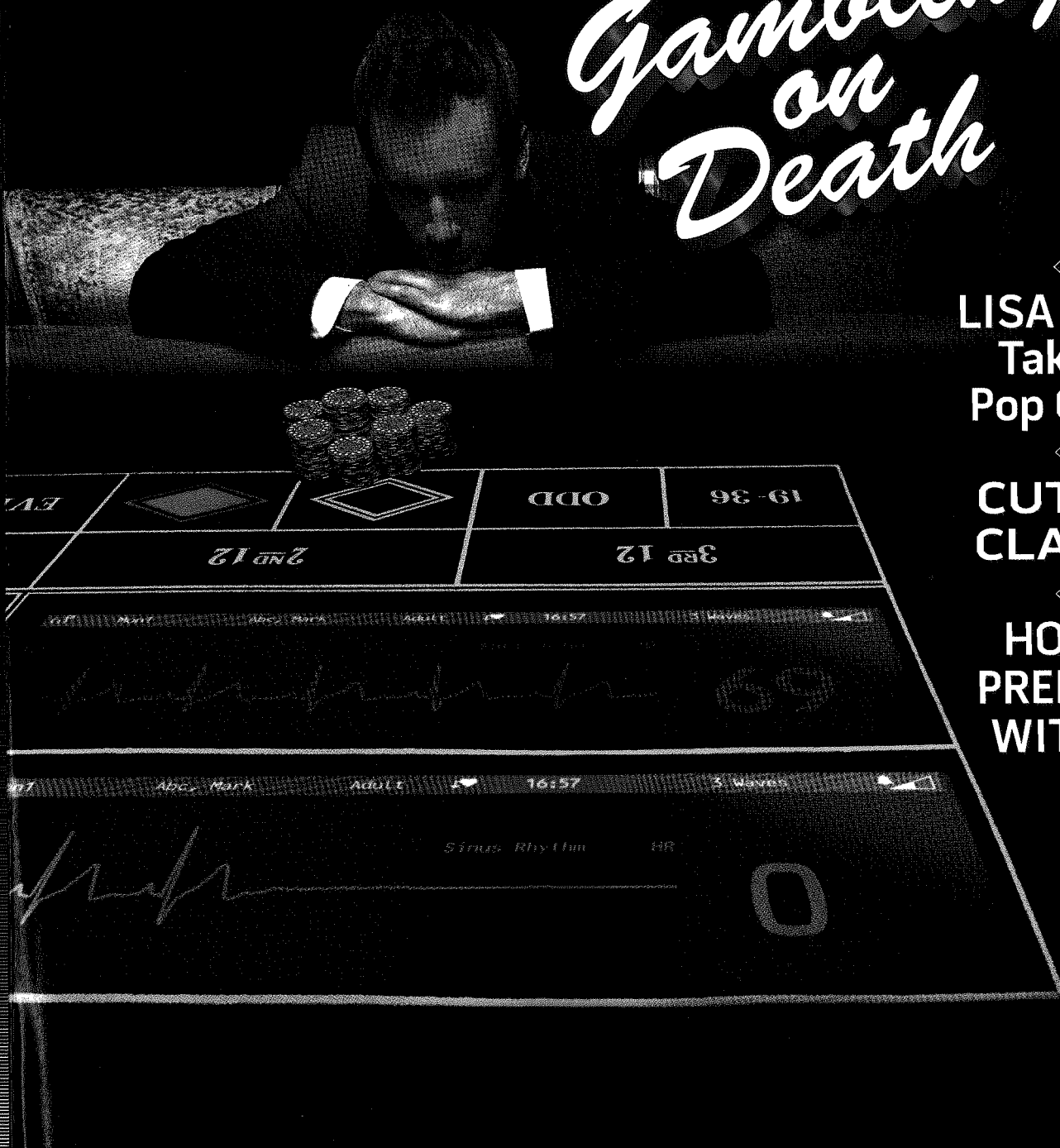


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# The 'Sham Guaranty' Defense

BY ROBERT M. HELLER

**S**ince the collapse of the last real estate bubble, commercial lenders have increasingly sought to recover from individual guarantors of loans that have fallen into default. Indeed, when an individual or entity guarantees a loan that is secured by real property, the guarantor enjoys few, if any, legal defenses should the original borrower fail to pay.

The law treats a guarantor very differently from a borrower, who has protection by virtue of California's strong "antideficiency" rule. Under that rule, if a mortgage loan goes into default, the lender is limited to recovering only the foreclosure value of the property pledged to secure the obligation; the lender cannot obtain a "deficiency" judgment against the borrower if proceeds from the foreclosure sale are insufficient to fully pay off the defaulted loan. The antideficiency rule is firmly embedded in the Code of Civil Procedure and related case law. (See Cal. Code Civ. Proc. §§ 580a (requiring credit for fair market value), 580b (limiting deficiency judgments on purchase money mortgages),

580d (limiting deficiency judgments on foreclosures under power of sale), and 726 (one form of action rule); and *Roseleaf Corp. v. Chierighno*, 59 Cal. 2d 35 (1963).)

The antideficiency statutes were enacted during the Great Depression to prevent creditors from realizing double recoveries by buying in at deflated prices in private foreclosure sales and then holding debtors liable for large deficiencies; they also protected debtors from personal liability for large deficiency judgments after a creditor took their property through foreclosure proceedings. The California Supreme Court has observed that these statutory provisions indicate the Legislature's intent to "limit strictly the right to ... recover on the debt more than the value of the security." This public policy objective means that a principal debtor cannot be compelled to waive the statute's protection by private agreement.

## GUARANTORS AND DEFICIENCY JUDGMENTS

By contrast, the Legislature did not extend antideficiency protection to guarantors, and the courts have so held (*Talbott v. Hustwit*, 164 Cal. App. 4th 148, 151 (2008), citing *Mariners*

*Sav. & Loan Ass'n v. Neil*, 22 Cal. App. 3d 232, 234 (1971)). Moreover, guarantors are allowed to waive any and all antideficiency defenses (Civil Code § 2856(3)), and most form guaranties routinely include extensive antideficiency waivers so lenders can pursue guarantors for any deficiency judgments they cannot obtain against the borrower.

However, a guarantor may still be able to take advantage of the antideficiency rule if the guaranty in question is a sham. As explained below, the "sham guaranty" doctrine can be a potent weapon.

## EXONERATION

Many guarantors fear that the only thing that can save them from a deficiency judgment is filing personal bankruptcy. But a finding of a sham guaranty may exonerate the guarantor, or at least create a strong negotiating position. In the right circumstances, the doctrine can practically be a get-out-of-jail-free card.

A sham guaranty arises when the principal debtor and the guarantor share a "substantial identity." (*Torrey Pines Bank v. Hoffman*, 231 Cal. App. 3d 308, 320 (1991); and *Trust One Mortg. Corp. v. Invest America Mortg. Corp.*, 134 Cal. App. 4th 1302, 1312 (2005).) Under Civil Code section 2787, a guarantor is one who promises to answer for the debt, default, or miscarriage "of another." Thus, when a principal obligor (legalese for the "borrower") purports to take on additional liability as a guarantor, the principal does not in fact

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guarantee the debt “of another” and nothing is added to the primary obligation.

It is crucial to note that the signatories in a loan transaction do not need to be identical in order to establish the “sham.” The fact that the names on the promissory note and trust deed, on the one hand, are different from those on the guaranty agreement, on the other, does not remove the matter from section 2787 (*River Bank America v. Diller*, 38 Cal. App. 4th 1400, 1420 (1995)).

The public purpose behind the sham guaranty defense is to prevent lenders from circumventing the antideficiency prohibitions by pursuing a true principal as if it had the status of a guarantor. If the guarantor actually is the principal obligor, the guarantor is accorded the same unwaivable protection of the antideficiency statutes.

Courts have recognized sham guaranties in a variety of circumstances.

#### PARTNERSHIP LIABILITY

If a partnership is the principal borrower, guaranties signed by the partners are sham guaranties. In one case, real property was purchased in the name of a partnership. The promissory note and deed of trust were signed by each partner, who individually guaranteed the note. The partnership defaulted. Although the court did not use the phrase “sham guaranty,” it found that because the partners were already jointly and severally liable for debts of the partnership—including the note, trust deed, and guaranty—the guaranty did not change the nature of the transaction sufficiently to circumvent antideficiency protection. The guarantors thus received the unwaivable protection of section 580b (*Riddle v. Lushing*, 203 Cal. App. 2d 831 (1962)).

Because general partners of a limited partnership are also viewed as primary obligors, guaranties they sign are deemed shams and antideficiency waivers contained therein are not enforceable (*River Bank America*, 38 Cal. App. 4th at 1422).

#### TRUSTORS AND TRUSTEES

If a trust is the principal borrower, guaranties executed by certain trustors and trustees may be sham guaranties. In the *Torrey Pines Bank* case, a husband and wife who were the trustors, trustees, and primary beneficiaries of their revocable living trust signed personal guaranties in connection with a construction loan to the trust. The court noted that the trustees were personally liable on contracts entered into on behalf of their trust and determined that the structure of the trust made no significant distinction between the guarantors and the trust. Thus, the couple were deemed to be the primary obligors, and the guaranties were not enforceable against them (*Torrey Pines Bank*, 231 Cal. App. 3d at 318).

By contrast, in another instance the husband and wife were settlors of the trust but were secondary, not primary, beneficiaries. More important, they were not trustees, having instead used a limited liability company to limit their per-

sonal liability. This made the couple true guarantors. They were ineligible for antideficiency protection (*Talbot v. Hustwit*, 164 Cal. App. 4th 148, 151 (2008)).

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#### CORPORATE ISSUES

If the actual purchaser of a property uses a third party to take title and enter into the loan obligation, a guaranty executed by the actual purchaser may be a sham guaranty. In *Wilton-Maxfield Management Co. v. Coast Federal Savings & Loan Ass’n* (117 F.2d 913 (9th Cir. 1941)), a corporation purchased real property in California and directed the seller to convey the property to a third party, which then executed a promissory note in favor of the seller. The seller was aware that the corpora-

tion, as guarantor of the note, was the real purchaser and that the third party merely took title as a “dummy.” The corporation guaranteed the promissory note. Upon default, the seller foreclosed on the property and sought a deficiency judgment against the guarantor, but the court concluded that because the corporation was the “actual purchaser” of the property, section 580b precluded the seller’s claim.

If a corporation is the principal borrower, guaranties signed by its officers and shareholders may be sham guaranties. In a case involving a real estate development, two individuals entered into a contract to purchase land and develop a housing tract. Pursuant to the contract, the individuals formed a corporation which they owned and controlled to take title to the property and execute a note and trust deed to the seller. The contract of sale, signed by the individuals, contained both a promise to perform and a guaranty of the note. When the corporation

defaulted, the seller sought to enforce the guaranties against the two individuals, but the court ruled that because the individuals were the purchasers of the land, the corporate entity was a “mere shell” and the guaranty was not a debt “of another.” (*Valinda Builders, Inc. v. Bissner*, 230 Cal. App. 2d 106 (1964).)

Other cases support this analysis. For example, in *Yunker v. Manor* (255 Cal. App. 2d 431 (1967)), the guarantor intended to borrow funds individually. However, the lender solicited him to form a corporation and told him his signature as guarantor was merely for use as collateral. This raised the issue of whether he was “truly a guarantor,” precluding summary judgment in favor of the lender. Similarly, in *Union Bank v.*

*Brummell* (269 Cal. App. 2d 836 (1969)), the guarantors also intended to borrow funds individually but the bank advised or required them to form a corporation. The guarantors argued that the bank intended this device to avoid the anti-deficiency statutes, and the court held that they sufficiently raised the sham guaranty issue at trial.

Although the *Yunker* and *Union Bank* guarantors "intended" to sign and be individually liable on the loans, and although the *Valinda* guarantor actually signed and was in fact liable for the loan, the next court to address sham guaranties did not limit the sham guaranty defense to those circumstances.

### JOINT VENTURERS

In the *River Bank America* case cited above, a developer proposed a joint venture arrangement with the bank to buy out an apartment complex. Instead, the bank insisted that the developer create a new entity to borrow the needed money and that the developer, his wife, and their development company guarantee the loan. After completing the project, the borrower defaulted. The bank sued for judicial foreclosure, appointment of a receiver, and enforcement of the guaranties. A foreclosure sale left a \$13 million deficiency, which the bank sought from the guarantors.

The guarantors argued that the guaranties were unenforceable sham guaranties because the bank actually looked to the guarantors as the primary obligors, and had structured the loan to avoid the protections of the antideficiency legislation. In denying the bank's summary judgment motion, the court concluded that there were triable issues of material fact regarding the sham guaranty defense, reflecting three critical factors. First, the bank changed the structure of the transaction to a participating loan with accompanying guaranties. Second, the bank insisted that the developer create a new limited partnership to be the "borrower," and agreed to it being a shell corporation

controlled by the developer. Finally, the bank never inquired about the financial condition of the borrower entity, and instead relied on the extensive financial statements of the guarantors.

Had the developer been the general partner of the limited partnership borrower, and had the developer guaranteed the loan, the court concluded, such a guaranty would unquestionably have been a sham. In such circumstances, the developer/guarantor would have been treated as the primary obligor and would be entitled to the unwaivable protection of section 580d, which prohibits a deficiency judgment after a nonjudicial foreclosure. Instead, the general partner was a shell corporation without assets, which the court concluded was a distinction without a difference because the bank "subverted the purpose of the antideficiency laws by 'making a related entity the debtor while relegating the principal obligors to the position of guarantors.'" (38 Cal. App. 4th at 1423.)

While the courts in *River Bank* and *Union Bank* relied on certain evidence ordinarily used to prove "alter ego" liability, there was no finding of alter ego in either case. Thus, a guarantor's direct liability, intended direct liability, or even alter ego liability is not required to prove a sham guaranty in the corporate context. To this degree, *River Bank* expands sham guaranty theory beyond the other cited cases.

### SHAREHOLDERS AND ALTER EGO

Can a shareholder avoid a guaranty merely by piercing his own corporate veil to prove he is the alter ego of the corporate principal? Given that direct liability supports a sham guaranty finding (as in the partner, trustor, and *Valinda* cases), and given that alter ego theory shifts liability to shareholders, the answer may be yes—but the courts have yet to give adequate direction on that question.

Notably, in both the *River Bank* and *Union Bank* cases, the courts were influenced by evidence of the lenders' "intent

to subvert" antideficiency protection. No such intent was considered in the partner and trustor cases, or even in *Valinda*, because as a matter of law those guarantors remained liable as principals. Thus, evidence of a lender's intent to subvert may become significant when officer or shareholder guarantors are not directly liable in the corporate context.

### A POTENT DEFENSE

Whether a person is a true guarantor or really the principal obligor is a factual issue. In the *Yunker* case, the court of appeal reversed a summary judgment in favor of the lender and held that the real issue was whether the person who signed the guaranty truly was a guarantor. In *River Bank*, the court denied the lender's motion for summary adjudication because of questions about whether the transaction was structured to avoid the antideficiency statutes, particularly since the principal obligor was an undercapitalized corporation, entirely owned by the guarantors, whose financial wherewithal the lender never investigated.

Keep in mind that the sham guaranty doctrine can be invoked well short of trial or a summary judgment motion: It can be asserted in opposition to an application for writ of attachment to counter the lender's required showing of the probable validity of its underlying claim.

From the guarantor's perspective, the sham guaranty defense may be one of only a few strategic theories available to thwart a lender's collection action. The key to the successful application of this defense is developing factual support for a sham guaranty before any lawsuit is pending. Such support may persuade a lender to reassess the risks of proceeding to a trial before jurors who may be more sympathetic to individuals than to lenders. If invoked early on, a strong sham guaranty argument may enable a guarantor's counsel to broker a favorable settlement with no litigation at all. ☐

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## The 'Sham Guaranty' Defense

- 1 California Code of Civil Procedure sections 580a, 580b, and 580d provide antideficiency protection to both the primary borrower as well as the guarantor of a real estate loan.  
 True  False
- 2 The primary borrower can waive California's statutory antideficiency protection code.  
 True  False
- 3 Guarantors may waive any and all antideficiency protection.<sup>4</sup>  
 True  False
- 4 Lenders often carefully draft their guaranties to expressly waive or otherwise exclude antideficiency defenses.  
 True  False
- 5 The sham guaranty defense can be defeated by a carefully drafted guaranty that expressly waives such defenses.  
 True  False
- 6 The sham guaranty defense is grounded on the theory that a principal borrower cannot promise, as a guarantor, to answer for his, her, or its own debt.  
 True  False
- 7 To be eligible for the sham guaranty defense, the signatories to the loan transaction and the guaranty must be identical.  
 True  False
- 8 An individual partner who guarantees the debt of his or her general partnership remains eligible for antideficiency protection.  
 True  False
- 9 A limited partner who guarantees the partnership's debt remains eligible for antideficiency protection.  
 True  False
- 10 A trustor, trustee, and primary beneficiary of a revocable living trust who guarantees its debt remains eligible for antideficiency protection.  
 True  False
- 11 Settlers of a trust who are secondary beneficiaries, and who also appoint a limited liability company as trustee, remain eligible for antideficiency protection in California.  
 True  False
- 12 Use of a "straw man" may allow a guarantor to remain eligible for anti-deficiency protection under the sham guaranty defense.  
 True  False
- 13 Lenders who advise or require borrowers to form a corporation and then guarantee its debt may be subject to the sham guaranty defense.  
 True  False
- 14 Evidence that a lender did not ask for or rely on financial statements from guarantors supports a sham guaranty defense.  
 True  False
- 15 Evidence that the principal entity is overcapitalized supports the sham guaranty defense.  
 True  False
- 16 Courts have definitively ruled that a guarantor may rely on "alter ego" doctrine to prove a sham guaranty defense.  
 True  False
- 17 Whether a guarantor can prove that a guaranty is a sham depends on the facts of the case.  
 True  False
- 18 A sham guaranty defense may prove useful in avoiding summary judgment.  
 True  False
- 19 A sham guaranty defense cannot be asserted in opposition to an application for writ of attachment.  
 True  False
- 20 Aside from the sham guaranty defense, guarantors enjoy little, if any, legal recourse should the original borrower fail to pay.  
 True  False

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