

GUARANTYS OF OBLIGATIONS SECURED BY REAL PROPERTY

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- I. **Definition of Guarantor**: One who promises to answer for the debt, default or miscarriage of another or hypothecates property as security therefor.

California Civil Code Section 2787

II. **Purpose of Guaranties**

- a. Credit Enhancement – third party credit support
- b. Guaranties of Payment or Completion
 - i. Full Payment
 - ii. Partial Payment including guaranty of non-recourse carveouts
 - iii. Completion

- III. **Statute of Frauds**: With some exceptions, guaranty must be in writing and is unconditional unless expressly stated in the guaranty. See also the discussion in Miller & Starr, California Real Estate 3d, Section 10:263 (2009).

IV. **Rights of Guarantors Under Law (Civil Code Sections 2787 through 2855)**

Since the guarantor is someone who is taking responsibility for the obligations of another, the law accords a guarantor various rights. Some of these are the rights:

- To require the lender to proceed against the principal obligor, or to pursue any other remedy in the lender's power that the guarantor cannot pursue and that would lighten the guarantor's burden;

- To compel the principal obligor to perform the guaranteed obligations when due;
- Upon satisfying all or any part of the guaranteed obligation, to reimbursement by the principal, including costs and expenses;
- Upon satisfying the guaranteed obligation, to enforce the remedies of the lender against the principal (i.e., " rights of subrogation), and to receive contribution from co-guarantors;
- To resort to security give by the principal obligor to the lender or to any co-guarantor;
- To have security given to the lender by the principal obligor applied before the guarantor's property securing the obligation is resorted to;
- To have the guarantor's obligations reduced so as to be neither larger in amount nor more burdensome than those of the principal;
- To the disclosure of information regarding the financial condition of the principal obligor known to the lender if (1) the lender has reason to believe that such information materially increases the risk beyond that which the guarantor intends to assume; (2) the lender has reason to believe that the facts are unknown to the guarantor; and (3) the lender has a reasonable opportunity to communicate the facts to the guarantor;
- To notice, as a debtor, of any intended sale of personal property collateral securing the guaranteed obligations," which right cannot be waived prior to the occurrence of a default; and

- To have personal property collateral securing the guaranteed obligation disposed of in a commercially reasonable manner.

V. Exoneration of Guarantys: The guaranty is exonerated (extinguished) if:

- any of the above rights are violated
- without the guarantor's consent, the original obligation of the principal is altered in any respect;
- the remedies or rights of a guarantor against the principal are in any way impaired or suspended;
- the guarantor is prejudiced by a failure of the creditor to proceed against the principal, or to pursue any other remedy not in the guarantor's power or the lender violates any of the guarantor's rights set forth above.

VI. Waiver of Rights Under Guarantys: California law is clear that the above rights can be waived

- a. Waiver requires that there be an intentional relinquishment of a known right and an understanding of the consequences of the waiver. *Cathay Bank v. Lee*, 14 Cal. App. 4th 1533, 1539, 18 Cal. Rptr. 2d 429 (1993).
- b. Case law: See e.g. *Union Bank v. Gradsky*, 265 Cal. App. 2d 40 (1968) and *Cathay Bank v. Lee*, above.
- c. Statute: Civil Code Section 2856.

VII. Special Problems with Guarantors/Guarantys

- a. Sham guarantees: Liability of guarantor is legally the same as liability of the borrower (e.g. 1) guaranty by general partner of partnership obligation,

2) guaranty of corporate debt by shareholder who operated as their alter ego; 3) before change in law – trustee of irrevocable trust as to trust obligation (now separate obligations))

b. Upstream, crossstream and downstream guarantys: raise issues of adequacy of consideration

- i. Definitions: An "upstream" loan transaction generally refers to any lending transaction where all or some portion of the loan proceeds is distributed directly to the equity owner (or "parent") of the actual borrowing entity. A "cross-stream" or "sidestream" guaranty transaction refers to the situation where all or some of the proceeds are distributed directly to an affiliated or "sister" entity. A "downstream" guaranty transaction is the reverse of the upstream transaction. The parent is guaranteeing a loan made to the parent's subsidiary and the parent's assets may be pledged as security
- ii. Issue: In either upstream or cross stream, a fraudulent transfer may occur either under state law or under § 548 of the Bankruptcy Code, because the borrower (who has not received the proceeds) remains obligated for the debt or has encumbered the mortgaged premises as security for the loan and may not reasonably equivalent value in return. An upstream or cross-stream transaction may also render the mortgagor entity insolvent, undercapitalized, or unable to meet its current debt obligations.

iii. Situations where there might be reasonably equivalent value in upstream or cross stream guarantees

1. Upstream: a subsidiary that guarantees a parent's debt could, for example, receive indirect benefits such as strengthening the parent so that it can benefit the subsidiary, obtaining a line of credit otherwise unavailable, or even improving its public image or "goodwill" through consummating a large transaction.
2. Cross-stream: When analyzing whether reasonably equivalent value exists in connection with a cross-stream guaranty by a corporation of a sister entity's debt, the courts often focus on whether such guaranties are customary and reasonably expected by creditors and whether such obligations enhance the financial strength of the entire corporate "group" either directly or indirectly and therefore provide value to all of the members. If, to the contrary, the result of such guaranties is that the creditors of a high-performing solvent entity are put at increased risk for the sake of an affiliated entity that is insolvent or on the brink of insolvency, then courts are more likely to find that the transfer was made for less than reasonably equivalent value and therefore fraudulent. Often, the subsidiaries are of varying financial strengths, and creditors of a stronger

subsidiary may be put at increased and unreasonable risk as a result of the cross-guaranty. The courts will analyze closely whether the cross-guaranty obligation results in a true benefit to the debtor, such as increased synergy with the group or increased credit availability, and whether the corporate group as a whole was a viable business enterprise at the time of the guaranty. See Murray, Jack C., *Fraudulent Conveyance / Transfer Issues, The First American Company*, 2001 (found at: <http://www.firstam.com/content.cfm?id=4310>).

VIII. Issues With Guarantys When Borrower's Obligation is Secured by Real Property

a. Applicability of California's one action rule (Code of Civil Procedure Section 726(a))

- (i) "There can be but one form of action for the recovery of any debt or for the enforcement of any right secured by a mortgage on real property."
- (ii) Direct recourse against debtor is prohibited
- (iii) Creditor must pursue real property collateral
- (iv) Sanction Aspect of One-Action Rule
 - (A) Affirmative defense to prevent creditor from obtaining relief requested

- (B) Forced waiver of collateral security after set off. Security Pacific National Bank v. Wozab, 51 Cal. 3d 991 (1990).
- (C) Forced waiver of collateral security after set off and bar to enforcement of debt. Bank of America v. Daily, 152 Cal. App. 767 (1984).
- (v) What is an "action"?
 - (A) Setoff
 - (B) Judgment on note
 - (C) Attachment of assets
 - (D) Violation of One-Action Rule
- (vi) Conduct which does not violate one-action rule:
 - (A) Separate trustee's sales as to multiple collateral parcels
 - (B) Exercise of rights against collateral other than real property which is subject to a security interest in favor of lender
 - (C) Draw upon letter of credit
 - i) Western Security Bank case
 - ii) CCP 580.5
- (vii) Exceptions to One-Action Rule:
 - (A) Sold-out junior

(B) Certain actions for fraud, waste, mistake

(C) Environmentally impaired property:

Absent a waiver in the Guaranty, the guarantor could require that the creditor first proceed against the borrower and any security for the obligation. This is not based on interpretation of the one action rule but rather on the rights of guarantors (see discussion at pages 2-3 above). Waivers of the right are valid and are not against public policy. Thus, the one action rule generally does not protect true third-party guarantors from a separate action on the guaranty. After recovery from the guarantor however, the lender must next foreclose on the real property that is collateral for the debt in order to avoid losing its lien on the real property. Lenders in this situation often file lawsuits for all relief at one time: recovery on the guaranty, judicial foreclosure of the deed of trust and deficiency judgment against the borrower.

b. Applicability of California's anti-deficiency law under Code of Civil Procedure Section 580d: Section 580d prohibits a deficiency judgment after a non-judicial foreclosure (trustee sale). The prohibition against deficiency judgment under CCP Section 580d may be indirectly applied to guarantors and undermine enforceability of guaranty since the lender's exercise of its non-judicial foreclosure remedy results in a bar against collecting a judgment for a deficiency against the borrower under CCP Section 580d but a guarantor who bears any portion of the borrower's liability is subrogated to the lender's rights against the borrower and

normally may seek reimbursement from the borrower for amounts paid to the lender on the borrower's behalf. This indirectly results in the borrower being liable for a deficiency. In the case of *Union Bank v. Gradsky*, 265 Cal. App. 2nd 40 (1968), the court held that the lender could not enforce the guaranty and thereby collect the "deficiency" from the guarantor because lender's election of remedies had impaired the guarantor's subrogation rights against the borrower. However, the guarantor may execute a valid waiver of its subrogation rights and after *Gradsky*, guarantor waivers of subrogation rights became commonplace. When developing case law invalidated certain waivers, the legislature enacted Civil Code Section 2856 to create a safe harbor waiver.

- c. Applicability of Fair Value Rules (Code of Civil Procedure Sections 580a, 726(b)).** Code of Civil Procedure Section 580a has several aspects: First, by its terms, it limits the deficiency judgment that a secured creditor may recover after a trustee's sale to the difference between the amount of the indebtedness and the fair value of the property, unless the actual sale price exceeds that value. Stated differently, the deficiency is limited to the difference between the indebtedness and the greater of either the fair value or the sales price. However, this aspect of Section 580a is rarely used since Section 580d, discussed above, was later passed and that Section prohibits a deficiency judgment after a non-judicial foreclosure sale. Secondly, Section 580a has been applied to limit a sold-out junior lienor's recovery. The third context in which the fair value rules occur is in

the context of Code of Civil Procedure Section 726(b) which limits the amount of a deficiency judgment after a judicial foreclosure to the same amount as in Section 580a. In connection with the guarantor, the issue is whether Section 726(b) protects a guarantor such that a lender who chooses to pursue the guarantor after judicial foreclosure can only recover the amount that it would recover from a borrower, who does have the fair value protection. California law, as recently as 2008 has held that no such protection extends to the guarantor. *Talbott v. Hustwit*, 164 Cal.App.4th 148 (2008). This result is also consistent with Civil Code Section 2856.

- d. Applicability of Purchase Money Protection (Code of Civil Procedure Section 580b):** CCP Section 580b provides that a lender cannot recover a deficiency judgment after judicial or non-judicial foreclosure of a purchase money obligation, which, in the standard transactions, consists of either: (1) a deed of trust given to the vendor to secure the payment of the balance of the purchase price or (2) any third-party purchase-money deed of trust encumbering an owner-occupied dwelling of four or fewer units. A guarantor that satisfies the borrower's obligation after the foreclosure of a purchase money obligation cannot recover against the borrower. Thus, the lender may recover against a guarantor on its guaranty after foreclosing on a purchase money obligation. *Baumann v. Castle*, 15 Cal. App. 3d 990, 994, 93 Cal. Rptr. 565 (1971).

XIV. Guarantys of Debts of Single Purpose Entities (SPEs)

iv. Background: Development of use of SPEs (entities whose only asset is the real estate secured by the loan), often required by lenders based on belief that with limited business assets, activities and unsecured creditors, borrower is less likely to go bankrupt, and even if it does so, lender more likely to obtain relief from automatic stay and be able to foreclose.

ii. Risk to guarantor: After foreclosure, there will, by definition, be nothing further owned by the borrower from which to recover a deficiency.

iii. Development of non-recourse loans and non-recourse carveout guarantys: liability of borrower limited such that the lender agrees to only go against the real property (i.e. not against the borrower personally for any possible deficiency). Also development of exceptions to that non-recourse status, called carve-outs, usually for bad conduct (waste, fraud, intentional acts of misconduct) and possibly other acts (bankruptcy filing, rent skimming, violating environmental laws or covenants, etc.). Even with the carve-outs, a lender is still limited in the likelihood of recovery from an SPE borrower. Thus, there also non-recourse carveout guarantys.

iv. Measure of loss: Is lender's recoverable loss limited to the extent its security is impaired or is the lender entitled to more?
