangler*, the *Long* court nevertheless rejected outright the defendant's argument that the facts showed a voluntary assumption of risk by the seller through his preparation of a prospectus on development of the property, his seeking out of a developer buyer, and his subordination of his security to obtain a higher price knowing that foreclosure of his security could result from failure of the project. The court simply said this line of argument "is wholly refuted by the fact that the seller in *Spangler* assumed the same risk for the same reason."[66] But the seller in *Spangler* most definitely *did not* assume

63. *Id.* at 502, 216 Cal. Rptr. at 339.
64. *Id.*
65. *Id.* at 506, 216 Cal. Rptr. at 342.
66. *Id.* at 508, 216 Cal. Rptr. at 344.

the same risk; recall that the seller in *Spangler* negotiated an express waiver by the buyers of the protections of 580b in order to be sure the entire risk of foreclosure of the subordinated security rested on the buyers *by contract*. As noted however, that waiver was not discussed or given contractual effect by the Supreme Court in *Spangler*, the court apparently preferring to create the balance-of-equities approach so grievously misapplied in *Long*.

The next major case following *Spangler* was *Roffinella v. Sherinian*.[67] The sellers owned a residential and commercial rental property in downtown Santa Cruz, California. They attempted to develop the property for senior housing but failed to obtain necessary permits. The property was neglected and was so severely damaged by vandals that it became uninhabitable. (In the language of *Spangler* one is tempted to ask what is the "security value" of such property?) In contrast to *Long*, where the owner actively sought out a developer buyer, the sellers in *Roffinella* received an unsolicited offer to purchase the property in which the buyer offered $390,000 to be paid $112,000 down in cash and $278,000 by a promissory note secured by a first deed of trust on the property. Given that the property was uninhabitable and virtually abandoned, it must be presumed that the value of the property was not based on any expectation that the existing use (actually nonuse) would be continued. In fact the purchase contract provided, "Seller to subordinate above mortgage in escrow to construction loan."[68]

In spite of the provision for subordination "in escrow," a construction loan was not placed on the property at the time of sale, and the sellers took back a first deed of trust. The sellers' escrow instructions stated, "Sellers herein agree to subordinate to a construction loan at a later date."[69]

After purchasing the property the buyers were consistently late in payments to the sellers under their note, and the sellers could have foreclosed. Instead, the sellers apparently decided to give the buyers more time to put their development deal together. Approximately one and a half years after the close of escrow the buyers contacted the sellers' attorney saying they were ready to obtain a construction loan, and the buyers requested a subordination agreement. A subordination agreement was negotiated with the sellers' attorney. Under that agreement the buyers paid a cash consideration of $1,100 to the

67. Roffinella v. Sherinian, 179 Cal. App. 3d 230, 224 Cal. Rptr. 502 (1986).
68. *Id.* at 233, 224 Cal. Rptr. at 504.
69. *Id.* at 234, 224 Cal. Rptr. at 504.

sellers for subordination, and they agreed to shorten the term of their promissory note by five years. In return the sellers agreed to subordinate the promissory note to a $4.5 million construction loan, the proceeds of which were to be used by the buyers to build residential condominiums on the property. Unfortunately the project was not a success and the construction lender foreclosed on the property with the sellers' note still unpaid.

The *Roffinella* court repeated almost verbatim *Spangler*'s formulations concerning "security value" and then focused on whether the transaction was "standard" within the meaning of *Roseleaf* and *Spangler*.[70] The buyers argued that *Spangler* shouldn't apply because in *Spangler* the seller subordinated pursuant to a requirement of the purchase agreement itself. Further, the vague reference to subordination in the purchase agreement merged in the deed and so had no legally binding effect after the closing. Thus, the subordination that actually occurred was not pursuant to the purchase agreement, but rather the later subordination agreement negotiated for a new consideration between the buyers and the seller's attorney a year and a half after the sale. The purchase and sale itself was therefore "standard" the buyers concluded.[71]

In reviewing the record, the court decided that "[t]here is substantial evidence to support the [trial] court's implicit finding that respondents subordinated pursuant to the agreement of sale."[72] Thus, the case fit neatly within *Spangler*'s focus on a subordination clause contained in the agreement of sale, notwithstanding the fact that new consideration was negotiated for the subordination long after the purchase. The court therefore concluded that the *Spangler* exception to 580b applied and the buyers were liable on the note.[73]

70. *Id.* at 237-38, 224 Cal. Rptr. at 507.

71. The buyer argued this point, *Id.* at 238, 224 Cal. Rptr. at 507, based on the language of *Spangler* which said, "However, *where the agreement of sale contains a subordination clause*, a markedly different situation is presented." Spangler v. Memel, 7 Cal. 3d 603, 613, 498 P.2d 1055, 1061, 102 Cal. Rptr. 807, 813 (1972) (emphasis added).

72. *Roffinella*, 179 Cal. App. 3d at 239, 224 Cal. Rptr. at 508.

73. The "implicit finding" that subordination was pursuant to the original contract of sale, which in turn underlies the court's finding that *Spangler* applies, is problematic not only in regard to the facts of the case. It also runs into headlong and unresolved conflict with well-established California case law regarding enforcement of subordination agreements. In 1967 the California Supreme Court held that, to be enforceable, a subordination agreement contained in a real estate purchase contract "must contain terms that will define and minimize the risk that the subordinating liens will impair or destroy the seller's security." Handy v. Gordon, 65 Cal. 2d 578, 581, 422 P.2d 329, 330-31, 55 Cal. Rptr. 769, 770-71 (1967). Such terms usually include restrictions on use of the funds (i.e., generally limited to improvement of the property), interest rate and repayment terms, maximum amount, and other key parameters of the debt. The naked agreement "to subordinate above mortgage in escrow to construction loan" or "to subordinate to a construction loan at a later date" as set forth in the *Roffinella* purchase agreement and escrow instructions obviously fails to meet the test of *Handy v. Gordon*. If the *Roffinella*

However, it appears that the real key to the decision in *Roffinella* was once again a normative or "equitable" view of who should bear the risk of loss in a sale for development transaction. The court stated simply, "The risk of loss should also be placed on appellants because respondents subordinated their deed of trust to a $4.5 million construction loan. Respondents were thereby *prevented from foreclosing* when appellants defaulted."[74]

This final statement by the court is hard to square with the fact revealed in the opinion that there was a considerable period of time during which the buyer was in default *before* the seller subordinated the deed of trust. Sellers could have foreclosed without hindrance of a construction loan; instead they elected not to in order to allow the buyers more "time to put the[ir] deal together."[75] The court also seems to ignore the fact that the sellers voluntarily bargained for their subordinated position for additional consideration consisting of a cash payment, a shortened term of the note, and other concessions by the buyer. Under these circumstances the conclusion that the entire risk "should" rest on the buyer begs for a more convincing rationale than the lone fact that the sellers voluntarily subordinated their deed of trust.

The court gives no compelling reason for transfering the sellers' obvious risk of loss of part of the price entirely to the buyer, contrary to the express language of 580b, which provides a statutory shield to buyers. The sellers obviously had a problem property. From the facts of the transaction, it may be inferred that the sellers anticipated that the only chance for them to realize substantial value from the property was for the buyers' development to go forward. The sellers, represented by counsel and receiving additional consideration for their agreement to do so, freely contracted to place themselves at risk through the subordination agreement to facilitate the development and their hope of maximizing their own gain. This was after the buyers had been in default for a considerable period of time and the sellers could have foreclosed without risk of losing the property to a senior lender. Why is this calculated economic decision on the sellers' part (as in the *Long* case) cause to ignore the plain words of 580b and transfer all of the risk to the buyer when the parties did

court had correctly analyzed the subordination agreement as a new agreement negotiated and supported by new consideration after the close of the sale, it would at least have had to recognize explicitly its extension of *Spangler*.

74. *Roffinella*, 179 Cal. App. 3d at 240, 224 Cal. Rptr. at 508.

75. *Id.* at 234, 224 Cal. Rptr. at 504.

not agree to do so in a negotiated contract?

In *Ziegler v. Barnes*,[76] yet another aspect of the *Spangler* decision was the focus of argument, and another surprising result was reached. In *Ziegler*, the buyer acquired a residential ocean view lot in Laguna Beach, California. As part of the consideration, buyer gave the seller a $185,000 promissory note secured by a deed of trust, which provided that the seller would subordinate to a construction loan not to exceed $250,000 for the purpose of building a single-family residence on the lot.

When the note came due, it was not paid. The seller took no action to foreclose. A month later the buyer requested an increase in the amount to which the deed of trust could be subordinated. The buyer offered to pay a $5,000 cash incentive to the seller and to reduce the principal balance of the then-overdue note by a $90,000 payment if the seller would subordinate his deed of trust to a $370,000 construction loan and extend the debt. These negotiations took place through, and the offer was accepted by, the seller's attorney. The $5,000 incentive was paid, the $90,000 payment was made, and a new promissory note in the amount of $95,000 was delivered to the seller with the deed of trust subordinated to a construction loan. The buyer proceeded with construction of the home but eventually defaulted on the construction loan. The construction lender foreclosed.

The buyer argued that there had been no "commercial development" of the property as contemplated by *Spangler* and therefore no real change in use.[77] "Change in use," it will be recalled, was the critical factor in the *Spangler* analysis that the Supreme Court said prevents the buyer from having a "clue" to the market value.[78] The buyer urged that the property was acquired as a residential lot and the project constructed was a single family residence. In finding that the *Spangler* exception applied and 580b did not, the court of appeal said that the lot was not "in use" when it was sold, and the fact that the purchaser envisioned a considerable improvement of the property by construction of an expensive residence brought the case within the reach of *Spangler*.[79] But it is clear that the seller also contemplated the construction of an expensive residence; the possibility of constructing an expensive residence on an ocean view lot was precisely what gave the lot substantial market value in the seller's hands. The decision in *Ziegler* once again comes down to the approach of pity for the seller. The court stated,

76. Ziegler v. Barnes, 200 Cal. App. 3d 224, 246 Cal. Rptr. 69 (1988).

77. *Id.* at 231, 246 Cal. Rptr. at 73 (quoting Spangler v. Memel, 7 Cal. 3d 603, 614, 498 P.2d 1055, 1062, 102 Cal. Rptr. 807, 814 (1972)).

78. *Spangler*, 7 Cal. 3d at 613, 498 P.2d at 1061, 102 Cal. Rptr. at 813.

79. *Ziegler*, 200 Cal. App. 2d at 233, 246 Cal. Rptr. at 75.

> Here, at the time the new note was executed, there was no construction on the Laguna lot; [the seller] had no more notion of what the property would be worth, if timely and efficiently improved, than he did when the first agreement of sale was prepared. He was neither a builder nor a developer. His only alternative to agreeing to the increased construction loan was to lose the sale of the property.
>
> The risks attendant in subordinating were substantial: the lot was vacant; although a view lot, the terrain was precipitous and difficult to build upon; there were myriad permits to obtain; the construction loan was due less than one year after it was obtained; interest rates were highly volatile; and, the residence would need to be built *and* sold speedily. [The seller] was "relegated to reliance upon [his] respective buyers to perform successfully and fully pay the purchase balance."[80]

But if the seller had no notion of what the property was worth if improved, how did the seller know what it was worth when he sold it as an unimproved lot? The lot had worth because it could be built on, worth resulting from supply and demand factors, worth in which the seller shared by obtaining the price of an ocean view lot that could be built on, rather than the price of a lot lacking such amenities and entitlements. The seller's loss was not the result of an error in judgment regarding worth of the property; the construction lender foreclosed because the buyer did not make payments on a construction loan. *Ziegler* is another illustration of the fact that the risk to a seller in a subordinated purchase-money note transaction has little to do with the original market value of the property established in arm's length negotiations between buyer and seller.

Once again in *Ziegler*, as in *Roffinella*, the seller seems to have knowingly taken the risk of subordination at a time when another option was available (i.e., foreclosure of the first deed of trust for default under the note). The note was past due and unpaid; seller could have foreclosed, kept the down payment and recovered the property to sell it again. It is not clear why the court in *Ziegler* thought this was so unpalatable a choice. ("His only alternative. . . . was to lose the sale."[81]) Instead, the seller chose to take a $90,000 partial pay-down of the note and a $5,000 incentive payment, and to accept subordination to a construction loan, no doubt hoping he would thereby realize payment in full. In the language of *Spangler*, the risk was not "thrust upon" the seller at all; it was quite clearly voluntarily accepted for consideration. A seller's rejection of the opportunity to foreclose is scant reason to throw aside the

80. *Ziegler*, 200 Cal. App. 3d at 232, 246 Cal. Rptr. at 74 (third alteration in original) (quoting Long v. Superior Court (Rickert), 170 Cal. App. 3d 499, 507, 216 Cal. Rptr. 339, 342 (1985)).
81. *Id.*

express rule of 580b that would have applied if the seller had foreclosed when he had the right to do so.

Boyle v. Sweeney,[82] is another case in which the "change in use" rational of *Spangler* was tested with a fact pattern somewhat similar to *Ziegler*'s. The property was an improved residential property in San Francisco. In the sale transaction, the seller took back a $50,000 note and deed of trust. The buyer planned to tear down the existing single family home on the lot and to build a three-unit residential condominium. The seller's note was subordinated to a construction loan. The purchase-money note due date was extended by the seller twice during the course of construction of the project. The construction project was completed, but the buyer was unable to sell the units in time to avoid default and foreclosure under the construction loan.

Merely repeating the language from *Spangler*, the court determined that the transaction was not a "standard" transaction within the meaning of *Roseleaf* and *Spangler*. Here again, the buyer argued that the transaction was not "a variation" because the contemplated improvement of the property was not a commercial development or a change in use. Although there was no change in use, the court nevertheless found that *Spangler* applied because "a more intensive use" was contemplated and "that makes the present value of the property an unreliable indicator of its actual fair market value."[83]

In *Boyle* the court fell into the same illusory view of value that bedeviled the *Spangler* decision. In referring to "actual fair market value" in contrast to the "present value of the property," the court seems to suggest that real estate "value" is a detached ideal or theoretical value which is only reflected by artifices such as "present value" and "security value." As noted above, however, in a real estate market the fair market value is the value that is agreed upon by a willing buyer and a willing seller, not a ghost or shadow number hiding behind a different or misleading "present value."

The fact patterns of *Long*, *Roffinella*, *Ziegler*, and *Boyle* show several important things that bear on further analysis of *Spangler* as policy.[84] First, the concept of "value," whether it be fair market

82. Boyle v. Sweeney, 207 Cal. App. 3d 998, 255 Cal. Rptr. 153 (1989).

83. *Id.* at 1005, 255 Cal. Rptr. at 157.

84. To add sheer wonderment to the surprises that spring out of the Pandora's box opened by *Spangler*, see Wright v. Johnson, 206 Cal. App. 3d 333, 253 Cal. Rptr. 418 (1988). In that case the plaintiff sold farmland for $1.5 million with a $300,000 cash down payment. The buyer later refinanced the property with a new first lien of $1,666,670 to which the seller subordinated. The land remained farm land; no change in use or commercial development was contemplated. When the buyer defaulted, the seller sued for judicial foreclosure and a deficiency judgment. The court determined that the transaction was "varietal" (i.e., a variation on the "standard," using the language of

value as determined by arm's length negotiation, or some more ethereal concept of "security value," really has little to do with the decisions other than to confuse them with meaningless distinctions between "present value," "actual value," "fair market value," and "security value." The loss to the parties does not appear in any of these cases to result from overvaluation, undervaluation, or anything else having to do with value of the property agreed upon in the purchase and sale transaction itself. Rather, the loss arises from factors such as the financial ability of the buyers, the timing and market factors influencing disposition of the developed property, the decisions of the construction lender to foreclose or not, the willingness of the sellers to extend and subordinate defaulted debt rather than foreclose, and a host of other factors that may be rolled up into a comprehensive term commonly known as "risk." In *Spangler* the buyer completed construction but was unsuccessful, in spite of "diligent efforts," to obtain tenants. In *Roffinella* the buyer, who was consistently late in payments on the note prior to subordination, nevertheless completed construction of the project after subordination but apparently could not sell the units in time to satisfy the construction lender. This seems also to have been the case in *Boyle*.

The courts in each case decry that the risk of development in such cases "is thrust upon the vendor."[85] However, by directing the analysis into hairsplitting between "standard" transactions and "variations," and by ignoring that a significant part of real estate value in the marketplace is the potential of the property for change of use and development, the courts have reacted to risk as merely an excuse for unthinking sympathy for the seller rather than as a subject for analysis, negotiation, and contractual allocation. They have thus failed to focus on the fact that in real estate transactions, especially those involving potential development of the property, risk is virtually always one of the primary subjects of negotiation between the parties.

Spangler) but shifted focus from change in use (which did not happen) to the size of the debt to which the seller subordinated, saying,

> It is clear, however, that it is the substantiality of the non-purchase money lien to which the seller subordinates in proportion to the value of the security it encumbers, that determines whether the transaction is so non-standard that it places the buyer/borrower outside section 580b.

Id. at 338, 253 Cal. Rptr. at 421.

If the seller consented to subordination to debt exceeding the value of the property, thus "overvaluing" it, and the purpose of 580b is to prevent "overvaluing," why should 580b not apply?

85. *Spangler*, 7 Cal. 3d at 612, 102 Cal. Rptr. at 813.

The underlying "equities" rationale for the *Spangler* line of cases, in spite of its elaborate and confusing trappings, is really based upon the notion of protecting sellers as a class from developers as a class, even though the price exacted by sellers who sell to developers is usually enhanced by the development potential of the property sold.

In counterbalance to the simplistic, protectionist approach of *Spangler*, consider the following hypothetical transaction: The seller has for many years owned a prime parcel of real property in a developing urban area, which is improved with six old homes. He has carried it speculatively with an eye to the gentrification and growing development of the area. The rental income from the property has covered the taxes and carrying costs which, thanks to Proposition 13, are now relatively low. The owner, recognizing the development potential of the property, secures approval of the local government agencies for a tentative subdivision map permitting development of the property into a twenty-eight unit town home project, and he secures a preliminary commitment for a construction loan from a willing lender. The owner also prepares detailed financial projections for the development, construction, and sale of the project with construction cost estimates, sales projections, cash flows, and the like. Using rather commonplace appraisal techniques and data from numerous sales of town homes and condominiums in the rapidly developing area, the owner determines a fair builder's overhead and profit for the project, a developer's profit, and an "as is" fair market value estimation for the property, which of course is substantially in excess of the amount he could borrow on the property based on its net cash flow from the rental of the six old houses.

The owner then presents his entire development and financial package to several builders. After negotiation with them he enters into a contract for sale of the property, plans, tentative map, construction loan commitment, and the rest of the development package for a negotiated price, half of which is to be paid by a note secured by a second deed of trust on the property. In the negotiations the seller initially stated he was not willing to subordinate to a construction loan. However, in the final negotiations the owner agrees to subordinate after the builder offers a somewhat higher price and a better interest rate on the second note.

It turns out that the owner underestimated the cost of construction and overestimated the potential sales proceeds. Also it takes nine months longer than he anticipated to actually get the new units all built, and there is a definite cooling of sales during the extended project build out. As a result of these factors, the builder/buyer defaults on the construction loan, and the seller's subordinated purchase-money deed of trust is foreclosed out.

When the owner sues the builder/buyer on the note, he of course says that under *Spangler* and its progeny this was, as a matter of law, a "variation" on the standard purchase-money transaction because the transaction contemplated substantial development and more intensive use of the property by the buyer. As such, the poor seller could not have had a clue as to the security value of his property, and the buyer must be personally liable on the sold-out junior note in spite of 580b and *Brown*. Otherwise the seller's subordination to the construction loan would unfairly have the result of thrusting onto him the entire risk of the development that he conceived, planned, packaged, and sold to the buyer. Seller would no doubt argue, citing from the decision in *Boyle*, that "the only possible protection available to the vendor is to allow a deficiency judgment against the developer purchaser."[86]

There would appear to be no way out of the conclusion that under *Spangler* and its progeny such a transaction would result in liability of the buyer on the promissory note, even though no equitable reason appears in such facts to protect the seller as opposed to the buyer, particularly under the mandate of 580b. Maybe the court would decide that such facts are so clearly a "variation" on the "standard" nonstandard transaction that the rule applicable to the standard transaction should apply after all, instead of the rule applicable to the usual nonstandard transaction. Or, as a commentator stated about *Ziegler v. Barnes*, maybe the court could just admit that "[l]ogic and rules have left this field; decisions result from courts' perceptions of the equities. . . . [F]orget the statutes, the nature of the transaction, and the provisions of the contract. [Just let the good guy win.]"[87]

There must be a better way to decide these cases. The courts do not give useful guidance to parties to such transactions by decisions that disguise searches for *ad hoc* equitable solutions in costumes of speculation about unrevealed "purposes" of 580b, or that continue fictions that sellers have inherently greater knowledge of value, or assert that some ideal "value" exists distinct from the actual fair market value established by negotiated agreement of buyer and seller, or that ask us to imagine that real estate transactions come in distinguishable packages labeled "standard" and "variation."[88]

86. *Boyle*, 207 Cal. App. 3d at 1003, 255 Cal. Rptr. at 156.
87. 11 CEB REAL PROP. L. REP. 127, 128 (1988).
88. For more hairsplitting of "standard" and "variation," see Thompson v. Allert, 233 Cal. App. 3d 1462, 285 Cal. Rptr. 367 (1991), where the seller of a multi-unit residential building agreed to subordinate after closing to a new loan of approximately 20% of the purchase price to finance "renovations" of a "purely cosmetic" nature. The

Some Conclusions: May We Rely on Contract?

The better way to decide cases involving subordinated purchase money liens is to look at the parties' contractual agreements instead of their status as a buyer or a seller. What is really at stake in these cases is not subservience to the "purposes" of section 580b, whatever they might actually be, but allocation of risk between buyers and sellers of development property. In the real world, next to price and terms, the subject of risk is probably the most intensely negotiated aspect of most purchase and sale agreements involving the sale of real property for development. The California Supreme Court in *Spangler* did not need to resort to fictions in order to decide the fair allocation of the risk in that case. The buyer and seller had already done it by contract; there was a negotiated waiver of section 580b and personal guaranty by the buyers. No risk had been "thrust upon" the seller; the seller had negotiated for it to be assumed by the buyer by contract.[89] All the court had to do was find that in a freely bargained exchange of subordination agreement for waiver of 580b and guaranty, the contractual waiver and guaranty should be binding.

The *Spangler* line of cases presents situations very frequently encountered in the real estate market in California and other growing areas of the country. The parties were represented by legal counsel and were dealing with an anticipated development of the property. The price realized by the seller was enhanced by the immediate prospect of development. There were market risks and benefits to both sides arising from the transaction, risk and benefits that were part of their negotiations.

To do away with the unpredictability of a rule based on an ill-defined notion of "standard" transactions, speculative statutory "purposes," confusion about the meaning of value, and vague ideas of equity between buyers and sellers as potentially victimized classes, clarity in the law and predictability in the market place should be established by adherence to two basic propositions in 580b subordination cases:

1. As *Brown v. Jensen* determined, "*in no event*" does 580b permit a deficiency judgment on a note secured by a purchase-money deed of trust on the property sold.[90] As interpreted in *Brown v. Jensen*,

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court held that *Spangler* was inapplicable because there was no significant change in use of the property. *Id.* at 1467, 285 Cal. Rptr. at 370. *Compare* the overvaluation aspect of this case *with Wright v. Johnston* discussed *supra* note 84.

89. None of the numerous comments and articles discussing *Spangler* and cited in this Article discusses the question of contractual allocation of risk by use of 580b waivers. In fact most of the academic discussions of *Spangler* do not even mention the buyer's guaranty and waiver in presentation of the facts of the case.

90. Brown v. Jensen, 41 Cal. 2d at 198, 259 P.2d at 427.

the words "in no event" preclude a deficiency judgment in the event of a sold-out junior lien, unless the parties otherwise agree.[91]

2. The parties to real estate transactions involving purchase-money deeds of trust should be free to bargain about waiver of 580b protection. As in *Spangler*, the seller may well insist on a waiver if the buyer requires subordination to a construction loan. After all, no buyer is compelled to purchase a property; if the buyer does not want the risk, he or she can shop elsewhere. Allocation of risk of failure of a development project is one of the terms and conditions of such a sale, and there is no compelling reason to have courts decide that allocation *a priori* for the parties after the fact, rather than have it decided by the parties themselves through the course of their negotiations and contractual agreements.

The suggestion that freedom of contract govern in such cases runs counter to the accepted wisdom about whether 580b may be waived by contract. Looking back to *Spangler*, it is possible that Justice Traynor's failure to consider the buyer's waiver of 580b is traceable to Professor Hetland's articles. In addition to urging the court to protect sellers from developer buyers on ill-defined considerations of comparative equities in Hetland II, Hetland said in Hetland I that waiver of 580b is not permissible. He asserted, "Although 580b is not within the no waiver statute, [section 2953 of the California Civil Code], the statute is nonwaivable."[92]

Did the Supreme Court in *Spangler* merely assume that the buyer's waiver of 580b was beyond the pale of consideration because of Professor Hetland's pronouncements?[93]

Professor Hetland's assertion in Hetland I was not supported by the cases cited.[94] The issue in *Lucky Investments, Inc. v. Adams*[95] was whether certain title company holding agreements that were

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91. *Id.*

92. Hetland I, *supra* note 27, at 17 n.71 (citations omitted).

93. A more jaundiced view would suggest the Supreme Court was so anxious to create the new "equitable" rule that it simply ignored the waiver issue as inconvenient to the court's purposes. There would certainly be an uncomfortable logical inconsistency in an opinion that analyzed a contractual waiver to find it contrary to public policy, but then on equitable grounds reached precisely the same result that would have occurred through validation of the waiver.

94. Subsequently, however, the court of appeal held that 580b cannot be waived; *see infra* text accompanying notes 109-18 for discussion of Palm v. Schilling, 199 Cal. App. 3d 63, 244 Cal. Rptr. 600 (1988).

95. Lucky Inv., Inc. v. Adams, 183 Cal. App. 2d 462, 7 Cal. Rptr. 57 (1960).

substituted for a purchase-money deed of trust were security instruments to which 580b applied. The court held that they were. In passing, the court also made the comment that, whatever the intent of the parties in substituting the holding agreement for a note and deed of trust, the buyer "could not waive the protection of section 580b in advance."[96] In support of that statement the court cited *Freedland v. Greco.*[97] *Freedland*, however, did not involve 580b. The *Freedland* case required construction of Section 580*d* of the Code of Civil Procedure, and the court specifically said, "Nor is there any contention that either the mortgage or trust deed was a purchase money security and thus controlled by Section 580b. . . ."[98] Thus, neither *Lucky Investments* nor *Freedland* considered the questions of negotiated contractual waiver of 580b, and they cannot be considered controlling precedent on the issue.

It must be said, however, that Professor Hetland was not alone in asserting without precise decisional authority that 580b cannot be waived. For example, in *Russell v. Roberts*,[99] the court of appeal considered whether waiver of 580b in a loan extension agreement was valid. In that case the court stated, "California's courts have repeatedly held that the provisions of section 580b may not be waived *in advance* by the vendee at the time of the sale and hypothecation of the property."[100] In the *Russell* case the court found that waiver of 580b after the sale and hypothecation of the property was not barred and was enforceable.[101]

96. *Id.* at 61 (citing, *see* Freedland v. Greco, 45 Cal. 2d at 462, 467, 289 P.2d 463, 465-66 (1955)).

97. Freedland v. Greco, 45 Cal. 2d 462, 289 P.2d 463 (1955); also one of the cases cited by Professor Hetland in Hetland I.

98. *Freedland*, 45 Cal. 2d at 465, 289 P.2d at 464.

99. Russell v. Roberts, 39 Cal. App. 3d 390, 114 Cal. Rptr. 305 (1974).

100. *Id.* at 394-95, 114 Cal. Rptr. at 308-09 (citations omitted).

101. *Lucky Investments* and *Freedland*, cited by the *Russell* court, are discussed *supra* and, as noted, did not decide that 580b cannot be contractually waived, because the issue was not actually presented in either case. Morello v. Metzenbaum, 25 Cal. 2d 494, 154 P.2d 670 (1944), like *Freedland*, considered 580*d*, not 580*b*. Salter v. Ulrich, 22 Cal. 2d 263, 138 P.2d 7 (1943), considered a purported waiver of section 726 of the Code of Civil Procedure, the one form of action rule, not section 580b. Venable v. Harmon, 223 Cal. App. 2d 297, 43 Cal. Rptr. 490 (1965), decided the issue of whether a land sale contract was a security device to which 580b applies, held that it was, and consequently denied the seller a personal judgment against the buyer for failure to complete the contract. No express contractual waiver of rights under 580b was presented in the case. Riddle v. Cushing, 203 Cal. App. 2d 831, 21 Cal. Rptr. 902 (1962), involved a general partnership as purchaser where the general partners signed a personal guaranty. The court in *Riddle* stated that in *Freedland* it was held that "the provisions of 580b may not be waived in advance by the debtor." As noted above, *Freedland* did not so hold. However, the finding that the general partners of the borrower partnership could not be held personally liable on the partnership purchase-money promissory note was correct. The guaranty by a general partner of the partnership's note is a nullity because the general partner is already liable. *See* Union Bank v. Dorn, 254 Cal. App. 2d 157, 61 Cal. Rptr. 893 (1967).

On careful analysis only one of the decisions cited in *Russell* actually held that 580b cannot validly be waived by contract. That case was *Valinda Builders, Inc. v. Bissner*.[102] *Valinda Builders* presented a *Spangler* fact pattern, in which a buyer of real property gave a note and deed of trust to the seller for part of the purchase price, and the seller subsequently subordinated to a construction loan which was foreclosed.

The corporate buyer in *Valinda Builders* was specifically found to be a mere shell or instrumentality put together by the actual individual buyers for purposes of the transaction. The seller obtained a personal guaranty from the individual principals of the corporate obligations under the purchase-money note. The guaranty appears to have contained an express waiver of 580b.

The court then was faced with a question of whether waiver of 580b was valid. It held that such waivers were contrary to public policy. The court relied heavily on *Freedland v. Greco*[103] and other cases construing sections 580d and 726 of the Code of Civil Procedure. However, it should be readily apparent that the policy considerations affecting waiver of sections 580d and 726 on the one hand, and those underlying 580b on the other, are very different. The rationale of voiding waivers of sections 580d and 726 is the necessity of borrowers, which can drive them to make ruinous concessions at the time that a loan is needed and, in the case of section 726, avoidance of multiple actions. Thus, as stated by the court of appeal in *Salter v. Ulrich*,[104] and as quoted in *Russell v. Roberts*: "Since necessity often drives debtors to make ruinous concessions when a loan is needed, section 726 should be applied to protect them and to prevent a waiver in *advance*."[105] The court in *Russell* said that this reasoning does not apply *after* the loan is made when all the rights have been established and there remains only enforcement of those rights. Similarly this reasoning should not apply when the necessitousness of borrowers is presumptively not present.

In a purchase and sale of real estate, the buyer is not in a position to be necessitous in the sense that borrowers frequently may be. A buyer is not compelled to buy real property. The sale transaction is

102. Valinda Builders, Inc. v. Bissner, 230 Cal. App. 2d 106, 40 Cal. Rptr. 735 (1964).
103. *See supra* notes 97-98 and accompanying text.
104. Salter v. Ulrich, 22 Cal. 2d 263, 267, 138 P.2d 7, 9 (1943).
105. Russell v. Roberts, 39 Cal. App. 3d 390, 395, 114 Cal. Rptr. 305, 309 (1974) (emphasis added) (quoting *Salter*, 22 Cal. 2d at 267, 138 P.2d at 9).

inherently more freely negotiable and less subject to unfair advantage against the buyer than a loan transaction may be subject to abuse by a lender. The idea of a necessitous buyer who may be forced by his necessity to "make ruinous concessions" in his purchase agreement with the seller just does not make sense, particularly in the context of sale of property to a developer who will be taking a variety of business risks to carry out the development project. Buyers, whether developers or not, may well be greedy, foolish, or unsophisticated, but they are not necessitous in the way that borrowers are necessitous.

Valinda Builders should be read as another application (although misguided in its treatment of the waiver issue), of the principle of *Riddle v. Rushing* and *Union Bank v. Dorn*,[106] that a partner (or shareholder of an alter ego corporation) cannot effectively guaranty the debt of the partnership (or alter ego corporation), since this would in effect be a guaranty of one's own obligation, a conceptual *non sequitur*. Indeed, this is how the case is commonly interpreted in practice.[107]

It is ironic that *Valinda Builders*, the only case preceding *Spangler* that directly held waiver of 580b impermissible, presented the very situation that gave Professor Hetland such concern in Hetland II, i.e., seller subordination to a developer buyer's construction loan. Because the court disallowed the buyer's waiver of 580b, the risk of loss on the subordinated note in *Valinda Builders* was returned to the sellers in spite of contractual agreement by the buyer to assume that risk. The Supreme Court in *Spangler* silently followed the same poorly reasoned path of *Valinda Builders* by failing to give effect to the buyer's express waiver of 580b and thereby forced itself to create a whole body of fiction to arrive at the same result as if the waiver had been enforced. If, as the *Spangler* court's term "variation" suggests, it is doubtful that the Legislature intended to include a development subordination transaction within the ambit of 580b in the first place, then there appears to be no reason to regard an express contractual waiver of 580b in such transactions as contrary to public policy.

In 1988 the *Russell* decision was criticized and expressly not followed in the case of *Palm v. Schilling*.[108] In *Palm*, a contractual waiver of 580b in a refinancing agreement subsequent to the sale transaction was expressly declared void as contrary to public policy.

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106. See *supra* note 101 for discussion of *Riddle* and *Union Bank*.

107. *See* Joint Committee of the Real Property Law Section of the State Bar of California and the Real Property Section of the Los Angeles County Bar Association, *Legal Opinions in California Real Estate Transactions*, 45 Bus. Law., 1139, 1176-77 (1987).

108. Palm v. Schilling, 199 Cal. App. 3d 63, 244 Cal. Rptr. 600 (1988).

Thus, *Palm* stands squarely for the proposition espoused by Hetland and others that 580b cannot be waived by contract. It must therefore be examined closely since it is directly contrary to the thesis of this article.

The Palms sold their home to defendants for $725,000 in 1980. (Even in inflated California one must assume it was a substantial property for that price in 1980.) The price was paid as $210,050 in cash, with the balance in the form of two promissory notes secured by second and third deeds of trust on the property due in three months and two years, respectively. The court found that the buyers intended to pay the short-term note largely through the sale of their previous home. In the lexicon of *Spangler* one might wonder whether this sort of risky swing ("creative") financing would be considered "standard" or a "variation." Whether standard or varietal, the transaction did not come off as planned. The defendants' previous home did not sell, and they were unable to pay the three-month note when it came due. Attempts to sell or refinance both properties were unsuccessful until mid-1981 when defendants secured a twelve-month loan from a third party to repay the overdue three-month note to the sellers. The sellers agreed to subordinate their remaining note to the new loan in exchange for a retroactive increase in the interest rate.

A year later, when the third-party second loan was due, the defendants again asked the sellers to subordinate their remaining loan to another loan from a new lender. The sellers agreed to do so only if the buyers paid a $25,000 principal reduction on the note and agreed to waive their 580b antideficiency protection. Buyers accepted these conditions and obtained the new loan.

This further refinancing left three deeds of trust on the property with the seller holding the third. Prior to the due date of the third, one of the senior trust deed holders foreclosed. The reported decision of the case does not state whether the foreclosure resulted from interest payment defaults or failure to pay a balloon principal amount when due.

Faced with these facts the trial court followed *Russell*, found the 580b waiver valid, and granted judgment to the plaintiff sellers in their suit on the note.

The court of appeal reversed. The court explicitly disagreed with *Russell* to hold a waiver of 580b invalid regardless of the fact that it is bargained for in a transaction subsequent to the creation of the purchase-money obligation.[109]

Interestingly, the *Palm* court began its discussion of the waiver issue by saying that the "Supreme Court has held the provisions of section 580b may not be contractually waived by the debtor in advance" and cited *Freedland* as the precedent for this point.[110] As noted above,[111] however, *Freedland* did not present an issue under 580b, and in *Spangler*, when the Supreme Court had an express contractual waiver of 580b standing naked before the bar, the court looked the other way but reached a result consistent with enforcing a waiver. Thus, for the *Palm* court to state the Supreme Court has held 580b "may not be contractually waived" was stretching a point, to say the least.

Beyond overstating, or misstating, the Supreme Court's actions regarding contractual waiver of 580b, the *Palm* court's analysis of the issue is confusing and contradictory in several respects. On the one hand, the court apparently interprets *Spangler*, *Roseleaf*, and *Spangler*'s line of developer subordination cases as decisions in which a "creditor is not recognized as a purchase money obligee,"[112] and "the court[s in those cases] refused to recognize the purchase money nature of the *original* transaction."[113] On the other hand, the court quoted the California Supreme Court's statement in *Brown* that "[w]ith purchase-money trust deeds, [] the character of the transaction must necessarily be determined at the time the trust deed is executed. Its nature is then fixed for all time. . . ."[114] In *Spangler* and several of its progeny,[115] the original secured note was clearly a purchase-money note and was only subordinated long after the closing (and a period of default) in a newly bargained agreement. It is highly discordant to theorize on one hand that the character of the transaction is fixed for all time at the time of the original transaction, but on the other hand that a purchase-money note is to be considered something other than a purchase-money note because of a bargained subordination later.

The court in *Palm* made a curious argument about the effect of

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109. *Id.* at 67, 244 Cal. Rptr. at 603. The conflict in the court of appeal between *Palm* and *Russell* has yet to be resolved.

110. *Palm*, 199 Cal. App. 3d at 67, 244 Cal. Rptr. at 602-03.

111. *See supra* notes 97-98 and accompanying text.

112. *Palm*, 199 Cal. App. 3d at 69, 244 Cal. Rptr. at 603.

113. *Id.* at 71, 244 Cal. Rptr. at 605 (emphasis added). This view is not supported by either the facts or the language of the decisions of *Spangler*, *Roseleaf*, *et al.* In those cases the courts clearly viewed the notes as purchase-money obligations avoiding application of 580b not because they were not purchase-money debts, but because the transactions were considered "variations" on the "standard" purchase-money note transaction.

114. *Palm*, 199 Cal. App. 3d at 76, 244 Cal. Rptr. at 609 (first two alterations in original).

115. *See, e.g.*, Roffinella v. Sherinian, 179 Cal. App. 3d 230, 224 Cal. Rptr. 502 (1986); Ziegler v. Barnes, 200 Cal. App. 3d 224, 246 Cal. Rptr. 69 (1988).

section 2953 of the Civil Code as well. Adopted in 1937 (four years after passage of 580b), section 2953 provides,

> Any express agreement made or entered into by a borrower at the time of or in connection with the making of or renewing of any loan secured by a deed of trust, mortgage or other instrument creating a lien on real property, whereby the borrower agrees to waive the rights, or privileges conferred upon him by Sections 2924, 2924b, 2924c of the Civil Code or by Sections 580a or 726 of the Code of Civil Procedure, shall be void and of no effect.[116]

Plaintiffs argued that failure of section 2953 of the Civil Code to include 580b in its proscription against waiver supports the notion that 580b may be waived, at least subsequent to the original loan transaction. The court responded,

> We do not read Civil Code section 2953 to support the Palms' claim that section 580b may be waived subsequently by contract. Section 580b predated Civil Code Section 2953, yet it is not mentioned in the later-enacted provision. One may presume the Legislature was aware of Section 580b *but intended to exclude it from the aegis of Section 2953.* But the reason is not that the Legislature intended to permit subsequent waivers of section 580b, but that it was unnecessary to include that section within Civil Code section 2953 because, *by its own terms*, section 580b was not waivable.[117]

This is a startling statement. "By its own terms" 580b says nothing about waiver, either with respect to the time of the original transaction or a later time; 580b merely states a rule. Similarly, the other sections that are referred to in section 2953 of the Civil Code "by their own terms" are silent about waiver. If it was not "necessary" to include 580b within section 2953, why was it "necessary" to include the other code sections in order to demonstrate a legislative intent to bar waiver when all of the provisions are equally silent regarding the possibility of waiver? The court's discussion on this point makes no sense. The plain words of the code sections involved show that the legislature said the borrower protection rules of sections 2924, 2924b, and 2924c of the Civil Code and sections 580a and 726 of the Code of Civil Procedure may not be waived; but knowing of the rule of 580b, the legislature did not say that rule cannot be waived. The logical inference that waiver is not prohibited is compelling.[118]

116. CAL. CIV. CODE § 2953 (West 1974 & Supp. 1993).

117. *Palm*, 199 Cal. App. 3d at 75-76, 244 Cal. Rptr. at 609 (citations omitted) (emphasis added).

118. The court's evident hostility to the idea of waiver of 580b, as reflected in its illogical approach to interpretation of section 2953 of the Civil Code, presents a curious contrast to its statement that: "[p]erhaps in recognition of the prohibition against deficiency judgments, or perhaps because of the potential unfairness to junior lienholders powerless to prevent the destruction of their security by a senior secured creditor, the

Since the *Palm* court's statement that the Supreme Court has held 580b cannot be waived is not supported by *stare decisis*, and its interpretation of section 2953 is illogical, what is the basis for the court's decision that a negotiated waiver of 580b for consideration long after the sale transaction is void? It would appear the decision boils down to an attempt to protect the buyer from hardship. Referring to *Salter*'s language about the necessity of borrowers and ruinous concessions, the court observed, "Ruinous concessions are, if anything, easier to obtain when the debtor is in default. Then the temptation to 'press the bet' is likely to be stronger than the poor decision to purchase the property in the first instance."[119]

Certainly there is surface appeal to the notion of protecting the debtor in a hard place; this after all is the basic rule of 580b. But sympathy for the buyer whose patently risky financing plans crumbled does not supply a compelling logical basis for holding a subsequently bargained waiver of 580b absolutely void. The *Palm* case presented two parties in a perfectly ordinary transaction; the purchase and sale of a home. There is nothing to suggest that either party was unaware of the potential financial consequences of their agreement (except perhaps that one was unaware of the surprise the court had in store). Under the circumstances it could be said the plaintiff sellers were equally forced by necessity (of threat of foreclosure by the senior creditor) to make the "ruinous concession" of again subordinating to new senior debt rather than foreclosing themselves when the defendants had failed to perform their contract.

What would or could the parties have done had the seller not agreed to subordinate when the first of the third-party second loans came due? The sellers could have attempted to cure defaults on the first and second while foreclosing their third, thus reinvesting in a sold property and placing themselves at further financial risk while accelerating the buyer's loss of equity. Alternatively, if the sellers refused to subordinate, perhaps the buyer could have obtained a much larger new second loan (at presumably greater cost) to pay off both the second and the seller's third, and losing the protection of 580b in the process. Considering the positions of the parties faced with these difficult, risky, and uncertain alternatives, with both of them under the guns of secured creditors holding the higher ground, an appeal to public policy simply does not provide a clear-cut basis for a court-made rule that flatly voids a bargained contractual waiver of rights by one party in exchange for valuable concessions from the other.

Supreme Court has taken a narrow view of purchase-money mortgages." *Palm*, 199 Cal. App. 3d at 69, 244 Cal. Rptr. at 604.

119. *Id.* at 73, 244 Cal. Rptr. at 607 (quoting Salter v. Ulrich, 22 Cal. 2d 263, 267, 138 P.2d 7, 9 (1943)).

In short, while *Palm* does directly hold contractual waiver of 580b to be void as contrary to public policy, it does not offer *stare decisis*, statutory, logical, or any other persuasive support for its conclusion, and it is in conflict with the *Russell* decision from an equal-level appellate court. *Palm* should not stand in the way of enhancing transactional predictability by permitting freedom of contract with respect to waiver of 580b.

A buyer is no more likely to be pressured by necessity into accepting a seller's demand for 580b waiver in negotiation of the purchase and sale than he or she will be pressured by necessity into meeting the seller's price or any other term of the deal. In *Spangler* and the other cases reviewed in this article, buyers negotiated with sellers for the seller's agreement to subordinate the purchase-money deed of trust to a construction loan. The desire to obtain subordination of the seller's lien as part of a consensual transaction can hardly be characterized as "necessity" justifying a public policy based limitation on the parties' ability to allocate risk by waivers and other contractual agreements as they see fit.

The Real Property Law Section and the Business Law Section of the State Bar of California recently published a proposed statute for comprehensive reform of California's real property foreclosure laws.[120] This proposed statute would replace the whole panoply of sections 726, 580a, 580b, 580c, 580d, and other sections of the Code of Civil Procedure. Regarding deficiency judgment rules, the approach of the proposed statute is somewhat different in particulars, but consistent in philosophy, with the thesis of this article. The proposed new set of laws would combine a clear statutory rule with freedom of contract to achieve transactional predictability. The proposed statute, insofar as it relates to the subject of this article, states three basic rules:

> 1. No deficiency judgments are permitted on *any* debt secured in whole or in part by the debtor's personal residence whether purchase money or other

120. *See* Joint Committee on Anti-Deficiency Laws of the Real Property Law Section and the Business Law Section of the State Bar of California, *Proposed Statute Reforming the California Real Property Foreclosure Laws*, 10 CAL. REAL PROP. J. (Special Supp. 1992) [hereinafter *Proposed Statute*]. This, of course, is not the first time major reform has been proposed of the depression-era legislation regarding foreclosure and deficiency judgments. *See, e.g.*, Cynthia A. Mertens, *California's Foreclosure Statutes: Some Proposals for Reform*, 26 SANTA CLARA L. REV. 533 (1986). Professor Mertens was critical of *Spangler*, but in the context of her larger purpose of overviewing reform generally of §§ 580a, 580b, 580d, and 726, she only briefly discussed its unrealistic attempt to apply the prevention of overvaluation "purpose" of 580b. *Id.* at 548-50.

(defined in the proposed statute as "protected debts").[121]

2. Rule number 1 may not be waived.[122]

3. Debt secured by real property other than the debtor's personal residence may be recourse or nonrecourse as the parties agree by contract, regardless of the nature of the debt (purchase money or otherwise), and regardless of whether foreclosure is by judicial or nonjudicial procedures (thus making 580d subject to contractual waiver as well as in other than homeowner transactions).[123]

We can expect lively debate to ensue over the breadth of protection offered to homeowners under the "protected debt" concept of the proposed statute (as well as other provisions). However, the tortured history of 580b in business and development transactions shows the need for greater freedom of contract (including negotiation of terms and conditions of recourse) in subordinated purchase-money deeds of trust under existing law. It follows that the drafters of the proposed new foreclosure statute are on the right track in their proposal to enlarge the permissible scope of freedom of contract as a means of simplifying and clarifying the law in real estate finance transactions.

121. *Proposed Statute* §§ 1.140, 1.160, 1.165 & 3.100-.300.
122. *Id.* § 2.1260.
123. *Id.* § 2.700.