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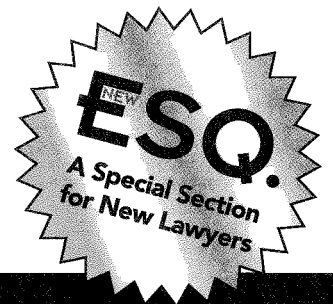
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The Sham Loan Guaranty Defense

Little-Known Ways to Protect Partners, Trustees, Corporate Officers, and Shareholders

By Robert M. Heller



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The sham guaranty defense is a tool by which commercial real estate loan guarantors can avoid liability when the loan is in default. Application of that defense requires proving that the guarantor is actually the principal obligor, and thus entitled to the same unwaivable protection of the anti-deficiency statutes.

However, just as there are different types of guarantors, the courts have made distinctions in the application of the sham guaranty defense. One of the most important is the defense's application to partners, trustees/trustors and officers and shareholders of corporations.

I. PARTNERS

If a partnership is the principal borrower, guaranties signed by the partners are sham guaranties. In *Riddle v. Lushing*¹, real property was purchased in the name of a partnership. The promissory note and deed of trust were signed by each partner. The partners individually guarantied the note. The partnership defaulted.

Although the court did not use the phrase "sham guaranty," the court focused on whether the transaction created different liabilities for the partners as guarantors. The court observed that, by law, partners were already jointly and severally liable for debts of the partnership. After remarking that the note, trust deed and guaranty were all part of one transaction, the court concluded that the guaranty "did not change the nature of the transaction"² in the manner necessary to circumvent anti-deficiency protection. The court thus permitted the "guarantors" to invoke the unwaivable protection of section 580b and entered judgment against the lender.

The court found that the guarantor-partners were "nothing more than a principal obligor under another name," and were thus entitled to the protection of section 580d.

The court reached a similar conclusion in *Union Bank v. Dorn*³. There, a note was executed by a partnership and guaranteed by the individual partners. The court found that the guarantor-partners were “nothing more than a principal obligor under another name,” and were thus entitled to the protection of section 580d. General partners of a limited partnership are also viewed as primary obligors. Thus, guaranties signed by general partners of limited partnerships are deemed shams, and anti-deficiency waivers contained therein are not enforceable⁴.

II. TRUSTORS AND TRUSTEES

If a trust is the principal borrower, guaranties executed by certain trustors and trustees may be sham guaranties.

In *Torrey Pines Bank v. Hoffman*⁵, a husband and wife, who were the trustors, trustees and the primary beneficiaries of their revocable living trust, signed personal guaranties in connection with a construction loan to the trust. The court applied the “instrumentality” test, defined as whether the trust was “anything other than an instrumentality used by the individuals who guarantied the debtor’s obligation, and whether such instrumentality actually removed the individuals from their status and obligations as debtors.”⁶

Specifically, the court noted that the trustees were personally liable on contracts entered into on behalf of their trusts. The court further determined that the structure of the trust made no significant distinction between the guarantors and the trust. Thus, the husband and wife were characterized as the primary obligors, and could not guaranty their own debt. As a result, the trust was deemed a “mere instrumentality.” Accordingly, the guaranties were not enforceable against them.

The *Torrey Pines* court did, however, recognize that some living trusts could create a greater degree of separation among trustors, trustees and beneficiaries, so as to fall outside of sham guaranty protection. Those facts subsequently arose in *Talbott v. Hustwit*,⁷ where the husband and wife were settlors of the Trust, but were secondary, not primary, beneficiaries. More importantly, they were not trustees. Instead, they used a limited liability company as trustee, thus limiting their personal liability for the Trust’s obligations.

The husband and wife became true guarantors because the trust arrangement “actually removed the[m] from their status and obligations as debtors.”⁸ Accordingly, the court held that they were ineligible for the anti-deficiency protection of section 580a.



III. CORPORATE OFFICERS AND SHAREHOLDERS

If a corporation is the principal borrower, guaranties signed by its officers and shareholders may be sham guaranties. In *Valinda Builders v. Bissner*,⁹ two individuals entered into a contract to purchase land and develop a housing tract. Pursuant to the contract, the individuals formed a corporation, owned and controlled by themselves, to take title to the property. The corporation executed 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. The corporation defaulted and the seller sought to enforce the guaranties against the two individuals.

The court ruled that notwithstanding the creation of the separate corporate entity as the principal debtor, the two individuals were the purchasers of the land and had liability; the entity was “merely an instrumentality through which the two individuals operated.”¹⁰ The court concluded that the corporation was a “mere shell” and the guaranty was not a debt “of another,”¹¹ so section 580b required the lender to look to the land for payment.¹²

In *Younker v. Manor*,¹³ 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 and the note would remain one for purchase money. 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*¹⁴, 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 the guarantors effectively raised the sham guaranty issue at trial.¹⁵

Although the *Younker* 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 on the loan, the next court to address sham guaranties did not limit the sham guaranty defense to those circumstances.

In *River Bank America v. Diller*,¹⁶ a developer sought a construction loan to build an apartment complex. The builder proposed a joint venture arrangement with the bank. Instead, the bank insisted that the developer create a new entity to borrow the construction funds and that the developer, his wife, and their development company guaranty the loan.

When the borrower defaulted after project completion, the bank sued for judicial foreclosure, appointment of receiver and enforcement of the guaranties. The bank thereafter completed a non-judicial foreclosure sale, leaving a \$13 million deficiency that the bank sought from the guarantors.

In opposition to River Bank's motion for summary adjudication, the guarantors argued that the guaranties were unenforceable "sham guaranties" because the bank actually looked to the guarantors as the primary obligors, and structured the loan to avoid the protections of the anti-deficiency legislation. In denying the bank's motion, the court concluded that there were triable issues of material fact regarding the "sham guaranty" defense.

The *River Bank* court's analysis is instructive, as it relied on three critical factors:

- The bank changed the structure of the transaction. Originally, the developer intended to acquire the real estate using his own existing limited partnership, of which his development company would be the general partner. The bank restructured the deal to a participating loan with accompanying guaranties.
- The bank insisted that to render the guaranties enforceable, the developer should create a new entity, a limited partnership, to be the "borrower," and that the general partner should be other than the developer's development company. In this case, the bank agreed to it being a shell corporation controlled by the developer.
- The bank never inquired about the financial condition of the borrower entity. Instead, it relied on the extensive financial statements of the guarantors.

IV. CONCLUSION

The *River Bank* court concluded that there would be no question that such a guaranty would have been a sham, had the developer been the general partner of the borrower limited partnership, and had the developer guarantied the loan. In such circumstance, the developer/guarantor would have been treated as the primary obligor and would be entitled to the unwaivable protection of C.C.P. §580d, which prohibits a deficiency judgment after a non-judicial foreclosure.

Instead, the general partner was a shell corporation, i.e., without assets, and the court concluded that that was a distinction without a difference. Based on the evidence, the *River Bank* court concluded that 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'."¹⁷

ENDNOTES

- 1 *Riddle v. Lushing*, 203 Cal.App.2d 831 (1962).
- 2 *Riddle*, 203 Cal.App.2d at 836.

- 3 *Union Bank v. Dorn*, 254 Cal.App.2d 157 (1967).
- 4 *River Bank America v. Diller*, 38 Cal.App.4th 1400, 1422 (1995).
- 5 *Torrey Pines Bank v. Hoffman*, 231 Cal.App.3d 308, 321 (1991).
- 6 *Torrey Pines*, 231 Cal.App.3d at 320.
- 7 *Talbott v. Hustwit*, 164 Cal.App.4th 148 (2008).
- 8 *Talbott*, 164 Cal.App.4th at 153.
- 9 *Valinda Builders, Inc. v. Bissner*, 230 Cal.App.2d 106 (1964).
- 10 *Valinda*, 230 Cal.App.2d at 110.
- 11 *Valinda*, 230 Cal.App.2d at 110.
- 12 *Valinda*, 230 Cal.App.2d at 110. The court further held that the defendants' purported waivers of anti-deficiency protection were unenforceable as against public policy.
- 13 *Younker v. Manor*, 255 Cal.App.2d 431 (1967).
- 14 *Union Bank v. Brummell*, 269 Cal.App.2d 836 (1969).
- 15 *Union Bank*, 269 Cal.App.2d at 836. The court ultimately entered judgment against the lender based on the Gradsky defense, perhaps relegating the sham guaranty portion of the opinion to dicta.
- 16 *River Bank*, 38 Cal.App.4th 1400 (1995).
- 17 *River Bank*, 38 Cal.App.4th 1400 at 1423.

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