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By Karl E. Geier

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ARTICLE:
HERE WE GO AGAIN: THE VICISSITUDES OF PUBLIC POLICY AND GUARANTOR LIABILITY FOR CALIFORNIA REAL ESTATE LOANS

By Karl E. Geier[*]

Many real estate practitioners in California remember a time when a personal guaranty of a real estate secured loan was of dubious value to the lender. The famous case of *Union Bank v. Gradsky*[1] and a number of other decisions suggested that enforcing a guaranty, particularly after a nonjudicial sale of the real property securing the principal debt, could be extraordinarily difficult because of the need for explicit, specific waivers of defenses raised by impairment of subrogation and reimbursement rights of the grantor due to the operation of the antideficiency laws. The potential for successful defenses to liability often caused lenders to forego enforcement actions against guarantors. It also had the effect of causing the principals of real estate borrowers to underestimate the risks of executing such a guaranty. The most egregious example of the apparent antipathy of California courts towards enforcement of guaranties was *Cathay Bank v. Lee,*[2] where the court found insufficiently clear some standard provisions in guaranties that purported to waive defenses based on guarantor rights of subrogation and reimbursement. *Cathay Bank* applied an exceedingly narrow—some would say artificial and strained—reading of the waiver language, suggesting a judicial attitude opposed to any enforcement of surety waivers against guarantors of real property secured debt.

The *Cathay Bank* decision led, in the early 1990s, to enactment of Civil Code § 2856, a broadly worded statute that, on its face, purports to make enforceable all guarantor waivers of defenses, regardless of the language contained in the waiver and regardless of the source of the defense, including but not limited to defenses that arise under the surety statutes set forth in the Civil Code (Civil Code § 2787-2855), or the one-action and antideficiency laws of the State of California (Code of Civil Procedure §§ 580a, 580b, 580d, and 726).[3]

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Since the enactment of § 2856, the more prevalent—and well warranted—assumption has been that guaranty waivers will be enforced and that a guarantor can have real liability both before and after a nonjudicial sale of the property securing the principal obligation. Reported appellate decisions arising out of the most recent real estate recession have supported this as a general rule, but one case in particular suggests that this topic will not go away, despite the legislative efforts.

For a while, it seemed that, finally, the ongoing tug of war between proponents of contract liability under guaranties and the general waivability of "surety defenses" by true guarantors, coupled with the Legislature's affirmative statement of policy favoring such waivers as embodied in Civil Code § 2856, would equalize the policy of the antideficiency and one-action rules with the competing policy that enforces contractual obligations freely entered into between competent parties, including guarantors. In a series of decisions between 2010 and 2013, the courts seemingly had no difficulty in holding the parties to the terms of their contracts without resort to the policy implications of the antideficiency laws or the remnants of *Union Bank v. Gradsky* and *Cathay Bank v. Lee*. Thus, in *Gray1 CPB, LLC v. Kolokotronis*,[4] the Third District Court of Appeal rejected a creative but ultimately fantastical argument that a typical long-form commercial guaranty executed by a real estate developer to guaranty payment of a construction or development loan was really a "promissory note" governed by the antideficiency laws rather than a "guaranty," which was all it claimed to be. Similarly, in *Series AGI Westlynn of Appian Group Investors DE, LLC v. Eves*[5], a sophisticated individual guarantor who negotiated a carveout from recourse liability under a similar guaranty to protect his second home (a lakeside residence on Lake Como, in Northern Italy), was held not to have sufficiently protected the *proceeds of sale* of that residence from recourse by the creditor, due to a failure on his part to negotiate for the express exclusion of proceeds, and not solely the real estate. By the same token, a lender who insisted on receiving a "non-recourse carveout" guaranty to cover the eventuality that a whole-building commercial office lease might terminate, leaving the property security valueless or insufficient to cover the debt, was unable to persuade a court that the guarantor's

liability was triggered when the tenant vacated the property and ceased to pay rent, but the borrower/landlord failed to take affirmative steps to "terminate" the lease because of the breach. In that case, *GECCMC 2005-C1 Plummer Street Office L.P. v. NRFCNNN Holdings, LLC*,[6] the court construed the carveout from the written guaranty strictly in accordance with the language of the guaranty, as a matter of law, rejecting the lender's claim that such a construction was inconsistent with the parties' intentions and holding that if the parties had intended to include a "vacates and fails to pay rent" clause, they were more than capable of doing so and such a clause would not be inferred from use of the distinct term of art, "termination of the lease."[7]

To be sure, none of these cases directly raised the question of surety waivers or the relationship between the guarantor's obligations and the implications of the one-action and antideficiency laws with respect to a guarantor's liability or potential defenses to liability under a guaranty. But these cases were indicative of a general willingness on the part of the courts to leave the parties to make their own bargains on these issues and not to introduce judicial notions of fairness or public policy into the interpretation and enforcement of guaranties. Moreover, another decision in 2011, *Gramercy Investment Trust v. Lakemont Homes, Nevada, Inc.*,[8] made it abundantly clear that under Civil Code § 2856, a guarantor's waiver of the antideficiency and one-action statutes was fully enforceable against the guarantor regardless of the earlier case law restrictions against such waivers.

The adoption of Civil Code § 2856, removing the obstacles to effective waivers of most surety defenses, thus had left guarantors who sought to resist liability with little to argue other than the "sham guaranty" defense. The "sham guaranty" defense emerged from a long line of cases supporting it in various contexts, dating back to the depression of the 1930s when the antideficiency laws were first enacted. At that time, because the enactment of Code of Civil Procedure § 580b barred a deficiency on both a seller carry-back debt and a third party loan, a number of clever real estate professionals attempted to structure transactions in which a shill or nominee would take title for the "true buyer" and execute a purchase money note,

and then the "true buyer" would execute a personal guaranty of the debt owed to the third party lender or seller. Due to the express nonwaivability of the antideficiency laws by a purchaser or borrower, the courts easily reached the conclusion that these "structured" transactions were an improper effort to circumvent the antideficiency laws and refused to enforce the purported "guaranty" by the party who ultimately was acquiring the property.[9]

Over time, a number of other "alter ego" or "sham guaranty" defenses were recognized, including efforts by a general partner of a partnership or trustee of an inter vivos trust to guaranty the debt of a partnership or trust (where that person already had liability for a partnership or trust debt as a general partner or grantor/trustee, and therefore could not execute a guaranty of his or her own debt).[10] Also, while it was clear that a shareholder of a bona fide pre-existing corporation could validly guaranty a corporate debt,[11] courts were surprisingly receptive to self-serving claims by the "guarantor" that he or she was, in fact, the true purchaser or borrower of a loan made to the corporation, that the guaranty was a sham, and that the corporation was no more than a subterfuge or alter ego designed to get around the antideficiency and one-action rules in order to reach the assets of the "guarantor." In such cases, the courts allowed the "guarantor" to avoid liability based on the claim that, as true borrower, he or she could not waive antideficiency or one-action defenses.[12]

The "sham guaranty" and "alter ego" arguments reached their zenith in the case of *River Bank America v. Diller*,[13] where the court of appeal held that whether a particular legal entity structure was designed by the parties as a subterfuge method of getting around the antideficiency and one form of action protections or reflected a true guarantor relationship was a question of fact that had to be determined in light of the circumstances. In other words, the purported guarantor was free to argue after the fact that the creditor induced him or her to structure the debt differently than they originally intended. In *River Bank* the argument was essentially that a tiered set of companies had been formed at the request of the lender in order to enable the lender to obtain recourse to an individual, the "true borrower" that it

could not otherwise have obtained if the "principal debtor," i.e., the purported guarantor, had been the direct borrower. The individual guarantor successfully claimed that there was a "question of fact" whether the lender had orchestrated the entity formation and loan structure in such a fashion as to provide recourse that otherwise would not have been available to it.

As demonstrated by the decision in *River Bank*, due to the enactment of Civil Code § 2856, the alter ego or sham guaranty defenses offered the most promising argument to avoid liability after a nonjudicial sale and the interposition of Code of Civil Procedure § 580d defenses to liability on the note. Basically, the argument was, if the guaranty was a sham or a nullity, the "guarantor's" waiver of defenses also were unenforceable and contrary to the public policy protecting the true debtor from liability after a nonjudicial sale.[14]

In the late 1990s and early 2000s the use of limited liability companies as the preferred mechanism for holding real property (rather than the limited partnership or other tiered entity structure that formally had been used), allowed for the creation of entities with limited liability protection for members but with the organizational flexibility (including lack of formalities) and pass-through tax status of a partnership. Even though the limited liability company statute clearly implied that a member could guaranty debt of a limited liability company,[15] the argument for alter ego defenses was begging to be made by individual guarantors or limited liability company debt, in particular based on the *River Bank* argument that the lender induced use of the limited liability company form.

The aspirations of limited liability company member guarantors for protection from the courts in this manner was drawn up short by the decision in *California Bank & Trust v. Lawlor,*[16] where the court found no triable issue of fact in upholding summary judgment against individual guarantors who argued that their preexisting legal entities (a limited liability company and a limited partnership) were merely their "alter egos," where there was no evidence either that the lender required formation of the entities or that the individuals had ever been the loan applicants or the intended primary obligors. The *Lawlor* court had no difficulty in finding the guarantees effective and observed

that there is a trade-off when individuals elect to do business or hold property in a limited liability entity; one of the inherent risks they assume in exchange for the privilege of limited liability is that they then may have personal recourse liability as guarantors of the entity's obligations.[17]

Lawlor was followed by an even stronger decision against self-serving "sham guaranty" defenses based on *River Bank*. In *CADC/RACD Venture 2011-1 LLC v. Bradley*,[18] several individual real estate investors had formed a series of limited liability companies to facilitate real estate investment and development activities, some of which had substantial operating histories. The individuals, in the course of structuring a tax deferred exchange for some of the properties, had initially proposed to borrow funds through a corporation with a substantial operating history and filed applications for a loan that were approved subject to the individuals guarantying the debt. At some point, the individuals received "tax advice" that caused them to place the properties in a newly formed single purpose limited liability company (wholly owned by the corporation). The LLC, rather than the corporation, then executed the loan documents as borrower, with the individuals executing the guaranties.

These individuals later claimed that they had been induced to create a new entity by the lender, that the lender had participated in "structuring" the debt and the guaranty to obtain recourse to their personal assets, and that the limited liability company was their "alter ego."

In a decision that painstakingly reviewed the transactional history, the court of appeal concluded, to the contrary, that these individuals had formed the limited liability companies of their own volition, in order to take advantage of the limited liability company protections and tax advantages of doing business in the entity format. The court rejected claims that the lender had orchestrated this or that loose language by the lender suggesting that the real borrower was the individuals was somehow a defense to their guaranty. As in *Lawlor*, the *CADC/RADC Venture* court specifically noted that when a person does business in the form of a corporate or limited liability company, one of the tradeoffs for that privilege is the potential for liability on a

personal recourse basis as guarantor. The court refused to go down the "sham guaranty" or "alter ego" path without some substantial evidence that the lender had a significant role in the decision to form and capitalize the entity in order to camouflage the original individual loan applicants' status as true borrowers in order to secure their personal guaranties.[19]

Although the *Lawlor* and *CADC/RADC Venture* decisions appear to embody a useful antidote to the *River Bank* precedent, they do not directly disavow that decision. Moreover, neither of these decisions involved a second aspect of the *River Bank* decision, involving the potential nonwaivability of certain types of surety defenses despite the enactment of Civil Code § 2856.

In *River Bank*, the court of appeal concluded that Civil Code § 2809, providing that the obligation of a surety can be neither larger in amount nor in other respects more burdensome than that of a principal, could validly be waived by the guarantor, if the guarantor was a true guarantor (hence the significance of the "alter ego" or "sham guaranty" findings of that case). However, although *River Bank*, which based its decision in part on the enactment of Civil Code § 2056, appears to support the general enforceability of a waiver,[20] and Civil Code § 2856 plainly allows for the waiver of the § 2809 defense, another recent decision has once again raised the implication that, to some extent, certain "bad acts" by a lender can lead to unenforceability of surety defense waivers and give rise to defenses on the part of the guarantor.

The new decision is *California Bank & Trust v. DelPonti*.[21] In that case, a construction loan was guaranteed by Thomas DelPonti and David Wood, who were principals of the borrower entity, Five Corners Realto, LLC. The construction project went well for 18 months, but the lender, Vineyard Bank, suddenly stopped processing disbursements or funding the loan based on various claimed defaults and breaches that were ultimately found not to be in good faith on the part of the lender. There is some indication the real reason for lender's failure to fund the construction loan draws was the bank's own impending failure as a result of the economic downturn. At some point, the borrower group took over funding and paid the contractors out of pocket

in order to be able to complete the project and sell the homes at auction, but the bank eventually reneged on an agreement to fund publicity for the auction, which was then cancelled. After the bank foreclosed, the bank sued Five Corners and the guarantors for the deficiency, and the contractor (Advent, Inc.) sued the bank as well as Five Corners for restitution, breach of contract, and promissory estoppel. Shortly after the lawsuit was filed, the bank was placed under receivership and California Bank & Trust, the successor holder of the debt (acquired from the receiver), substituted in as plaintiff and continued the guaranty collection litigation.

Ultimately, the cases were consolidated and the trial court found in Advent's favor on the contract claims, and found for the guarantors against the bank, denying the bank's recovery on the guaranty on the basis that the bank had breached the loan contract and had done so in "bad faith," and the guarantors could not be liable for nonpayment caused by the bank's own misconduct.

On appeal, the court of appeal upheld the decision denying liability on the part of the guarantors. Rejecting the claim that the guarantors had waived all defenses under the guaranty agreement based on Civil Code § 2856, the court of appeal held, to the contrary, that a guarantor cannot be held liable where a contractual waiver is unlawful or contravenes public policy.[22] The court was unwilling to allow the bank to enforce a predefault waiver that would allow the bank to profit from its own misconduct, and suggested that it would be contrary to public policy for a bank to require a waiver of its own misconduct as part of a guaranty. Among other things, the court suggested that the covenant of good faith and fair dealing precluded such a requirement.[23] The court accordingly held that "a rule of strict construction" would be applied to guarantors' contractual waivers; and further held that it would be a violation of public policy to enforce the guarantors' predefault waivers of "equitable defenses" where the bank willfully breached the loan agreement, causing the default.[24] As stated by the court, "we do not read Civil Code section 2856 to permit a lender to enforce pre-default waivers beyond those specified, where to do so would result in the lender's unjust enjoinment, and allow the lender to profit from its own fraudulent conduct."[25] Here,

the guaranty expressly provided, "Except as *prohibited by applicable laws*, Guarantor waives . . . ." (emphasis added). This was enough for the court to conclude the waiver could not extend to equitable defenses or defenses that violated "public policy" arising out of the lender's own misconduct or fraud.[26]

The facts of the *DelPonti* decision were compelling in favor of the guarantors, and the outcome of the decision is not surprising for that reason. However, the decision invites the expansion of arguments for guarantors to be relieved of liability based on alleged lender misconduct and suggests a new "public policy" argument for nonenforcement of waivers, the limits of which have yet to been seen. This was already foreshadowed by a 2007 decision, *WRI Opportunity Loans II LLC v. Cooper*,[27] where the court refused on public policy grounds to apply a Civil Code § 2856 waiver to make enforceable a waiver of Civil Code §§ 2809, 2810 as applied to usury defenses. But, *DelPonti* goes further in suggesting a revival of the "strict construction" limitations of guaranty waivers that harkens back to pre-Civil Code § 2856 cases such as *Cathay Bank v. Lee*[28]. Even though, for example, § 2856 would appear to constitute a legislative expression of policy that all defenses are fully waivable by true guarantors, the argument that in egregious circumstances such a waiver may contravene public policy if it relieves the lender from its own "wrong" is a new "grey area" that will require further litigation to resolve, as is the notion of "strict construction" of a contractual waiver. Another equally plausible outcome would have been to give the creditor an absolute right to recover its loan from the guarantor while presumably leaving the parties to their damages claims for lender misconduct, but this possibility was not explored in *DelPonti* (most likely because the party at fault, Vineyard Bank, was not a party to the action and in any case would have been judgment-proof). As a result, while the *Lawlor* and *CADC/RADC Venture* decisions would seem to have put the genie released by *River Bank* back in the bottle, *DelPonti* may have loosened the stopper just enough for the genie to leak out in yet another round of guarantor liability litigation in the coming years.

ENDNOTES:

[1]*Union Bank v. Gradsky*, 265 Cal. App. 2d 40, 48, 71 Cal. Rptr. 64

(2d Dist. 1968).

[2]*Cathay Bank v. Lee*, 14 Cal. App. 4th 1533, 1539-1542, 18 Cal. Rptr. 2d 420 (4th Dist. 1993). See also *Indusco Management Corp. v. Robertson*, 40 Cal. App. 3d 456, 463-464, 114 Cal. Rptr. 47 (2d Dist. 1974).

[3]Civ. Code § 2856. See *WRI Opportunity Loans II LLC v. Cooper*, 154 Cal. App. 4th 525, 544-545, 65 Cal. Rptr. 3d 205 (2d Dist. 2007), discussing the legislative history and amendments of § 2856.

[4]*Gray1 CPB, LLC v. Kolokotronis*, 202 Cal. App. 4th 480, 486-487, 135 Cal. Rptr. 3d 448 (3d Dist. 2011).

[5]*Series AGI West Linn of Appian Group Investors DE LLC v. Eves*, 217 Cal. App. 4th 156, 168, 158 Cal. Rptr. 3d 193 (1st Dist. 2013).

[6]*GECCMC 2005-C1 Plummer Street Office Ltd. Partnership v. NRFC NNN Holdings, LLC*, 204 Cal. App. 4th 998, 1000, 140 Cal. Rptr. 3d 251 (2d Dist. 2012).

[7]*GECCMC 2005-C1 Plummer Street Office Ltd. Partnership v. NRFC NNN Holdings, LLC*, 204 Cal. App. 4th 998, 1000, 140 Cal. Rptr. 3d 251 (2d Dist. 2012).

[8]*Gramercy Inv. Trust v. Lakemont Homes Nevada, Inc.*, 198 Cal. App. 4th 903, 910-911, 130 Cal. Rptr. 3d 496 (4th Dist. 2011).

[9]*E.g., In re Wilton-Maxfield Management Co.*, 117 F.2d 913 (C.C.A. 9th Cir. 1941). See *Younker v. Manor*, 255 Cal. App. 2d 431, 438, 63 Cal. Rptr. 197 (1st Dist. 1967).

[10]*Union Bank v. Dorn*, 254 Cal. App. 2d 157, 158, 61 Cal. Rptr. 893 (2d Dist. 1967); *Riddle v. Lushing*, 203 Cal. App. 2d 831, 837, 21 Cal. Rptr. 902 (2d Dist. 1962). See also *Union Bank v. Brummell*, 269 Cal. App. 2d 836, 838, 75 Cal. Rptr. 234 (4th Dist. 1969); *Torrey Pines Bank v. Hoffman*, 231 Cal. App. 3d 308, 319, 282 Cal. Rptr. 354 (4th Dist. 1991) (inter vivos trust); *Westinghouse Credit Corp. v. Barton* (C.D.Cal. 1992) 789 F.Supp. 1042.

[11]*Glendale Fed. Sav. & Loan Assn. v. Marina View Heights Dev. Co.*, 66 Cal. App. 3d 101, 154-155, 135 Cal. Rptr. 802 (4th Dist. 1977); *Paradise Land and Cattle Co. v. McWilliams Enterprises, Inc.*, 959 F.2d 1463 (9th Cir. 1992) (corporation had substantial operating history and was not an alter ego).

[12]See, e.g., *Valinda Builders, Inc. v. Bissner*, 230 Cal. App. 2d 106, 110, 40 Cal. Rptr. 735 (2d Dist. 1964); *Roberts v. Graves*, 269 Cal. App. 2d 410, 417-418, 75 Cal. Rptr. 130 (1st Dist. 1969); *Kincaid v. Gomez*, 274 Cal. App. 2d 839, 79 Cal. Rptr. 539 (1st Dist. 1969).

[13]*River Bank America v. Diller*, 38 Cal. App. 4th 1400, 1420-1424, 45 Cal. Rptr. 2d 790 (1st Dist. 1995).

[14]*River Bank America v. Diller*, 38 Cal. App. 4th 1400, 1420-1424, 45 Cal. Rptr. 2d 790 (1st Dist. 1995).

[15]Corporations Code § 17703.04, subd. (c) (see former Corporations Code § 17701, subd. (c)).

[16]*California Bank & Trust v. Lawlor*, 222 Cal. App. 4th 625, 638-640, 166 Cal. Rptr. 3d 38 (4th Dist. 2013), as modified, (Dec. 20, 2013).

[17]*California Bank & Trust v. Lawlor*, 222 Cal. App. 4th 625, 638-640, 166 Cal. Rptr. 3d 38 (4th Dist. 2013), as modified, (Dec. 20, 2013).

[18]*CADC/RAD Venture 2011-1 LLC v. Bradley*, 235 Cal. App. 4th 775, 788-792, 185 Cal. Rptr. 3d 684 (1st Dist. 2015).

[19]*CADC/RAD Venture 2011-1 LLC v. Bradley*, 235 Cal. App. 4th 775, 788-792, 185 Cal. Rptr. 3d 684 (1st Dist. 2015).

[20]*River Bank America v. Diller*, 38 Cal. App. 4th 1400, 1420-1424, 45 Cal. Rptr. 2d 790 (1st Dist. 1995).

[21]*California Bank & Trust v. DelPonti*, 232 Cal. App. 4th 162, 181 Cal. Rptr. 3d 216 (4th Dist. 2014).

[22]*California Bank & Trust v. DelPonti*, 232 Cal. App. 4th 162, 167-168, 181 Cal. Rptr. 3d 216 (4th Dist. 2014).

[23]See *Sumitomo Bank of Cal. v. Iwasaki*, 70 Cal. 2d 81, 85, 73 Cal. Rptr. 564, 447 P.2d 956 (1968).

[24]*California Bank & Trust v. DelPonti*, 232 Cal. App. 4th 162, 167-168, 181 Cal. Rptr. 3d 216 (4th Dist. 2014).

[25]*California Bank & Trust v. DelPonti*, 232 Cal. App. 4th 162, 181 Cal. Rptr. 3d 216 (4th Dist. 2014).

[26]*California Bank & Trust v. DelPonti*, 232 Cal. App. 4th 162, 167, 181 Cal. Rptr. 3d 216 (4th Dist. 2014).

[27]*WRI Opportunity Loans II LLC v. Cooper*, 154 Cal. App. 4th 525, 544-545, 65 Cal. Rptr. 3d 205 (2d Dist. 2007).

[28]*Cathay Bank v. Lee*, 14 Cal. App. 4th 1533, 1539-1542, 18 Cal. Rptr. 2d 420 (4th Dist. 1993). See also *Indusco Management Corp. v. Robertson*, 40 Cal. App. 3d 456, 463-464, 114 Cal. Rptr. 47 (2d Dist. 1974).

