Entered on Docket
July 20, 2005
GLORIA L. FRANKLIN, CLERK
U.S BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

The following constitutes the order of the court. Signed July 19, 2005

Marilyn Morgan
Marilyn Morgan
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

SECURITY NATIONAL GUARANTY, INC., dba SNG DEVELOPMENT COMPANY and SNG REALTY, Debtor.	Case No. 03-55847-MM Chapter 11
SECURITY NATIONAL GUARANTY, INC., dba SNG DEVELOPMENT COMPANY and SNG REALTY, Plaintiff, vs. SHORES LLC, et al., Defendants.	Adversary No. 03-5504
SECURITY NATIONAL GUARANTY, INC., dba SNG DEVELOPMENT COMPANY and SNG REALTY, Plaintiff, vs. SHORES LLC, et al., Defendants.	Adversary No. 04-5102 **MEMORANDUM DECISION AND ORDER AFTER TRIAL**

INTRODUCTION

Before the court are two complaints by Security National Guaranty, Inc., which have been consolidated for purposes of trial. The complaints seek a determination of the amounts due under a secured promissory note, raising issues regarding the application of California's usury laws and the statute of frauds. Resolution of these legal issues is significant since the defendant's expert computes the debt on the note at $18,950,687.68, while the plaintiff's expert indicates the debt is $7,800,235.88.

FACTUAL BACKGROUND

The facts are largely undisputed, either set forth by stipulation or through the uncontroverted testimony of Edmond Ghandour, the president and sole shareholder of Security National Guaranty, Inc. (SNG). Don D. Lukens, the other signatory to the contracts at issue, has moved out of state and did not testify at trial. Although the facts are generally agreed, controversy arises in their interpretation.

Monterey Bay Shores is a 39.65 acre parcel west of coastal Highway 1 in Sand City, California, just north of Monterey and Carmel, which Ghandour believes is the last developable real property on the California coastline. In 1992, the California State Parks Foundation and the Dezonia Family Trust each owned a one-half interest in the property. In June, 1993, SNG acquired an option to purchase Monterey Bay Shores for $4 million that expired on December 31, 1996.

SNG needed financing in order to exercise the option, however, conventional financing was unavailable. The only alternative available to SNG was a "hard money" loan. In November 1996, when all other potential sources of funding had evaporated, and the purchase option would soon expire, a loan broker introduced Ghandour to Lukens, dba Community Group Funding ("CGF"), a business that offered loans of broker controlled funds in return for deeds of trust secured by real property. Lukens was the principal of CGF, but he was also a licensed real estate broker.

During November and December 1996, Lukens and Ghandour negotiated the terms of a loan to enable SNG to purchase and develop the Monterey Bay Shores property. The loan terms contemplated funding over multiple phases since Lukens did not have the funds necessary to advance all the loan proceeds at one time. Funds were so short that on December 27, 1996, just four days before the option expired, Lukens imposed

as a condition to the loan that SNG acquire, in lieu of cash, two additional real properties in California, one in Adelanto, San Bernardino County, and one in Bakersfield, Kern County. Lukens asserted that SNG could quickly liquidate these properties and apply the proceeds to the interest reserve fund for the last six months of the loan period. Ghandour testified that he assented to the inclusion of the Adelanto and Bakersfield properties with an aggregate assigned value of $900,000 in lieu of cash upon Lukens' assurance that SNG could reconvey the properties if their market values were not as represented.

During their negotiations, Ghandour specifically requested that all reserve funds be placed in interest bearing trust accounts in favor of SNG. Still, Lukens never promised to create a reserve account. By a commitment letter from CGF dated December 27, 1996, Lukens provided:

> An interest reserve on said Four Million Dollars ($4,000,000) shall be established by Lender, and Lender shall cause the first twelve months of monthly interest payments to be made from said reserve. The payments shall be made by means of a bookkeeping entry on Lender's books. Borrower shall have no interest in said reserve, except to the extent that Borrower may pay off the full amount of the loan prior to the expiration of the first twelve (12) months of the loan.

On December 30, 1996, Ghandour on behalf of SNG and Lukens, dba CGF, executed a Promissory Note and a Loan Agreement. The Note was in the principal amount of $7.5 million, accrued interest at the rate of 14% per annum, included an 18% default rate of interest, matured in January 1999, and was secured by the Monterey Bay Shores property. The Loan Agreement provided that CGF, defined in the agreement as "Lender," would fund the loan proceeds in three phases. It also provided that the lender would credit a disbursement of $900,000 to account for the transfer of the Adelanto and Bakersfield properties. Consistent with the commitment letter, the Loan Agreement provided the following with respect to reserves for the payment of interest and entitlements:

> First Phase
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> * * *
>
> (e) The sum of Five Hundred Sixty Thousand Dollars ($560,000) shall be retained by Lender as a twelve month interest reserve on the sums set forth in sub-paragraphs a through d above.
> (f) The sum of One Hundred Sixty Two Thousand Dollars ($162,000) shall be retained by Lender and disburse (sic) Borrower, upon the written request of Borrower, for entitlements which are directly related to the use of the Property. Borrower's request shall set forth the amount of fund requested, the entitlement to which it is applicable, and proof of the expense. Funds will be disbursed by Lender on the 1st day of the month for all requests received and

approved by Lender prior to the 15th day of the previous month.

Second Phase

* * *

The sum of Ten Thousand Five Hundred Dollars ($10,500) shall be retained by Lender as a nine (9) month interest reserve on the sums set forth in sub-paragraphs a through d above.

Third Phase

* * *

(d) The sum of Four Hundred Ninety Thousand Dollars ($490,000) shall be retained by Lender as a twelve month interest reserve on all funds disbursed and retained in the Third Phase. In addition Lender shall retain an interest reserve in the sum of Two Hundred Eighty Thousand Dollars ($280,000) for an additional six months on all funds disbursed and retained in the First Phase and an interest reserve in the amount of Seven Thousand Dollars ($7,000) for an additional six months on all funds disbursed and retained in the Second Phase.

(e) The sum of One Hundred Ninety Six Thousand Five Hundred Dollars ($196,500) shall be retained by Lender and disbursed to Borrower, upon the written request of Borrower, for entitlements which are directly related to the use of the Property. Borrower's request shall set forth the amount of fund requested, the entitlement to which it is applicable, and proof of the expense. Funds will be disbursed by Lender on the 1st day of the month for all requests received and approved by Lender prior to the 15th day of the previous month.

Section 7.15 of the Loan Agreement specifically provided that the terms of the agreement "may not be modified, waived, discharged, or terminated except by a written instrument signed by the party against whom enforcement of the modification, waiver, discharge, or termination is asserted." From the inception of the loan, observance of its terms was fluid, and negotiations concerning its structure continued. The parties immediately entered into a written amendment to the Loan Agreement whereby, subject to Lukens' discretion, SNG could use up to $250,000 designated for the interest reserve to pay for entitlements.

SNG's acquisition of the State Parks Foundation's interest in the property closed on January 6, 1997. CGF funded the purchase price and recorded a deed of trust in first position. However, it did not deposit the entitlements reserve and the interest reserve amounts in interest bearing trust accounts established for SNG's benefit. The checks from CGF were issued from general operating accounts of CGF, and some were returned for insufficient funds and required re-issuance. SNG experienced significant delay and difficulty obtaining checks for entitlements. Ghandour testified that he would not have agreed that interest would accrue on the reserves had he realized that the reserves were not funded in trust accounts per the custom and practice in the industry. Nonetheless, he never complained of this non-compliance to Lukens.

CGF funded the first phase of the purchase with investment proceeds from various lenders, including the Ng Cobb Trust, Straight Jacket Enterprises, and the Tri-County Produce Profit Sharing Plan and Trust, in the amounts of $300,000, $600,000, and $75,000, respectively. Thereafter, it received funds from other investors, including $125,000 from Jessie Barbara Dixon in February 1997. CGF furnished a Lender/Purchaser Disclosure Statement and Service Agreement and Power of Attorney to each of these investors. On the Department of Real Estate Loan Origination forms, Lukens consistently identified the investor as the lender and characterized the secured loan to SNG as a multiple lender transaction for which Lukens, as broker, was acting as an agent in arranging the loan.

First American Title Insurance Company required that the lenders be aggregated into one entity for title insurance purposes. In response to this requirement, Shores LLC was formed in June 1997, and Lukens was designated its manager. By June 30, 1997, CGF had not found lenders to fund the acquisition of the interest of the Dezonia Family Trust. Its inability to fund required that SNG obtain an extension from Dezonia to August 15, 1997. On June 27, 1997, SNG and Dezonia amended the purchase contract to provide that SNG would pay a penalty of $75,000 for the extension, $100,000 as a portion of the purchase price, $68,762.18 in interest on the balance of the purchase price, $23,539.76 in real property taxes, and additional penalties of $2,000 per day if the close of escrow were extended beyond August 15, 1997 to September 15, 1997. To account for the delay, SNG and CGF also entered into the Second Amendment to Loan Agreement dated June 28, 1997, which provided:

> Lender desires an extension of time to perform its obligations to fund certain portions of the Loan described in the Loan Agreement, in part to allow it to form a limited liability company or other entity to hold by assignment all of the Lender's interest in the Loan Agreement and the Note. . . .

The Second Amendment provided that CGF would pay one-half of the real property taxes and the additional penalties of $2,000 per day, but that the $75,000 penalty would be drawn against the interest reserve. It further provided that all lender's and broker's fees in connection with the third phase of the Loan Agreement would not be earned until closing of the purchase of the Dezonia interest. Ghandour contends that any delay beyond the time of formation of Shores was attributable to Lukens' need to raise more funds from investors.

Although Ghandour was unaware of it at the time, Lukens' real estate broker's license expired on

September 10, 1997. Lukens allowed his license to lapse while he was under investigation by the Federal Bureau of Intelligence and the Securities and Exchange Commission for improprieties involving investors' funds.

CGF again did not have sufficient funds to close the purchase of the Dezonia interest by the extended date, September 15, 1997. Consequently, SNG obtained a further extension of the closing date. SNG and Dezonia entered into another amendment of the purchase contract effective September 12, 1997 to extend the closing date to December 15, 1997. The amendment provided that SNG would pay a $60,000 penalty for the delay, $200,000 as a portion of the purchase price, $26,252.41 in interest on the balance of the purchase price, all accrued real property taxes, and additional penalties of $1,000 per day until close of escrow. Thereafter, SNG and CGF entered into the Third Amendment to Loan Agreement, which provided that SNG would execute a deed of trust equal in priority to the first deed of trust previously recorded and that CGF would bear the expense of any additional penalties of $1,000 per day and not charge it against the loan. CGF also paid the $60,000 penalty but did not charge it against the loan.

Throughout the fall of 1997, Ghandour corresponded with CGF inquiring about the status of funding the purchase of the Dezonia interest and received assurances that Lukens was soliciting funds from investors and doing his best to have the funds available. The escrow on SNG's purchase of the Dezonia interest ultimately closed on November 26, 1997. The Department of Real Estate disclosure statement for Michelle Karpinski indicates that her investment funds in the amount of $650,000 were advanced just days before on November 24, 1997. A statement from Prudential Securities for a CGF account reflects a deposit on November 24, 1997 in the same amount as the Karpinski investment, as well as two other large deposits in the amounts of $350,000 and $550,000 that same day. The Prudential Securities statement also shows that on November 25, 1997, CGF withdrew from that account $1,446,510,43, the same amount that was deposited into the escrow.

In January 1998, the Adelanto and the Bakersfield properties were transferred to SNG. Ghandour testified that, from the inception, SNG did not want the properties. He obtained brokers' opinions of the values and determined that they were worth far less than represented. As it turned out, the properties were difficult to market. The Bakersfield property had environmental remediation problems. SNG reconveyed the properties to Lukens in August 1998, but Lukens again conveyed the properties to SNG in December 1998.

In January 1999, when the Promissory Note matured, SNG was unable to pay it since the entitlement process was not complete, and SNG had not been able to liquidate the Adelanto and Bakersfield properties. CGF recorded a Notice of Default on January 26, 1999 and on May 13, 1999 posted a Notice of Trustee's Sale scheduled for May 28, 1999. However, CGF did not proceed with the Trustee's sale because, on May 15, 1999, SNG, CGF, and Shores entered into a letter agreement modifying the terms of the Promissory Note and Loan Agreement. Ghandour was anxious to resolve the default under the Promissory Note and Loan Agreement because there was an important Coastal Commission hearing scheduled for May 20, 1999, and, as a result of Lukens' prompting, the project was under scrutiny by local media. The letter agreement provided that CGF and Shores would rescind the Notice of Trustee's Sale and extend the maturity date of the Promissory Note to January 6, 2000. SNG agreed to pay $750,000 for the extension, to accept the Adelanto and Bakersfield properties as provided in the Loan Agreement, and to list the property with a national broker if the loan were not repaid by January 6, 2000. SNG also acknowledged that the loan had been fully funded and that all conditions had been performed. Nonetheless, Ghandour testified that the parties agreed that a full accounting would be performed after the letter agreement was executed.

Lukens executed the letter agreement on behalf of CGF and Shores. Although the letter agreement contains a signature line for David J. Abraham, Jr., who is a licensed real estate broker associated with CGF, Abraham did not execute the agreement. During his deposition, Abraham testified that he did not have any knowledge of or participation in the Monterey Bay Shores loan. Ghandour also testified that Abraham was not involved in the Monterey Bay Shores loan in any manner.

Finally, SNG and CGF agreed as to how to account for the Adelanto and Bakersfield properties in September 1999. Ghandour testified that Lukens agreed to reduce the amount of the loan by the difference between $900,000, plus accrued interest, and the total amount for which SNG sold the properties, net of expenses. He memorialized the terms of that agreement by memorandum dated September 10, 1999; however, a copy of the memorandum purportedly executed by Lukens was not admitted into evidence at trial as the document was not produced during discovery, and Lukens' signature could not be authenticated. In September 1999, SNG sold the Adelanto property to Tanam Corporation, a corporation wholly owned by Ghandour's wife, Anna Ghandour, for only $25,000. SNG sold the Bakersfield property for $260,000 in

February 2000.

SNG defaulted under the terms of the letter agreement by failing to repay the loan in January 2000. Shores thereafter commenced non-judicial foreclosure proceedings by posting a Notice of Default, then subsequently publishing a Notice of Trustee's Sale, under the power of sale clause in the deeds of trust. Before a non-judicial foreclosure sale took place, however, SNG filed a complaint against Shores in Monterey County Superior Court on June 18, 2003 for fraud, breach of contract, rescission, reformation, and for an accounting. SNG sought, but failed to obtain, a temporary restraining order to enjoin the non-judicial foreclosure sale.

SNG commenced this Chapter 11 case by filing a voluntary petition on August 22, 2003. It removed the pending Monterey County Superior Court action to the bankruptcy court and also filed an adversary proceeding to determine the extent, validity, and priority of liens. These two proceedings are now before the court. Since the commencement of the bankruptcy case and the adversary proceeding, Shores has sold its interest in the Promissory Note and Deed of Trust to The Berkley Group, which has agreed to be bound by this judgment.

CONTENTIONS OF THE PARTIES

The key disputed issue is whether SNG is required to repay all the interest and fees due under the Loan Agreement, or whether usury law applies to portions of the loan. The parties stipulate that the only applicable exemption to usury is the licensed broker exemption. SNG asserts that the loan was a multiple lender transaction arranged over an extended period of time. It concedes that it must pay interest and fees on the amounts funded prior to September 10, 1997 when Lukens' broker's license expired. However, SNG contends that the amounts funded after Lukens' license expired accrued interest at a usurious rate. Shores disputes that Lukens engaged in any activities after September 10, 1997 that would have required a broker's license.

SNG further contends that the May 15, 1999 letter agreement is a forbearance agreement subject to the usury law. Because Lukens was no longer licensed at the time he arranged the forbearance agreement, SNG argues that the agreement does not qualify for the licensed broker exemption. Shores responds that the May 15, 1999 letter agreement constitutes a settlement of an exempt transaction that remains exempt from the

usury law.

Next, the parties dispute the accounting of certain disbursements. First, SNG contends that CGF failed to fund the interest and entitlements reserves in interest bearing trust accounts. It argues that interest cannot accrue on the unfunded reserves. Shores responds that the Loan Agreement should be enforced pursuant to its terms, which did not mandate the deposit of the reserves into interest bearing accounts, but allowed for interest accrual nonetheless.

Secondly, SNG contends that Lukens agreed to modify the loan terms such that SNG would not have to repay the $900,000 attributable to the Adelanto and Bakersfield properties. Instead, SNG would only be required to repay the actual amount for which SNG ultimately sold the two properties, net of expenses. Shores disputes that the parties entered into an enforceable agreement modifying the amount due for the Adelanto and Bakersfield properties.

Finally, the parties stipulate that Lukens voluntarily paid some of the interest and late penalties associated with the Dezonia extensions and did not charge these amounts to the loan. However, they dispute the existence of agreements modifying the amounts SNG would pay on account of penalties and interest arising from the extensions. SNG contends that Lukens agreed not to charge to the loan a penalty payment in the amount of $75,000 and an interest payment of $26,252.41. Shores asserts there is no enforceable modification agreement.

At the close of its evidence, SNG made an election of its remedies and determined to forego its rescission claims.

LEGAL DISCUSSION

I. Portions of the Monterey Bay Shores Loan Are Usurious

A. The Monterey Bay Shores Loan is a Multiple Lender Transaction Arranged by Lukens

California law provides an exemption to the limitation on interest rates for a loan or forbearance made or arranged by a California licensed real estate broker and secured in whole or in part by liens on real property. Cal. Const. art. XV, § 1; Cal. Civ. Code § 1916.1. A loan is "made" by a licensed real estate broker when

the broker acts as a principal in the transaction by lending his own money. Del Mar v. Caspe, 222 Cal App.3d 1316, 1324 (Cal. Ct. App. (6th Dist.) 1990). A loan or forbearance is "arranged by" a licensed real estate broker when the broker acts for compensation or in expectation of compensation for soliciting, negotiating, or arranging the loan for another. Cal. Civ. Code § 1916.1. The phrase "arranged by" refers to some conduct by a real estate broker, acting as a third party intermediary rather than as a party to the loan, that causes a loan to be obtained or procured. It includes structuring the loan as an agent for the lender, setting the interest rate and points to be paid, setting the terms of the forbearance agreement, reviewing the loan and forbearance documents, conducting title searches, or drafting the terms of the loan. Gibbo v. Berger, 123 Cal. App. 4th 396, 402 (Cal. Ct. App. (4th Dist.) 2004). The court must look beyond the form of the transaction to its substance. Ghirardo v. Antonioli, 8 Cal.4th 791, 802 (1994); Boerner v. Colwell Co., 21 Cal.3d 37, 44 (1978). The character of a transaction is determined from all the surrounding facts and circumstances. Montgomery v. Spect, 55 Cal. 352, 353-54 (1880).

Although the Loan Agreement and Note define Lukens as the Lender and SNG as the Borrower, there is an abundance of evidence clearly indicating that the Monterey Bay Shores loan is a multiple lender transaction arranged by Lukens on behalf of third party investors. Lukens acknowledged by letter dated December 27, 1996 that he would be raising the funds from investors. Some of the loan proceeds were paid to CGF through escrow as fees for the transaction. The evidence establishes that Lukens solicited funds from investors over an extended period of time to meet the funding requirements under the Loan Agreement. Lukens corresponded with the Monterey Bay Shores investors requesting checks or confirming the receipt of their investment funds and prepared and furnished to the investors Lender/Purchaser Disclosure Statements and Service Agreements and Powers of Attorney. In these Department of Real Estate disclosure statements, Lukens consistently identified the investor as the lender and characterized the Monterey Bay Shores loan as a multiple lender transaction for which Lukens acted as broker and agent in arranging the loan. The disclosure statements for the Ng Cobb Trust, Straight Jacket Enterprises, and the Tri-County Produce Profit Sharing Plan and Trust suggest that investor funds in the amounts of $300,000, $600,000, and $75,000, respectively, were advanced late December 1996 or early January 1997, shortly before the close of escrow on the State Parks Foundation's one-half interest in the Monterey Bay Shores property. A title report reflects that these investors and others

received from Lukens assignments of fractional interests of the Monterey Bay Shores deed of trust in February 1997. After the loan matured, Ghandour noted that a list of investors' proportionate interests in the Monterey Bay Shores Note was appended to the Note.

After the acquisition of the interest of the State Parks Foundation, Lukens continued to solicit funds to meet the disbursements requirements of the second and third phases under the Loan Agreement. The disclosure statement for Jessie Barbara Dixon, who invested $125,000, reflects that Lukens was soliciting funds from her in February 1997. However, it appears Lukens was not able to raise sufficient funds to timely meet CGF's disbursements obligation to SNG since checks for entitlements were periodically dishonored or reissued. At Lukens' request, SNG obtained an extension from June 30, 1997 to September 15, 1997 from Dezonia to purchase the second one-half interest in the property. The Second Amendment to Loan Agreement between SNG and CGF recited, "Lender desires an extension of time to perform its obligations to fund certain portions of the Loan. . . ." Although Shores asserts that First American Title required that the fractional interests in the first deed of trust be aggregated, this requirement had been fulfilled by June 1997 with the formation of Shores LLC. Ghandour frequently inquired of Lukens when the acquisition of the Dezonia interest would be funded and received assurances from CNG's staff on August 28, 1997 that Lukens was "doing his best to have funds available. . . ." When escrow did not close by September 15, 1997, SNG obtained a further extension from Dezonia, and Lukens voluntarily paid some of the penalties and interest associated with the extensions without charging the amounts to the Monterey Bay Shores loan, suggesting his acknowledgment of responsibility for the delay. Lukens' conduct, including soliciting funds, negotiating terms, and furnishing documents for compensation, constitutes "arranging" the loan as defined in Cal Civ. Code § 1916.1.

B. <u>The Third Phase Funding for the Acquisition of the Dezonia Interest is Usurious</u>

The distinction whether a licensed broker lent his personal funds or negotiated a loan between the lender and the borrower does not effect the applicability of the exemption to the transaction because, in both circumstances, the loan would be exempt from the usury law. 8 Miller & Starr, *California Real Estate* § 21:34 (West (3d ed.) 2001). The character of the transaction is significant because whether and when broker services were performed determines whether the licensed broker exemption is applicable. The exemption

applies only if the broker was licensed at the time the services that give rise to the commission were performed. Del Mar v. Caspe, 222 Cal App.3d at 1333-34. Different funded portions of a loan may be analyzed separately to determine whether the exemption is applicable. See, e.g., In re Lara, 731 F.2d 1455, 1462-63 (9th Cir. 1984). Once the borrower establishes that a loan is usurious on its face, the burden shifts to the lender to prove that the loan qualifies for an exemption. Jansen v. Nu-West, Inc., 6 P.3d 98, 102 (Wash. Ct. App. 2000), review denied, 143 Wash.2d 1006 (2001); Stevens v. Security Pacific Mortgage Corp., 768 P.2d 1007, 1012 (Wash. Ct. App. 1989), review denied, 112 Wash.2d. 1023 (1989) ; 45 AM. JUR. 2d *Interest and Usury* § 354-55 (West 2005). In this case, Shores bears the burden of proof that the licensed broker exemption is applicable.

Lukens was a licensed broker when the Loan Agreement was negotiated and when the acquisition of the State Parks Foundation's interest closed. SNG and Shores have stipulated that the first phase funding is subject to the licensed broker exemption. The second phase funding of a portion of the purchase price for the Dezonia interest is also exempt. However, Lukens' brokerage license expired on September 10, 1997 before the third phase of the loan was funded. Whether the exemption is applicable to the third phase funding turns on whether Lukens was "arranging" the loan after his license had expired.

While Shores argues that $336,252.41 disbursed into the Dezonia escrow on September 15, 1997 was not solicited after Lukens lost his license, no evidence was introduced to meet its burden of proof. The stipulated facts reveal that the escrow for the acquisition of the Dezonia interest closed on November 26, 1997. CGF made the escrow deposit for the purchase price of the Dezonia interest from an account at Prudential Savings. A statement for the Prudential Savings account reflects that on November 24, 1997, CGF made three large deposits, including one for $650,000 from investor Michelle Karpinski. The court infers from this evidence that Lukens raised the funds necessary to close escrow from investors during the period between September 15, 1997 and November 25 1997 after he was no longer licensed. He apparently deposited the investors' funds into CGF's Prudential Securities account and issued a check from that account into the Dezonia escrow. The activities in which Lukens engaged after September 10, 1997 can only be construed as arranging the loan on behalf of third parties. He had conveyed fractional shares of the deed of trust to Shores and various other investors. The weight of the evidence indicates that Lukens continued to arrange the loan

after September 10, 1997 by soliciting and raising funds, negotiating amendments to the loan, and preparing the deed of trust that was recorded after the acquisition of the Dezonia interest. Under the circumstances, Shores has failed to meet its burden of proof that the licensed broker exemption is applicable to the third phase funding under the Loan Agreement.

C. The May 15, 1999 Letter Agreement Constitutes a Forbearance Subject to the Usury Law

Usury law includes forbearances within the scope of its prohibition on excessive interest. Cal. Const. art. XV, § 1; Cal. Civ. Code § 1916.1. A forbearance is the giving of further time for the payment of a debt or an agreement not to enforce a claim at its due date. Southwest Concrete Products v. Gosh Construction Corp., 51 Cal.3d 701, 705 (1990); Boerner v. Colwell, 21 Cal.3d at 44, fn.7. The May 15, 1999 letter agreement extended the maturity date of the Promissory Note by one year to January 6, 2000, rescinded the Notice of Trustee's Sale of the Monterey Bay property, and provided for the payment of a $750,000 fee for the extension. It constitutes a forbearance subject to the usury law. Whether it is exempt depends upon whether a licensed broker arranged the transaction. As Shores' manager, Lukens acted as its agent in negotiating with Ghandour the terms of the extension and forbearance. However, he was no longer a licensed broker in May 1999. Shores suggests that David Abraham, a broker associated with CGF, may have participated in negotiating the May 15, 1999 letter agreement. However, the evidence is to the contrary. His deposition indicates that Abraham had no knowledge of or involvement in any aspect of the Monterey Bay Shores loan. Ghandour's testimony corroborates this. Shores has failed to meet its burden of proof that the licensed broker exemption applies to the May 15, 1999 letter agreement. Consequently, the forbearance is also usurious.

Ghirardo v. Antonioli, 8 Cal.4th 791, and DCM Partners v. Smith, 228 Cal. App. 3d 729 (Cal. Ct. App. (4th Dist. (1991), upon which Shores relies, are distinguishable. These cases involved modifications of exempt credit sales, which retained their exempt character. They did not involve either a loan or forbearance of money to which the usury law is applicable. The difference between a credit sale and a forbearance of a loan is that a purchaser who cannot afford the purchase price can simply walk away from a high interest rate while

a borrower is forced by economic circumstances to resort to a usurious loan. Ghirardo v. Antonioli, 8 Cal.4th at 804-05. A forbearance is a separate element in a transaction. Although the original loan is not usurious, any extension or forbearance of the loan may be subject to the usury limitations unless it is exempt by some other provision. 8 Miller & Starr, *California Real Estate* § 21:4.

Generally, a usurious forbearance, renewal, or extension of a non-usurious loan taints only the forbearance since it is considered a separate transaction. The original non-usurious loan is unaffected and may be enforced according to its terms. See, e.g., Westman v. Dye, 214 Cal. 28 (1931); Strike v. Trans-West Discount Corp., 92 Cal. App. 3d 735 (Cal. Ct. App. (4th Dist.) 1979). See also 45 AM. JUR. 2D *Interest and Usury* § 242 (West 1999); 47 C.J.S. *Interest & Usury* § 180 (West 1982). A creditor may collect the interest at the contract rate and the principal under the original loan. 8 Miller & Starr, *California Real Estate* § 21:4. Here, however, the May 15, 1999 letter agreement modified the terms of the original Loan Agreement. Under California law, a modification supercedes the original agreement. Thiele v. Merrill Lynch, Pierce, Fenner & Smith, 59 F. Supp. 2d 1067, 1070 (S.D. Cal. 1999). It changes the obligations of a party by the subsequent mutual agreement of the parties and alters the affected portions of the original written contract. Yet, where the general purpose of the contract is the same, the original contract is not extinguished, remains in effect, and may be enforced as modified. Travelers Ins. Co. v. Workmen's Comp. Appeals Bd., 68 Cal. 2d 7, 17 (1967), disapproved on other grounds, Levesque v. Workmen's Comp. Appeals Bd., 1 Cal. 3d 627 (1970); Conley v. Matthes, 56 Cal. App. 4th 1453, 1465 (Cal. Ct. App. (2nd Dist.) 1997), review denied; 1 Miller & Starr, *California Real Estate* § 1:96, 1:98.

The case of Westman v. Dye involved an action to recover a promissory note in the principal amount of $2,500 with interest at 8% per annum. The note was renewed for successive six month intervals with the lender charging $125 for each renewal. The California Supreme Court agreed with the lower courts that the renewals were usurious because the payment of 8% plus the bonus for the renewal exceeded the interest rate permitted by statute. Although not usurious at its inception, a usurious renewal taints all subsequent related transactions. The Court allowed the lender to collect interest on only the original, non-usurious note. It declined to award any interest that accrued subsequent to the effective date of the usurious renewal. Westman v. Dye, 214 Cal. at 37-38.

Shores has asserted that the May 15, 1999 letter agreement is unenforceable because all beneficiaries did not execute it. However, where there are multiple beneficiaries to a deed of trust, one beneficiary may exercise its remedies following a default without the consent of the other beneficiaries. See Perkins v. Chad Dev. Corp., 95 Cal. App. 3d 645, 650-51 (Cal. Ct. App. (4th Dist.) 1979); 1 Bernhardt, *California Mortgage and Deed of Trust Practice* § 1.42 (3rd ed. 2005). Here in particular, Shores cannot reasonably argue that the May 15, 1999 letter agreement is not enforceable because Lukens, as its manager, executed it on behalf of Shores. It has not raised any other viable defenses to enforcement. Hence, the Loan Agreement may be enforced according to its terms, as modified by the May 15, 1999 letter agreement. While the original non-usurious loan may be enforced according to its terms, however, the creditor is subject to the penalties applicable to the usurious renewal or forbearance. See Westman v. Dye, 214 Cal. at 36-38; 8 Miller & Starr, *California Real Estate* § 21:4. As a result, Shores may collect interest at the contract rate for the first phase only through the effective date of the May 15, 1999 letter agreement.

Where the transaction was originally usurious, a subsequent renewal is also rendered usurious. Taylor v. Budd, 217 Cal. 262, 265-66 (1933); Westman v. Dye, 214 Cal. at 38. Consequently, Shores may not collect any interest on the third phase funding under the Loan Agreement, which the court previously concluded to be usurious. The effect of a determination that a transaction is usurious is that the creditor may recover only the principal and prejudgment interest at the legal rate from the date of maturity until the date of judgment. It cannot recover any interest that accrued during the term of the loan before maturity. Green v. Future Two, 179 Cal. App. 3d 738, 744 (Cal. Ct. App. (2nd Dist.) 1986).

II. Interest Does Not Accrue on Unfunded Interest and Entitlements Reserves

The Loan Agreement clearly provides that $1,347,500 would be retained by the Lender as an interest reserve and that $358,000 would be retained by the Lender and disbursed to the Borrower upon the Borrower's written request for entitlements for the property, yet is silent as to whether the reserves would be deposited into interest bearing trust accounts established for SNG's benefit. SNG's expert, Guy Puccio, testified that in the mortgage lending industry, it is customary practice that funds earmarked for a specific purpose should be maintained in a segregated, interest-bearing account identified for that purpose. Moreover,

California law mandates that interest must be computed on the actual amounts advanced from the date of the advance, and further that interest accrues only on amounts actually made available to the borrower. Penziner v. West American Finance Co., 133 Cal. App. 578, 590 (Cal. App. (1st Dist.) 1933); 13A CAL. JUR.3d *Consumer and Borrower Protection Laws* § 661 (West 2004). Here, there is no evidence that the interest and entitlements reserves were ever deposited into interest bearing trust accounts. To the contrary, the checks for entitlements disbursements, which SNG frequently forwarded to its vendors, were issued from CGF's general account. Consequently, SNG is not liable for interest accrual on the reserve amounts.

With respect to SNG's claim for breach of contract for failure to fund the reserves, that claim has been waived. It was plain as early as May 1997 when CGF was issuing checks to SNG vendors that the disbursements were being made from CGF's general operating account. Nonetheless, Ghandour concedes that he never complained to Lukens that the reserves were not set aside. Instead, SNG continued to accept performance from CGF. If an aggrieved party with knowledge of a contract breach continues to accept performance from the breaching party, that conduct may constitute a waiver of the breach. Whitney Investment Co. v. Westview Development Co., 273 Cal. App. 2d 594, 603 (Cal. Ct. App. (4th Dist.) 1969). Although interest may not accrue on the unfunded amounts, the court concludes that SNG has waived any claim for breach of contract arising from the failure to segregate the interest and entitlements reserves.

III. SNG and CGF Did Not Enter Into an Enforceable Modification with Respect to Accounting for the Bakersfield and Adelanto Properties

The Loan Agreement provides that $900,000 would be disbursed to SNG upon the recordation of the deeds of trust on the Adelanto and Bakersfield properties. SNG contends that negotiations over the treatment of the properties were ongoing because SNG never wanted to include them in the transaction. Finally, in September 1999 Lukens agreed to reduce the amount of the loan attributable to these two properties. Ghandour testified that the parties agreed to assign values to the Adelanto and Bakersfield properties based on their sales prices and would book only the net proceeds of sales to the loan, memorialized in a memorandum by Ghandour to Lukens dated September 10, 1999.

Under California law, the statute of frauds provides that, subject to a few exceptions not applicable in

this case, when a contract is in writing, any modification of the written agreement also must be in writing executed by each of the parties. Twohey v. The Realty Syndicate Co., 4 Cal. 2d 379, 383 (1935); Haase v. Lamia, 229 Cal. App. 2d 654, 659 (Cal. Ct. App. (2nd Dist.) 1964); Cal. Civ. Code § 1698; 1 Miller & Starr, *California Real Estate* § 1:65, 1:98 (3rd ed. 2000). Moreover, the Loan Agreement itself provides that its terms may not be modified, waived or discharged except by a writing executed by the party against whom enforcement is sought. The purported signature of Lukens on the September 10, 1999 memorandum by Ghandour could not be authenticated, and the signed memorandum was not admitted into evidence. As a result, it does not satisfy the statute of frauds and may not be used to reduce the amount of the debt attributable to the Adelanto and Bakersfield properties. Consequently, SNG must repay the loan amount attributable to these two properties as provided for in the Loan Agreement, except that interest would not accrue on that amount because it was disbursed after Lukens lost his license.

IV. SNG and Lukens Did Not Enter Into an Enforceable Modification with Respect to the Disputed $75,000 Penalty Payment to Dezonia

SNG contends that Lukens agreed that the $75,000 penalty that CGF paid to Dezonia for the extension of the purchase closing through September 15, 1997 would not be charged to the loan because Lukens' inability to timely fund the purchase had caused the delay. The Second Amendment to the Loan Agreement provides that the $75,000 penalty would be drawn against the interest reserve under the Loan Agreement. Later, Lukens paid the $60,000 penalty incurred under the Third Amendment to Loan Agreement and did not charge the amount against the loan.

SNG offered a letter dated September 14, 1997 from Ghandour to Lukens, in which Ghandour confirmed their agreement that Lukens would bear the cost of the $75,000 penalty. However, Lukens did not execute the letter. As discussed *supra*, a written contract may only be modified by a written agreement executed by the parties. Twohey v. The Realty Syndicate Co., 4 Cal. 2d at 383; Haase v. Lamia, 229 Cal. App. 2d at 659. Because the Loan Agreement expressly limits modifications to a writing executed by the party against whom enforcement is sought, the September 14, 1997 letter by Ghandour is not sufficient to satisfy the statute of frauds. Absent an enforceable modification, SNG must repay the disputed Dezonia penalty as part

of the loan amount.

V. SNG Has Not Established an Enforceable Agreement With Respect to the Disputed $26,252.41 Interest Payment to Dezonia

As required under the second amendment to the purchase contract with Dezonia, SNG made an interest payment in the amount of $68,762.18 to Dezonia from loan advances by CGF. The Second Amendment to the Loan Agreement provides that the $68,762.18 payment would be included in the loan amount. CGF also advanced funds on behalf of SNG to make interest payments to Dezonia in the amounts of $26,252.41 and $21,056.33 in connection with the extension through December 15, 1997. SNG does not dispute that the interest payment in the amount of $21,056.33 should be part of the loan. However, SNG contends that Lukens agreed that the interest payment in the amount of $26,252.41 would not be charged against the loan because of Lukens' role in the delay. It has not proffered any documentary evidence to support this contention, and the agreements between SNG and GCF are silent as to the allocation of this payment.

Courts often refer to the course of dealing between the parties to interpret contracts that are silent as to the disputed terms. See Insurance Co. of North America v. NNR Aircargo Service (USA), Inc., 201 F.3d 1111 (9th Cir. 2000); Southern Pacific Transportation Co. v. Santa Fe Pacific Pipelines, Inc., 74 Cal. App. 4th 1232, 1240 (Cal Ct. App. (1st Dist.) 1999). Throughout the term of the Monterey Bay Shores loan, the parties consistently treated the interest payments as part of the amounts to be repaid under the loan. SNG has failed to establish why the $26,252.41 interest payment should be treated any differently.

CONCLUSION

The Monterey Bay Shores loan is a multiple lender transaction arranged by Lukens, whose brokerage license expired on September 10, 1997. Consequently, the first phase and second phase funding are subject to the licensed broker exemption to usury, and SNG must repay the principal with interest at the contract rate through the date it was superceded by the May 15, 1999 letter agreement. However, the third phase does not qualify for the exemption, so SNG must repay only the principal plus interest at the legal rate from the date of

maturity, as extended, until the date of judgment. The May 15, 1999 letter agreement constitutes a forbearance subject to usury law and supercedes the terms of the Loan Agreement. Like the third phase, the forbearance is usurious, and SNG must repay only the principal plus interest at the legal rate from the date of maturity until the date of judgment.

Under California law, SNG is not required to pay interest on unfunded interest and entitlements reserves. However, it has waived any claim for breach of contract arising from CGF's failure to segregate the reserves because it accepted performance from CGF without complaint.

The statute of frauds precludes SNG from enforcing a modification to the written Loan Agreement, as amended, unless the modification is in writing executed by the party against whom enforcement is sought. As a result, SNG must repay the amounts attributable to the Bakersfield and Adelanto properties and the $75,000 Dezonia penalty in accordance with the terms of the Loan Agreement, as amended.

Finally, SNG has failed to establish any basis for treating the $26,252.41 Dezonia interest payment differently than the parties' prior course of dealing. Accordingly, it must also repay this amount.

The parties are directed to recompute the amounts owing on the Note. Plaintiff shall submit a proposed judgment accompanied by a declaration indicating that both counsel have reviewed the calculations and find them consistent with the court's decision.

Good cause appearing, IT IS SO ORDERED.

*** * * END OF ORDER * * ***

Adversary No. 03-5504

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