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Exploring the "Sham Guaranty" Defense to Eliminate Liability Under a Guaranty

By Robert M. Heller



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Lenders commonly require principals of a company to personally guarantee a real estate loan. While the business may be protected by California's antideficiency statute, guarantors are not. Lenders also carefully draft guaranties to expressly waive or otherwise exclude antideficiency defenses. In many cases, the only defense a guarantor may have to secure the protections of the California antideficiency statute is the "sham guaranty" defense.

I. CALIFORNIA'S ANTIDEFICIENCY STATUTE DOES NOT APPLY TO GUARANTORS

Code of Civil Procedure § 580d provides in relevant part: "No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property ... in any case in which the real property ... has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust." This protection against deficiency judgments cannot be waived. (*See River Bank America v. Diller* (1995) 38 Cal. App.4th 1400, 1420.)

However, § 580d applies only to primary obligors. Guarantors, on the other hand, are not statutorily protected against deficiency judgments after non-judicial foreclosures. (*Hodges v. Mark* (1996) 49 Cal.App.4th 651, 656-657.)

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II. ABSENT ANTIDEFICIENCY PROTECTIONS, LENDERS CREATE WINDFALLS FOR THEMSELVES

In one recent case, the lender conducted a non-judicial foreclosure sale of real property and was the sole bidder. The amount of the indebtedness owed on the subject loan was approximately \$3,000,000. The fair market value of the property was approximately \$2,400,000. The lender purchased the property with an arbitrary and unchallenged bid of \$1,500,000, i.e., \$900,000 less than the property's fair market value.

The borrower would be protected in this circumstance by the antideficiency statute. However, because a guarantor is not protected by the antideficiency statute, the lender may proceed against the guarantor in the amount of the lender's unilateral foreclosure bid and the indebtedness owed (\$1,500,000). If the lender owns real property valued at \$2,400,000, and further obtains judgment in the amount of \$1,500,000 against the guarantor, the lender will enjoy a very significant \$900,000 windfall.

The circumstance above presents a classic example of a lender creating a golden opportunity and taking advantage of a guarantor's non-coverage under California's antideficiency protections to obtain for itself an excessive deficiency judgment after a non-judicial foreclosure sale of the real property securing its loan. Similar scenarios have recently been reviewed and affirmed by appellate courts. (See *Talbott v. Hustwit* (2008) 164 Cal.App.4th 148 (fair value protections of section 580a do not extend to guarantors; lender permitted to deduct lower purchase bid amount instead of fair value of property from balance due on loan).)

Unless and until additional legislation remedies this situation, guarantor defendants will remain exposed to substantial judgments well exceeding the lender's actual damages.

III. THE "SHAM GUARANTY" DEFENSE: WHEN A GUARANTOR CAN SHOW THE LENDER EFFECTIVELY LOOKED TO THE GUARANTOR AS A PRIMARY OBLIGOR

Under Cal. Civ. Code § 2787, "[a] surety or guarantor is one who promises to answer for the debt ... of another ... (emphasis added)." Conversely, a principal obligor cannot "guaranty" its own debt. A "sham guaranty" occurs where the guarantor is not a true guarantor but rather "a principal obligor in guarantor's guise." (*River Bank, supra*, 38 Cal.App.4th at 1422.)

Where a "sham guaranty" exists, the guarantor, in essence, gains the protection of the antideficiency statute which is ordinarily accorded to the principal. "[I]f the guarantor is actually the principal obligor, he is entitled to the unwaivable protection of the antideficiency statutes, including Code of Civil Procedure section 580d." (*River Bank, supra*, 38 Cal.App.4th at 1420.) Another court has gone so far as to say that any such purported guaranty is superfluous and unenforceable; in other words, such "sham guaranties" are of no legal effect. (*Valinda Builders v. Bissner* (1964) 230 Cal.App.2d 106, 112; see also, *River Bank, supra*, 38 Cal.App.4th at 1420.)

Whether a guarantor defendant can prove he or she was the principal obligor depends, of course, upon the facts of the case. Case law broadly holds that "[t]he correct inquiry set out by the authority is whether the purported debtor is anything other than an instrumentality used by the individuals who guaranteed the debtor's obligation, and whether such instrumentality actually removed the individuals from their status and obligations as debtors. [Citation.] Put another way, are the supposed guarantors nothing more than the principal obligors under another name? [Citation.]" (*River Bank, supra*, 38 Cal.App.4th at 1422, quoting *Torrey Pines Bank v. Hoffman* (1991) 231 Cal. App.3d 308, 320.)

More specifically, the River Bank court considered three principal factors:

1. Whether the named borrower was a legitimate entity as opposed to a mere shell for the guarantors as individuals
2. Whether the lender inquired about the financial standing of the named borrower or actually relied on the financial statements of the guarantors; and
3. Whether the purpose of the loan agreements was to subvert the antideficiency statutes.

(*River Bank, supra*, 38 Cal.App.4th at 1420-1424.)

Such factual inquiry can grow rather broad. Relevant questions in pursuit of the defense include:

- Is the defaulting entity a shell company created solely for the purposes of obtaining equity financing from various investors to purchase the property, hold title to the property, and obtain the loan?
- At the time the loan was made, did the entity have substantial assets other than the property itself and/or was it undercapitalized?
- When it made the loan, was the lender aware of the entity's assets or lack thereof? Did the lender ask the entity for a financial statement or otherwise inquire about its financial standing, or did the lender merely ask for financial statements from the guarantors?
- Did the lender demand that additional collateral owned by the guarantors be added to the transaction?
- Did the lender first seek to secure liens against the personal property of the guarantors?
- Did the lender look from the outset and throughout its lending relationship exclusively to the purported "guarantors" for collection of any deficiency after foreclosure?
- Was the lender aware and/or did the lender intend that the structure of the loan would circumvent the antideficiency statute in the event a deficiency existed after foreclosure on the property?

These and other related factors will determine the trial court's willingness to entertain the "sham guaranty" defense and thereby protect the guarantor instead of allowing the lender a windfall.

MCLE TEST QUESTIONS

- Code of Civil Procedure § 580d provides antideficiency protection to guarantors of real estate loans for business purposes.
True False
- In many cases, the only defense a guarantor of a real estate loan for business purposes may have to secure the protections of the California antideficiency statute is the “sham guaranty” defense.
True False
- Protection under Code of Civil Procedure § 580d can be waived.
True False
- Lenders often carefully draft their guaranties to expressly waive or otherwise exclude antideficiency defenses.
True False
- The “sham guaranty” defense can be defeated by a carefully drafted guaranty which expressly waives antideficiency defenses.
True False
- A lender may be the sole bidder at a non-judicial foreclosure sale.
True False
- If a lender is the sole bidder at a non-judicial foreclosure sale, the lender is required to pay fair market value for the property.
True False
- Where no antideficiency protections are in place, lenders can create golden opportunities for themselves by paying less than the fair market value of real property at a foreclosure sale.
True False
- A guarantor is always entitled to a credit of the fair market value of the property acquired by a lender at a foreclosure sale.
True False
- A windfall to a lender occurs when it pays less than the fair market value of real property at a foreclosure sale, then obtains from the guarantor the difference between the reduced amount actually paid and the amount due on the loan from the guarantor.
True False
- Such windfall would be eliminated if the lender were required to credit the fair market value of real property against the amount due on the loan from the guarantor.
True False
- Unless and until legislation is enacted, lenders are likely to continue to seek windfalls from guarantors of real estate loans for business purposes.
True False
- Under Cal. Civ. Code § 2787, “[a] surety or guarantor is one who promises to answer for the debt ... of another ... (emphasis added).”
True False
- Where a “sham guaranty” exists, the guarantor, in essence, gains the protection of the antideficiency statute which is ordinarily accorded to the principal.
True False
- Sham guaranties” have legal effect.
True False
- Whether a guarantor can prove a “sham guaranty” depends upon the facts of the case.
True False
- Evidence of overcapitalization of the principal entity supports the “sham guaranty” defense.
True False
- Evidence of a lender structuring a loan to include a guaranty to intentionally circumvent the antideficiency statute supports the “sham guaranty” defense.
True False
- Evidence that a lender did not ask for or rely on financial statements from the guarantors supports the “sham guaranty” defense.
True False
- Evidence that a lender first looked to the guarantors for collection of any deficiency after foreclosure supports the “sham guaranty” defense.
True False

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If you are interested in submitting an article, please contact, in advance, the MCLE editor of *Big News*, Marilyn Monahan, at mamonahan@earthlink.net. She can provide you with important information about the magazine’s editorial calendar. The guidelines for articles are as follows:

- 1,000 – 1,500 word article on a specific area of the law, ethical issue, or management advice
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- California style cites
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- 20 questions, preferably true/false; the questions can be multiple choice, but each question must have only one answer
- Answer rationales must be provided for each question, providing the correct answer and why it is the correct answer; the rationales should be no more than 2-3 sentences long and may include citations, where appropriate
- A head-and-shoulders photo and a 3-line bio of the author must be included
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