DRAFTING AND ENFORCEMENT OF GUARANTIES:

The Enforcement of Payment Guaranties, “Springing Guaranties”, Completion Guaranties, and “Partial” Guaranties under California Law

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I. INTRODUCTION & SOURCES OF LAW IMPACTING GUARANTORS 1

II. CONSIDERATION 4

III. ANTI-DEFICIENCY PROTECTIONS: DEBTORS AND GUARANTORS 5

IV. SURETYSHIP DEFENSES 21

V. WAIVERS OF SURETYSHIP RIGHTS AND DEFENSES: CIVIL CODE SECTION 2856 24

VI. CONTINUING GUARANTY 37

VII. CREDITOR’S DUTY OF DISCLOSURE 40

VIII. COMPLETION GUARANTIES 41

IX. RECOURSE GUARANTIES, SPRINGING GUARANTIES & INDEMNITIES 42

X. SUBROGATION AND REIMBURSEMENT RIGHTS OF GUARANTORS UNDER CALIFORNIA LAW 53

XI. PARTIAL GUARANTIES 58

XII. THIRD-PARTY COLLATERAL 64
I. INTRODUCTION & SOURCES OF LAW IMPACTING GUARANTORS

A. General Matters

1. Guarantees are frequently utilized, somewhat fragile and highly technical, and are subject to a broad arsenal of statutory and judge-made rights and defenses which may, unless effectively waived, undermine the efficacy of a guaranty.

2. Terminology

(a) “Surety” (defined in Cal. Civil Code § 2787). The statutory definition includes both one who promises to pay the debts of another as well as one who simply pledges “property” to secure the debts of another. Section 2787 states:

“The distinction between sureties and guarantors is hereby abolished. The terms and their derivatives, wherever used in this code or in any other statute or law of this state now in force or hereafter enacted, shall have the same meaning as defined in this section. A surety or guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor. Guaranties of collection and continuing guaranties are forms of suretyship obligations, and except in so far as necessary in order to give effect to provisions specially relating thereto, shall be subject to all provisions of law relating to suretyships in general. A letter of credit is not a form of suretyship obligation. For purposes of this section, the term “letter of credit” means a “letter of credit” as defined in paragraph (10) of subdivision (a) of Section 5102 of the Commercial Code whether or not the engagement is governed by Division 5 (commencing with Section 5101) of the Commercial Code.”

Thus, an “accommodation pledgor” is always a surety.

All third-party collateral (whether real or personal) confers suretyship status upon the party granting a lienor securities interest. Consider the use of suretyship waivers in every 3rd-party pledge and encumbrance. Third-party collateral gives rise to significant structuring issues, especially with respect to real property collateral as a function of the “one-action” rule codified in CCP Section 726. (See Part XII below.)

(b) “Principal” - refers to the primary obligor whose obligations are being guaranteed or secured.

3. Suretyship by Operation of Law

The existence of certain relationships between parties where two or more persons or entities are each obligated to pay or perform a duty or payment owed to a third-party also gives rise to the existence of suretyship by operation of law.
Examples include:

(i) Assignee of lease where assignor remains liable; the party in possession is viewed as primarily responsible and the assignor is treated as primarily responsible and the assignor is treated as secondarily liable, thus transforming the prior lessee – now assignor – into a surety by operation of law with the entire arsenal of suretyship defenses at its command.

(ii) Co-signers. The law will confer suretyship status based upon identifying between or among co-signers who is primarily liable and who is secondarily liable. Thus, two or more parties signing a prior note will always raise a factual inquiry as to which among them is primarily liable. **UCC Section 3419.**

(iii) Co-obligors.

B. Sources of Law Relating to Guarantors & Sureties

1. Civil Code Sections 2787 through 2855 contain a codification of basic common law “suretyship” principles. Most of these were initially enacted in 1872 as part of the “Field” Code and thereafter materially amended in 1939.

2. The 1939 amendments to the Civil Code destroyed the prior distinction between “guarantors” and “sureties”. **Civil Code § 2787.** See generally, Regents v. Hartford Acc. & Indem. Co., 21 Cal.3d 624 (1978); Bloom v. Bender, 48 Cal.2d 793 (1957). The revisions were generally intended to provide guarantors with the broader universe of rights and defenses previously accorded to sureties alone.

   **Note:** Since guarantors were not deemed to be “sureties” prior to the 1939 amendments, pre-1939 cases dealing with guarantors should be reviewed with extreme caution to determine whether the rationale of such cases relied upon this now-abolished distinction. Cf. Bloom v. Bender, supra. (‘39 Amendments’ abolition of surety/guarantor distinctions used to justify denial of exoneration defense to guarantor based on running of statute of limitations (as to debtor) by extending rule that “sureties” had no such defense prior to 1939.) However, guarantors were so exonerated prior to 1939; *Ibid.,* 48 Cal.2d at 797-8. It is ironic that a statutory modification apparently intended to benefit guarantors was used by the California Supreme court to deprive guarantors of defenses that would have been available to them under pre-1939 law.

3. **Case Law**

4. **Restatement of Suretyship and Guaranty.**


   A. **Impact of the Restatement in California.**

   Promulgation of the Restatement of Suretyship and Guaranty does not, by itself, change the statutory and common law principles applicable to the enforcement of guaranties and other
suretyship obligations in California. Its impact will, therefore, be a function of the degree to which the judiciary chooses to apply the concepts, rules, doctrines and policy choices articulated in the Restatement to govern suretyship relationships and contracts under California. In some respects, the Restatement of Suretyship and Guaranty is consistent with California law. For example, both California Civil Code Section 2787, and Section 1 of the Restatement broadly define suretyship. In other respects, the Restatement is inconsistent with California current suretyship principles, especially in the area of discharge or exoneration of sureties.

B. The Restatement’s Approach to Exoneration and Discharge.

One fundamental area in which the Restatement of Suretyship and Guaranty differs from current California law is the degree to which a surety is discharged when a creditor alters the underlying debt or otherwise impairs the subrogation or reimbursement rights of a guarantor.

1. Strictissimi Juris Rejected. With two exceptions, the Restatement only discharges or exonerates a guarantor or other surety to the extent that the creditor’s conduct would cause loss to the surety. Restatement of Suretyship and Guaranty, Section 37(3). In adopting this rule, the Restatement rejected the more traditional approach that any act by a creditor which alters the underlying debt or otherwise affects a surety’s rights against the primary obligor automatically discharged a surety in full. This view, doctrinally dubbed strictissimi juris, was viewed as too rigid. Also, strictissimi juris often resulted in unnecessarily discharging compensated sureties in settings where the underlying risk to a surety had not materially changed. Restatement, Section 37, Comment a.

The Restatement approach to discharge continues the trend typified by the revised version of Article 3 of the Uniform Commercial Code completed in 1991 which also rejects strictissimi juris in the context of negotiable instruments and provides that accommodation parties are discharged by an extension of time or modification “only to the extent of loss caused thereby.” Article 3 similarly provides that release of the primary obligor does not discharge a secondary obligor. See, Restatement, Section 37, Comment a.

2. Fundamental Alterations. The ghost of strictissimi juris principle does survive in the Restatement in two contexts by entirely discharging a surety where the creditor “fundamentally alters the risks imposed on …” a surety:

(a) by releasing the primary obligor from a duty other than the payment of money, Restatement, Section 37(2)(a) & Section 39(c)(iii); or

(b) by agreeing to a modification which either (i) amounts to a “substituted contract” or (ii) “imposes risks” on the surety “fundamentally different from those imposed on the secondary obligor prior to modification.” Restatement, Section 37(2)(b) and Section 41(b)(i).
II. CONSIDERATION.

As with any contractual obligation, consideration is required to support a guaranty.

A. Guaranties of New Indebtedness. Civil Code § 2792 presumes the existence of consideration when a guaranty is executed “at the same time” with the creation of the principal obligation:

“Where a suretyship obligation is entered into at the same time with the original obligation, or with the acceptance of the latter by the creditor, and forms with that obligation a part of the consideration to him, no other consideration need exist. In all other cases, there must be a consideration distinctive from that of the original obligation.”

Civil Code § 2792.

At least one case has found a guaranty of a vendee’s obligations of an equipment sales contract to be “contemporaneous” where execution and delivery of the guaranty occurred 3 days after execution of sales contract, Donovan v. Wechsler, 11 Cal.App.3d 210 (1970) (dictum), but prior to the vendor’s delivery of the equipment under the sales contract. See, e.g., Pacific States Savings, etc. v. Stowell, 7 Cal.App.2d 280 (1935); Citizens Trust & Savings Bank v. Bryant, 53 Cal.App. 735 (1921) (Guaranty executed 3 weeks after note held valid as part of single transaction).

B. Guaranties of Existing Indebtedness. More significant issues arise as to a guaranty of pre-existing debts which clearly fall outside the statutory presumption of Section 2792.


2. A creditor’s renewal of an existing obligation and/or forbearance upon the exercise of remedies with respect to collection of an existing debt have been held to constitute consideration supporting a new guaranty of prior indebtedness. See, Beverly Hills Nat’l Bank v. Glynn, 267 Cal.App.2d 859, 867 (1968).

3. Making of new loans or advances to a borrower has also been held to constitute consideration for contemporaneous delivery of a guaranty covering past indebtedness. Oakland Bank of Commerce v. Washington, supra, 6 Cal.App.3d at 796-7; Beverly Hills National Bank v. Glynn, supra, 267 Cal.App.2d at 867.

C. Fraudulent Conveyances and Upstream Guaranties.

1. “Constructive Fraud”. Even where sufficient consideration exists to create a legally binding contract, a guaranty may be attacked under the “Uniform Fraudulent Transfer Act,” Civil Code § 3439.01 et seq., as “constructively fraudulent” by an existing
creditor if such obligation is incurred without receipt of “reasonably equivalent value” and, when made, the guarantor is insolvent or will be rendered insolvent thereby. *Civil Code Section 3439.05.* In addition, a transfer made or obligation incurred by a debtor without receiving reasonably equivalent value in exchange for the transfer or obligation is fraudulent against a creditor, whether the creditor’s *claim arose before or after the transfer* was made or the obligation was incurred, and the debtor either:

(A) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction.

(B) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due. *Civil Code Section 3439.04(a)(2).*

*Note:* “Actual Fraud”. If a party making a transfer of incurring an obligation does so with actual intent to hinder, delay, defeat or defraud its creditors, no absence of “reasonably equivalent value” need be shown. *Civil Code § 3934.04(a)(1).*

2. *Reasonably Equivalent Value.* Similar issues arise under Section 548 of Bankruptcy Code as to transfers made in exchange for less than “reasonably equivalent value”.


Fraudulent transfer issues should be examined closely where a subsidiary guarantees the obligations of its corporate “parent” (“upstream guarantee”) or “sister” subsidiary (“sidestream guarantee”). The most significant issue is likely to relate to what, if any, “reasonably equivalent value” was received by the “sidestream” or “upstream” guarantor in exchange for the obligation incurred by the guarantor. See, *Rubin v. Manufacturers Hanover Trust Co.,* 661 F.2d 979 (2d Cir. 1981) for an exceedingly complex factual setting involving a series of cross-guaranties and “indirect security” attacked as constructively fraudulent under Section 67 of the former Bankruptcy Act.

“Reasonably equivalent value” problems generally are absent in “downstream” guarantees since the “parent” is presumed to benefit from the extension of credit to its subsidiary.

III. **ANTI-DEFICIENCY PROTECTIONS: DEBTORS AND GUARANTORS.**

1. *The California Anti-Deficiency Statutes*

A. *Statutory Components*

The principal statutory components of the California anti-deficiency rules are Code of Civil Procedure Sections 726, 580a, 580b and 580d. These four statutes have generally been held only to protect borrowers and others primarily obligated on a debt secured by real property and have generally been treated as inapplicable to guarantors. E.g., *Everts v. Matteson,* 21 Cal. 2d 437 (1942). However, the courts have recognized at least one defense of a guarantor based on

B. Judicially Created Doctrines

Most of the key issues and doctrines which presently define the anti-deficiency landscape arise from judicial interpretations of the “one form of action” rule codified in CCP § 726, for example, the “security-first” doctrine, addressed in Wozab v. Security Pacific National Bank, 51 Cal. 3d 991 (1990), and the “sanction aspect,” first articulated in Walker v. Community Bank, 10 Cal. 3d 729 (1974), not necessarily from the language of CCP § 726. In addition, some exceptions to seemingly absolute statutes have been created by the courts. E.g., Spangler v. Memel, 7 Cal. 3d 603 (1972).

2. CCP § 726

A. The “One Form of Action” Rule

1. Statutory language. “... there can be but one form of action for the recovery of any debt, or for the enforcement of any right secured by mortgage on real property ...” CCP § 726.

2. Security-First Mandate. Where a “debt” is secured by real property, whether totally or partially, direct recourse against the party obligate upon such debt is not permitted; instead, all real property security must be exhausted in a judicial foreclosure action where a deficiency judgment may be obtained against debtor, subject to the “fair value” limitations set forth in Section 726, or the creditor may conduct a private non-judicial trustee’s sale. In Security Pacific National Bank v. Wozab, 51 Cal. 3d 991 (1990), the California Supreme Court unequivocally reaffirmed the importance of the exhaustion of collateral or “security-first” rule of CCP § 726. “... Section 726 and the statutory scheme of which it is a part require a secured creditor to proceed against the security before enforcing the underlying debt.” 51 Cal. 3d at 999 citing Walker v. Community Bank, 10 Cal 3d 729, 733-34 (1974). Thus, the setoff of sums on deposit in a bank account prior to exhaustion of real property collateral pledged to security obligation as to which the setoff was effected was held to violate the “security-first rule” even though the setoff was held not to constitute an “action.”

Note: § 726 exhaustion of security requirement applies even if real property collateral is pledged by third-party. Gnarini v. Swiss American Bank, 162 Cal. 181, 184 (1912).

3. Fair Value Under CCP § 726

A. “Fair Value” added to CCP 726 in 1933

CCP § 726 was initially adopted in 1860 but post-foreclosure deficiency judgments were unlimited until 1933 when the amendment of CCP § 726 (and passage of CCP 580a), respectively, imposed “fair market value” limits on deficiency judgments obtained through judicial foreclosure (and, until the 1940 enactment of CCP § 580d, following non-judicial trustee’s sales). Stats. 1933, Chap. 793, § 1.
B. 1937 Amendment of Statutory Terminology

CCP § 726 was amended in 1937 to change “fair market value” to present-day terminology: “fair value.” Stats. 1937, Chap. 353, § 9. One appellate court has viewed the statutory change as motivated by Depression-era concern that no “market” would exist. Rainer Mortgage v. Silverwood Ltd., 163 Cal. App. 3d 359, 366 (1985). The Rainer analysis of “fair value” has been rejected in subsequent case law.

C. Existing Case Law


In San Paolo, the Second District Court of Appeal interpreted the term “fair value” as used in CCP Section 726 and rejected the “intrinsic value” reasoning of Rainer Mortgage. In concluding that the trial court had improperly used historical market values to determine the “fair value” of an office project located in downtown Los Angeles, the Court defined the term “fair value” within the context of section 726, subdivision (b) as “the fair market value of the real property, as of the date of the foreclosure sale, without any reduction for the adverse impact of the foreclosure and the one-year right of redemption that temporarily lowers the market value of the real property.” Ibid. 62 Cal. App. 4th at 1013.

At issue in San Paolo was the scope of the deficiency judgment sought by the creditor after a foreclosure sale held on January 17, 1996 at which it purchased the collateral for $1.5 million. (The property was subsequently resold to a third-party for $1,000,000). At a “fair value hearing,” the borrower and lender each introduced competing appraisal testimony. The Bank’s appraiser testified that the property had a “fair value” of $1.5 million, while the borrower’s appraiser focused on the “intrinsic value” definition of “fair value” set forth in the Rainer Mortgage opinion and concluded that the property was worth $5,100,000.

In rejecting the debtor’s approach, the Second District Court of Appeal observed that “the term ‘intrinsic value,’ as used in the context of Rainer, means nothing more than the fair market value of the property without a reduction for the temporary price-reducing effect on the judicial foreclosure and the one-year period of redemption. To the extent Rainer can be read to go beyond this conclusion, we consider the language dicta and decline to follow it.” 62 Cal. App. 4th at 1026.

The Court also focused on the precise statutory language by observing: “The language in section 726 subdivision (b) is clear: “The value of property is determined as of the date of foreclosure sale. The company’s valuation plan is inherently flawed, because it does not focus upon the date of the sale. As a result, it is erroneous as a matter of law.” Ibid. 62 Cal. App. 4th at 1027.

Among other things, the appellate court was critical of the approach used by the borrower’s appraiser which utilized comparable sales during the period 1986 through 1990 as a function of the appraiser’s view that downtown Los Angeles represented a “distressed market” which did not represent “normal market conditions.”
Comment: This case is extremely significant. The somewhat tortured view of Rainer Mortgage has haunted judicial foreclosures for the past several years. In particular, to the extent that San Paolo is generally followed, trial courts should presumably reject appraisals which seek to ignore present market conditions and focus upon some type of historical value during better market conditions. The second district’s opinion does not specifically address the additional discussion in Rainer Mortgage where the Court of Appeal suggested in a 726 context that a lender should bear the risk of overvaluation. Although there are Supreme Court cases justifying such type of risk-shifting under Code of Civil Procedure Section 580b, there does not appear to be any policy inherent in CCP Section 726(b) which supports the Rainer analysis. Although Rainer Mortgage cites the Supreme Court’s Opinion in Roseleaf as authority for its view as to the propriety of a lender bearing the risk of post-closing declines in value, there is nothing in the portion of the Roseleaf Opinion addressing Code of Civil Procedure Section 726 which even remotely suggests such an analysis.

2.  


This case involved a judicial foreclosure in federal court on the basis of diversity jurisdiction. The 9th Circuit affirmed a multi-million dollar deficiency judgment by rejecting the defendants’ contention that the “fair value” of the real property collateral “should have been assessed at the time the promissory notes were executed.” In particular, the borrower argued that Citicorp “should be required to bear the ‘risk of loss where encumbered property declines in value,’” relying upon a statement in Rainer Mortgage to the effect that “if the lender overvalues property for purposes of a loan, or misjudges the commercial liability of a real estate project, it is entirely proper that the risk of loss be with the lender.”

In the 9th Circuit’s view, the language of Rainer Mortgage represented a departure from the “express language of Section 726.” The 9th Circuit specifically rejected the defendants’ effort to argue by analogy to CCP § 580b that a risk of overvaluation should be shifted to the lender. A close reading of the Rainer mortgage and its citation to Roseleaf as authority for shifting a risk of overvaluation to a creditor suggests that the Rainer Mortgage opinion incorrectly relied upon the portions of Roseleaf v. Chierighino in which the California Supreme Court addressed the policy and purposes of CCP Section 580b. In rejecting the contention that the policies of Section 580b should be applied to a foreclosure proceeding under CCP § 726, the 9th Circuit observed that Section 580b was applicable only to a particular “class of debtors” and that Sections 580b and 726 “are fundamentally distinct.”

3.  

Rainer Mortgage

In Rainer Mortgage, the 3rd District held that “fair value” should “be construed as the intrinsic value of real property subject to judicial foreclosure, taking into consideration all of the circumstances affecting the underlying worth of the property at the time of sale, without consideration of the impact of foreclosure proceedings on this value.” 163 Cal. App. 3d at 367. Rainer Mortgage held trial court’s use of appraisals based upon impact of foreclosure sale and redemption rights improper. Although result is clearly correct if statutory purpose of preventing “double recovery” is to be served, Rainer Mortgage also contains dicta likely to spawn significant confusion among the courts. For example, relying on Roseleaf v. Chierighino and analogizing to CCP § 580b, the court stated all “risk of loss” in foreclosure is shifted to lender on
theory that 726 was not designed to “insulate commercial lenders… where property declines in value,” if lender has initially overvalued collateral or misjudged a project’s commercial viability. *Ibid*, at 367-8. Court seems to be confusing purposes of CCP 580b with § 726. Also, troubling implication that lender’s pre-transaction appraisals might be determinative of “fair value.” The court does, however, correctly indicate that creditor should have bid up to “fair value” at judicial sale since statutory limits are intended to discourage underbids.

4. Nelson v. Orosco, 117 Cal. App. 3d 73 (1981) held that “fair value was to be determined by all of the circumstances attending the property at a foreclosure sale, including the state of its title and merchantability”. *Ibid*, 117 Cal. App. 3d at 79. At issue was the trial court’s failure to consider impact of title cloud resulting from lis pendens filed by trustor’s transferee, a vendee under a land sale contract. The concept is that “fair value” is not to be ascertained in the abstract.

Comment: Rainer Mortgage and Nelson v. Orosco illustrate distinction between impact of title clouds or other extrinsic factors affecting fair value when cloud arises independently of foreclosure sale itself and irrelevance of distress nature of foreclosure sale and “value chilling” of post-sale redemption.

4. Guarantors and Section 726.

A. CCP § 726 is typically viewed as protection for the principal debtor only, not a guarantor. Everts v. Matteson, 21 Cal. 2d 437 (1942). See generally, Bernhardt, California Mortgage and Deed of Trust Practice; Murphy v. Hellman Commercial Trust, 43 Cal. App 579 (1919). Guarantors are also denied the benefits of section 726 on the ground that the obligations of a debtor and a guarantor are so separate and distinct that only the debtor’s obligations can be viewed as secured by real property. E.g., Adams v. Wallace, 119 Cal. 67 (1897); Loeb v. Christie, 6 Cal. 2d 416 (1936).

B. Note: Distinction between guaranty obligation and primary debt based upon separate nature of obligations may be undermined by Civil Code § 2787. See, American Guaranty Corp. v. Stoody, 230 Cal. App. 2d 390, 393 (1964); Component Systems v. Eighth Judicial District Court, 692 P.2d 1296 (Nev. 1985). (Nevada court purportedly applying California law held that obligations of guarantor and debtor are identical and exonerated guarantors for creditor’s failure to exhaust security where creditor counter-claimed to recover secured debt in action initiated by guarantors. Most, but not all, of the trust deeds the corporate debt raised in the counterclaim; court nevertheless released all real property security, including property securing personal guaranty not covered by counterclaim on theory that guaranties and corporate debts constituted a single obligation. This rationale was clearly unnecessary as to the other four trust deeds which directly secured the corporate debt asserted by counterclaim. In two subsequent cases which presented only questions of Nevada law, the Nevada Supreme Court has directly extended the statutory deficiency protections available in that jurisdiction to protect guarantors. See, First Interstate Bank of Nevada v. Shields, 730 P.2d 429 (1986); Crowell v. John Hancock Mutual Life Insurance Company, 731 P.2d 356 (1986). Both of these cases make “fair value” protections directly available to a guarantor. The *Shields* court was primarily concerned with the possibility of excess recovery by a creditor who might first “bid an insignificant price for real property . . . and then pursue a second essentially full satisfaction from
a financially responsible guarantor.” In addition, the Court reasoned that failure to provide deficiency protections to guarantors might harm debtors because of a guarantor’s rights to seek reimbursement from the primary obligor. This second rationale is somewhat questionable since any available deficiency protections should presumably be imputed to bar a reimbursement claim asserted by a guarantor against a debtor.

Crowell, in turn, relied upon the Shields case to bar a deficiency judgment previously awarded against a guarantor after a jury trial in which the jury found that the value of the property exceeded the total unpaid debt.

C. A waiver of Section 726 by a guarantor should be valid, Mariners Savings & Loan v. Neil, 22 Cal. App. 3d 232 (1971), except where the guaranty itself is secured by real property. Not only does CCP 726 not apply to guarantors by its terms, but Civil Code Section 2856 clearly authorizes waiver by a guarantor of any rights they may have under CCP Section 726.


E. Note: the statutory language of CCP § 726 refers to the term “obligation.” By contrast, CCP § 580d only refers to a “note” secured by deed of trust. The statutory language may conceivably, be broad enough to encompass guarantors. However, interpreting the term as referring only to the obligation secured by real property and not to a guaranty of such debt may be more plausible and closer to the intent of parties in structuring a transaction.

5. CCP § 580d - Borrowers

A. General Rule

1. No deficiency after trustee’s sale

No deficiency judgment against debtor as to note secured by real property after trustee’s sale foreclosure. Enacted in 1940 to remove any incentive on creditor’s part to underbid and thereby maximize deficiency to be recovered in later action.

2. Statutory Protections not waivable in advance

3. Statutory Terminology Only Refers to a “Note”

Statutory language refers only to collection of a deficiency judgment on a “note.” Thus, deficiency judgment may conceivably be recovered after non-judicial foreclosure sale if secured obligation is not evidenced by a “note.” Passanisi v. Merit McBride Realtors, Inc., supra, 190 Cal. App. 3d at 1508-9 (beneficiary’s judgment for attorneys’ fees incurred in defeating an attempt to enjoin a trustee’s sale held not barred by CCP § 580d since the specific statutory language “applies . . . only to actions for ‘any deficiency upon a note secured by a deed of trust’ and not to actions based on other obligations”). See, Coppola v. Superior Court, 211 Cal. App. 3d 869 (1989); Willys of Marin v. Pierce, 140 Cal. App. 2d 826 (1956) (CCP § 580d ruled inapplicable to bar recovery of a deficiency after trustee’s sale under trust deed securing a lease). But see, Commonwealth Mortgage v. Superior Court, 211 Cal. App. 3d 508 (1989) (CCP § 580d applied to bar recovery by a mortgage insurer against a borrower under an indemnity agreement).

B. Guarantors and § 580d


Arises out of § 580d where deficiency sought from guarantor after trustee’s sale foreclosure. Lender elected to foreclose by power of sale under TD securing debtor’s note, thus rendering guarantor’s subrogation rights worthless. The Court of Appeal held that the lender was estopped from collecting a deficiency from the guarantor due to its “election” of remedy which impaired guarantor’s rights as a subrogee. The general suretyship waivers in the guaranty were deemed not to be specific enough. Ibid., 265 Cal. App. 2d at 45.


The Gradsky defense is clearly waivable. Gradsky, supra, 265 Cal. App. 2d at 48; Mariners, supra, 22 Cal. App. 3d at 236. See also, Union Bank v. Brummell, 269 Cal. App. 2d 836 (1969). As a result, virtually all guaranty forms presently in use in California contain some form of “Gradsky waiver.” Query: Given the creditor’s “election” as the “evil,” should other potential types of elections be specifically waived? Consider, e.g., Bankruptcy Code § 1111(b)(2); UCC § 9604.

In all circumstances, with or without waiver, creditor should always make demand upon guarantor prior to or concurrently with action against debtor and offer to tender note and deed of trust. See Mariners, supra, 22 Cal. App. 3d at 236-7. But cf., Krueger v. Bank of America, 145 Cal. App. 3d 204, 209 (1983) (Creditor’s tender of note and deed of trust to guarantor prior to nonjudicial sale deemed ineffective to raise estoppel bar since creditor knew guarantor lacked requisite funds).
Rule of *Gradsky* can impact quite adversely upon guarantors by encouraging direct action against guarantor prior to realization of creditor’s security, at least where Civil Code §§ 2845 and 2849 are waived. See, *Mariners*, supra 22 Cal. App. 3d at 235-6.

An attempt by a guarantor to use “*Gradsky*” defense “offensively” as a “sword” was soundly rejected in *Krueger v. Bank of America N.T. & S.A.*, 145 Cal. App. 3d 204 (1983). In *Krueger*, creditor first non-judicially foreclosed personal property collateral (publicly listed stock) pledged by guarantor to support its guaranty and thereafter elected to foreclose by trustee’s sale upon debtor’s real property. The 2nd District held that permitting guarantor “to recover damages” (i.e., recoup its losses) whenever a creditor first proceeds against the guaranty and thereafter elects to conduct a nonjudicial foreclosure of the real property . . . “would render the obligations undertaken by a guarantor less than worthless” (emphasis added). *Ibid.*, 145 Cal. App. 3d at 211.

Estoppel analysis resulting from impact of 580d upon subrogation rights of guarantor may be conceptually undermined by *Regents v. Hartford Acc. & Indem. Co.*, 21 Cal. 3d 624, 637 (1978), which held, inter alia, that a surety’s payment of the principal debt extinguishes that obligation and precludes enforcement by the surety of principal obligation as a subrogee of the original creditor. Supreme Court viewed guarantor’s action against debtor as founded upon implied right of reimbursement, not based upon subrogation rights under Civil Code § 2878. *Ibid.*, 21 Cal. 3d at 638. At issue in *Regents* was whether expiration of statute of limitations as to debtor exonerated surety. Strict subrogation analysis would have precluded holding that no exoneration results. However, to bolster this holding, the Supreme Court incorrectly described *Gradsky* as premised upon impairment of guarantor’s implied right of reimbursement, not destruction of guarantor’s subrogation rights.

Conceptual confusion was furthered in *Krueger v. Bank of America*, 145 Cal. App. 3d 204, 210 (1983), which similarly mischaracterized *Gradsky* as a case in which “the bank had elected to pursue the remedy of a nonjudicial sale of the security and had thereby destroyed the guarantor’s right to obtain reimbursement from the principal debtor,” as distinguished from impacting guarantor’s subrogation rights.

Note possible impact of *Regents* analysis: If satisfaction of debt by guarantor extinguishes primary obligation, isn’t security therefor also arguably destroyed? If so, what is the difference if guarantor pays debt before or after creditor’s resort to real property security? Also, reimbursement claim by guarantor against debtor would appear to be an unsecured claim and not involve 726 or 580d issues. Nonetheless, the ultimate result of *Gradsky* should probably not change due to strong public policy behind 580d. *Cf.*, *Regents*, supra, 21 Cal. 3d, Note 11 at 640.


*Cathay Bank v. Lee*, 14 Cal. App. 4th 1553 (1993). In reversing a judgment obtained against a guarantor for the unpaid balance of a debt remaining after completion of a non-judicial trustee’s sale, the Fourth District Court of Appeal refused to enforce a somewhat vague “plain language”-type “*Gradsky* waiver.” The Court treated the following waiver language as
inadequate on the ground that a waiver should set forth the basis for the defense being waived by a guarantor. *Ibid.*

“Guarantor authorizes bank at its sole discretion . . . (h) exercise any right or remedy it may have with respect to the Credit or any collateral securing the Credit . . . including . . . exercise of power of sale . . . and Guarantor shall be liable to Bank for any deficiency resulting from the exercise by it of any such remedy, even though any rights which Guarantor may have against others might be . . . destroyed.”

Several observations are in order. First, there is no statutory or case law basis for the apparent requirement articulated in *Cathay Bank* that a waiver must explicate the underlying defense. Although *Union Bank v. Gradsky*, supra, refused to accept a general suretyship waiver as sufficient to constitute a valid waiver of a guarantor’s right to be exonerated upon the creditor’s election of a remedy which destroyed the guarantor’s subrogation and reimbursement rights against the primary obligor, nothing in *Gradsky* requires a precise iteration of the defense or any “magic words.”


The Legacy of Cathay Bank:

The *Cathay Bank* opinion was sufficiently troubling that the California Legislature promptly adopted Civil Code Section 2856 to overrule its tortured logic. The 1994 version of Section 2856 was modified in 1996 and is analyzed in depth in Part V below.

6. **CCP § 580a**

A. Scope of Statute

CCP § 580a purports to limit deficiency judgment after trustee’s sale by deducting “fair value” of acquired collateral. Comparable to CCP § 726 in judicial foreclosure context, but of little general relevance with regard to principal obligor since 1940 passage of CCP § 580d barring such claims entirely by foreclosing trust deed holder.
B. CCP § 580a Case Law

Despite its vestigial nature, CCP § 580a has been resurrected.

1. In *Bank of Hemet v. U.S.*, 643 F.2d 661 (1981), the Ninth Circuit resolved a dispute between U.S. government and sold-out junior who had purchased at senior lienor’s sale as to amount needed to redeem extinguished junior tax lien by ruling that under California law § 580a would limit sold-out junior’s recovery. In doing so, the Ninth Circuit distinguished *Roseleaf Corp v. Chierighino*, 59 Cal. 2d 35 (1963) which had held § 580 inapplicable to a sold-out junior on ground that Roseleaf was relevant only where sold-out lienor was not successful purchaser at senior’s sale. In *Walter E. Heller Western v. Bloxham*, 176 Cal. App. 3d 266 (1985), relying upon *Bank of Hemet*, CCP § 580a “fair value” standards were applied to limit recovery of deficiency by sold-out junior lienor who purchased at senior trust deed holder’s trustee sale.

Although statutory language seems clearly applicable only to a deficiency judgment sought by party who conducted trustee’s sale, the rationale of Hemet and Bloxham is prevention of “double recovery,” i.e., purchase of collateral at bargain distress sale price followed by recovery of deficiency judgment as “sold-out” junior lienor.

C. Judicial Expansion of Statutory Language.

1. Although Bloxham relied upon *Bank of Hemet* and reasoned that it was “equitable” to apply § 580a to limit recovery by purchasing sold-out junior (“Any loss to him as creditor by his own underbidding is gained by him as purchaser for a bargain price,” *Bloxham*, *supra*, 167 Cal. App. 3d at 273-4), the two cases had sharply different impacts upon sold-out junior. In *Bank of Hemet*, the application of § 580a was used to significantly increase the redemption amount needed to be paid by the U.S. to redeem its extinguished tax lien under federal law. By contrast, *Bloxham* applied the statute to reverse a judgment awarding the entire deficiency to the sold-out junior.

2. Neither *Bloxham* nor *Bank of Hemet* fit within the literal language of § 580a (“following the exercise of the power of sale in such deed of trust or mortgage . . .”). Although prevention of double-recovery rationale is attractive, will these cases chill bidding by junior lienors and thus undermine apparent goal of “fair value” limits -- i.e., promotion of full bidding -- in context of solvent debtor? In many settings, junior will probably follow the “bird in the hand” theory.

3. Despite attractiveness of *Hemet* and *Bloxham* in context of action to recover deficiency, § 580a’s “fair value” limits have consistently been held not to apply to limit sequential realization of multiple collateral. *E.g.*, (*Dreyfus v. Union Bank of California*, 24 Cal. 4th, 400 (2000)) *Hatch v. Security-First Nat’l Bank*, 19 Cal. 2d 254 (1942). An attempt to further expand the *Bloxham/Hemet* rationale was soundly rejected in *In re Madera Farms Partnership*, 66 B.R. 100, 103 (Ninth Cir. B.A.P., 1986) where a creditor had underbid at a trustee’s sale and sought to recover sequestered rentals despite underbid roughly $2MM below low range of stipulated fair value of real property collateral. In reversing bankruptcy court order invalidating
claim to rentals, B.A.P. relied on Hatch and rejected “double-recovery” policy of § 580a on ground that statute only relates to deficiency judgments, not pursuit of additional security.

4. In *In re Franklin, supra*, the 9th Circuit held that § 580a did not bar recovery of a deficiency judgment by a “soldout junior lienor” who had purchased at a senior lienor’s foreclosure because of fraud allegations against a Chapter 7 debtor. However, the opinion assumed that a failure to file an action to recover a deficiency judgment within three months of the trustee’s sale would have barred the “soldout junior’s” claim under Section 580a in the absence of a fraud allegation.

*Query:* While imputing the fair value limitation of § 580a may serve some purpose in terms of preventing a double recovery by a “soldout junior” who acquires the property at a senior’s sale, there is no justification whatsoever for applying the procedural requirements of § 580a in this context. First, this stretches the statutory language too far since the statute was clearly intended to only apply to a lender who had conducted a trustee’s sale under its deed of trust. Second, applying the statutory time frame for commencing a deficiency claim serves no purpose and may further serve to deter bidding by junior lienors at a senior lienor’s foreclosure sale. If so, the underlying purpose of the anti-deficiency statutes to discourage a multiplicity of actions would appear to be undermined.

5. In *Citrus State Bank v. McKendrick*, 215 Cal. App. 3d 941, (1989), the Second District Court of Appeal held that the 3-month statute of limitation contained in CCP § 580a applies to a deficiency action brought by a sold-out junior lienor who had purchased at a foreclosure sale under a senior trust deed. The *Citrus State Bank* decision relied heavily upon Blockham for the proposition that § 580a’s “fair value” limitations should apply to a sold-out junior who purchases the real property collateral at a sale conducted under a power of sale contained in a senior deed of trust. Having concluded that § 580a applies to a purchasing sold-out junior for “fair value” purposes, the Second District reasoned that the three-month statute of limitation contained within the statute must also be applied.

*Citrus Bank* does not address the fact that the statutory language of CCP § 580a in effect prior to July 1, 1989 did not encompass sold-out juniors. Although the statute was amended effective July 1, 1989 (see Stats. 1988, Ch. 1199, § 6) to replace some of the references to “such deed of trust or mortgage” with the phrase “the deed of trust or mortgage,” the introductory language of the statute continues to use terminology which seems to include only the obligation secured by the senior deed of trust being foreclosed.

*Query:* Both Blockham and Citrus Bank refused to follow the Supreme Court holding in *Roseleaf* that the fair value limitations of § 580a do not apply to a sold-out junior lienor where the property was purchased at the senior beneficiary’s foreclosure sale by a junior lienor. If the recent statutory amendments can be viewed as seeking to expand the coverage of this otherwise defunct statute, does the revised language possibly undermine the *Roseleaf* holding?
D. Judicial Refusal To Expand Section 580a:


**Facts:** *Union Bank* held deeds of trust covering three separate parcels of real property to secure a single debt. Two of the three parcels had been added as additional collateral in the context of a workout. After numerous extensions, modifications and forbearance agreements, the lender commenced nonjudicial foreclosure sales against all three properties. Each of the three properties was sold at foreclosure sales during a four month period. At each sale, the bank entered a “partial credit bid”.

The borrower and an affiliated guarantor then commenced suit against *Union Bank* asserting that the foreclosures of the second and third properties violated Code of Civil Procedure Sections 580a and 580d. The court granted the bank’s motion for summary judgment which was affirmed by the Second District Court of Appeal.

*CCP § 580a* provides as follows:

> “Whenever a money judgment is sought for the balance due upon an obligation for the payment of which a deed of trust or mortgage with power of sale upon real property . . . was given as security, following the exercise of the power of sale in such deed of trust or mortgage, the plaintiff shall set forth in his or her complaint the entire amount of the indebtedness which was secured by the deed of trust or mortgage at the time of sale, the amount for which the real property or interest therein was sold and the fair market value thereof at the date of sale and the date of that sale. . . . Before rendering any judgment the court shall find the fair market value of the real property . . . sold, at the time of sale. The court may render judgment for not more than the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value of the real property or interest therein sold at the time of sale with interest thereon from the date of the sale; provided, however, that in no event shall the amount of the judgment, exclusive of interest after the date of sale, exceed the difference between the amount for which the property was sold and the entire amount of the indebtedness secured by the deed of trust or mortgage.” (Italics added.)

*Code of Civil Procedure Section 580d* provides a relevant part as follows:

Code of Civil Procedure section 580d, in pertinent, part provides: “No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property or an estate for years therein hereafter executed in any case in which the real property or estate for years therein has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.” (Italics added.)
In a unanimous opinion, the Supreme Court soundly rejected the borrower’s strained interpretation of §§ 580a and 580d. The court’s decision was based upon the following rationales:

By their terms, both CCP §§ 580a and 580d apply only when a “personal judgment against the debtor is sought after a foreclosure”.

Secondly, “. . . a creditor’s resort to any and all security on debt does not implicate the anti-deficiency provisions.” Relying upon the earlier supreme court decision in *Hatch v. Security-First National Bank*, the Supreme Court again emphasized that § 580a “applies only to shield the borrower from personal liability;”. Citing both *Freedland v. Greco* and *Western Security Bank v. Superior Court*, the Supreme Court emphasized that pursuit of security by a creditor is not an attempt to obtain a deficiency judgment.

The court also rejected the debtor’s argument that CCP § 580a obligates a creditor, after completing a trustee’s sale, to seek a judicial determination as to the fair value of the foreclosed collateral. In rejecting this argument, the Court noted that despite repeated changes in the language of § 580a, the Legislature has not altered the wording or scope of the statute to cover anything other than a “money judgment . . . for the balance due upon an obligation”.

Neither appraisal nor judicial determination of fair market value was required in the context of *seriatim* exhaustion of multiple parcels of real property collateral since, as a matter of law, inadequacy of price at a foreclosure sale is not a basis for setting aside a trustee’s sale.

The court noted that the Legislature is capable of imposing fair market value limitations and minimum bidding requirements as set forth in the CCP sections governing execution sales of personal residences. 24 Cal. 4th at 410, fn 5.

The court also rejected two further arguments proffered by the debtors. First, the court declined the debtor’s invitation to equate creditors pursuit of multiple collateral as the “functional equivalent of a deficiency judgment” to prevent windfall recoveries by a creditor. To do so, the court reasoned, would destroy the “quick, inexpensive, and efficient remedy” of non-judicial foreclosure sales.

Similarly, the court also rejected an argument that the guarantor had been coerced to pledge additional collateral, thereby creating the “functional equivalent pre-range security for a deficiency recovery”. In rejecting this argument, the Court relied upon the language of CCP § 580d which only applies when a money judgment is sought. Lastly, the Court also rejected the debtor’s argument that underbidding in an amount less than the fair market value of the property collateral constituted a violation of the implied covenant of good faith and fair dealing.
E. Guarantors and CCP § 580a.


2. In the (now decertified) decision in Bank of Southern California v. Dombrow, 46 Cal. Rptr 656 (1995), the Fourth District Court of Appeal held that a guarantor was entitled to assert “fair value” protection under CCP § 580a following a non-judicial trustee’s sale at which a lender submitted a “full credit bid” upon the obligations secured by its first deed of trust and thereby transformed itself into a “sold-out junior lienor” as to a separate note secured by a fourth deed of trust on the same property. This opinion, which was subsequently depublished by the California Supreme Court, raises a series of troubling implications with regard to the potential applicability of CCP 580a to guarantors. Although the opinion dealt with a situation where 580a was deemed to be applicable because the lender had extinguished its own junior lien by foreclosing under a senior deed of trust, much of the reasoning set forth in the (now decertified) opinion seems to focus more upon the breadth of the term “obligation” in Section 580a than the self-inflicted “sold-out junior lienor” status.

Statutory Language: An “Obligation.”

If guaranty itself secured by real property, it is possible that creditor may be able to assert post-trustee’s sale deficiency claim against guarantor since CCP § 580d literally applies only to actions upon a “note.” See, Willys of Marin v. Pierce, 140 Cal. App. 2d 826 (1956). If this analysis is correct, “fair value” limitations of CCP § 580a probably apply to limit recovery since statute applies to any “obligation for the payment of which a deed of trust . . . given as security.”

F. “True Guarantors” and General Partners as Guarantors

1. Invalidity of General Partner Guaranties

Creditors have often sought methods of evading anti-deficiency prohibitions by attempting to recast principal debtor (or its partners) as guarantors. See, e.g., Union Bank v. Brummel. Thus, guaranties have been taken from general partners of partnerships whose debt is secured by California real property. These attempts have been uniformly unsuccessful since parties already liable on primary obligation are not viewed as “true” guarantors. E.g., Union Bank v. Dorn, 254 Cal. App. 2d 157 (1967) (Civil Code § 580d held applicable to general
2. **Non-Recourse Debt & Guarantors**

1. Reasoning of *Union Bank v. Dorn* is that general partner already liable for debt, subject, however, to CCP §§ 580d and 726, so that rendering GP liable as “guarantor” would evade anti-deficiency rules. What if GP or debtor itself was *not* personally liable due to contractual non-recourse language? Although reasoning of *Dorn* and *Riddle* would be inapplicable, it is unlikely on public policy grounds that courts would sanction the practice of making non-recourse loan and simultaneously obtaining guaranty from debtor or its partners.

2. *Westinghouse Credit Corporation v. Barton*, 789 F. Supp. 1043 (1992). In *Westinghouse Credit Corporation v. Barton*, the United States District Court for the Central District of California refused, following completion of a trustee’s sale, to enforce a guaranty executed by a general partner of a partnership with respect to a non-recourse partnership obligation secured by California real property. The Court refused to treat the non-recourse feature of the underlying debt as significant; rather, the Court reasoned that the completion of a trustee’s sale rendered the obligation non-recourse anyway by virtue of CCP § 580d. Moreover, the Court viewed the combination of a contractual non-recourse provision with respect to the borrower partnership (and its general partners) coupled with a payment guaranty from one of the general partners as a device to “circumvent the legislative intent of the anti-deficiency rules.”

3. **Alter Ego**

1. Various guarantors have been exonerated when viewed as the “alter ego” of the primary obligor and thus entitled to anti-deficiency protections accorded to borrowers. See, e.g., *Valinda Builders, Inc. v. Bissner*, 230 Cal. App. 2d 106 (1964). These claims are frequently asserted by guarantors who are the principal or sole stockholder of a corporate trustor. See, e.g., *Glendale Federal S&L Ass’n v. Marina View Heights Development Co.*, 66 Cal. App. 3d 101, 155. Cases are split and distinctions are hard to discern. Compare, *Roberts v. Graves*, 269 Cal. App. 2d 410 (1969) (stockholder guarantor held liable) and *Engelman v. Gordon*, 242 Cal. App. 2d 510 (1966) (stockholder guarantor held liable), with *Valinda Builders, Inc. v. Bissner, supra* (guarantor exonerated). It may be possible to group cases on basis of intent at outset of transaction as to who was intended to be debtor, but each case is probably limited to facts, not principles of law.


3. The potential universe of “sham” guaranties was addressed at length in *Paradise Land & Cattle Company v. McWilliams Enterprises, Inc.*, 959 F.2d 1463, (9th Cir. 1992). *Paradise Land* involved the purchase of a ranch in Nevada by two individuals who acquired a 61% undivided interest in the ranch and two wholly-owned corporations who respectively acquired the remaining 39% of the undivided interests in the real property. The individuals executed a $1,100,000 purchase-money note secured by a purportedly second deed of
trust on the ranch and guaranteed by one of the corporations, McWilliams Enterprises, Inc. This guaranty was secured by a purportedly third deed of trust on the ranch.

After extinguishment of the two trust deeds respectively securing the purchase-money note and the McWilliams Enterprises guaranty in the foreclosure of a first trust deed held by Connecticut General, the vendor sued McWilliams Enterprises to recover under the guaranty. McWilliams Enterprises unsuccessfully asserted three principal defenses:

(a) the bar of CCP § 580b;
(b) the guaranty was a “sham”; and
(c) that a “transactional instrumentality” rule should be adopted to insulate corporate guarantors controlled by a purchaser from liability in respect of an underlying debt covered by CCP § 580b.

In affirming summary judgment in favor of the vendor/creditor, the Ninth Circuit rejected all three defenses. The Ninth Circuit refused to recharacterize the guaranty as a purchase-money debt subject to the prohibition upon deficiency judgments contained in CCP § 580b. The Ninth Circuit relied primarily upon the terms of the guaranty which clearly recited that it was a guaranty of the purchase-money note executed by the individuals. The court also relied upon the fact that the buyers specifically requested the transaction to be structured in the manner described above. This represented a change from the original purchase option which had been granted in favor of McWilliams Enterprises.

The Ninth Circuit refused to treat the guarantor as a “sham” and distinguished four cases (In Re Wilton-Maxfield Management Company, Younker v. Reseda Manor, Valinda Builders Inc. v. Bisner, and Riddle v. Lushing), as irrelevant because each of those four cases involved an individual guarantor who was either a partner in an underlying borrower partnership or the stockholder of an allegedly “dummy” corporation. By contrast, Paradise Land involved a corporate guarantor which had been in existence as a corporation for many years.

Transactional Instrumentality. The Ninth Circuit also rejected a “transactional instrumentality” rule by which the guarantor sought to embrace what is, in essence, the “alter ego” doctrine. Thus, the guarantor suggested that a corporation controlled by a purchaser/debtor should be treated as the purchaser for purposes of applying CCP § 580b and thereby bar recovery against a closely-held corporate guarantor in any setting where § 580b would preclude recovery from a purchaser/shareholder. As the court noted:

“At bottom, this is a case about a party attempting to gain a tax advantage without stopping to consider the possible downstream consequences of executing a guaranty. . . . We find no equities that compel this court to retrieve their chestnuts from the fire.”

4. The “Alter Ego” Doctrine

The “alter ego” doctrine seems conceptually inapplicable for use as a “shield” when intended as a “sword” to pierce the corporate veil where recognition of separateness would
promote fraud or injustice. Only in *Heckes v. Sapp*, 229 Cal. App. 2d 549, 554 (1964) has this issue been confronted directly with holding that stock ownership alone is insufficient to permit “veil piercing.” See also, *Glendale Federal v. Marina View Heights Development Co.*, *supra*, 66 Cal. App. 3d at 155 (1977).

However, a defense based on “alter ego” was judicially blessed in *Riverbank America v. Diller*, 38 Cal. App. 4th 1400 (1995) on facts which may substantially expand the scope of such issues. *Riverbank America* is discussed below.

**IV. SURETYSHIP DEFENSES.**

**A.** The Civil Code contains numerous statutes that confer significant rights and defenses upon sureties which, if not waived, may undermine the practical value of a guaranty. See, Civil Code Sections 2787 to 2855, inclusive. Consider the lack of waivers in a typical “comfort letter”.


**B. Alteration Without Consent.**

1. **Exoneration.** A surety is exonerated (except insofar as he may be indemnified by the principal) if a creditor alters the original obligation of the principal or impairs or suspends its rights against the primary obligor. *Civil Code § 2819*. See, e.g., *U.S. on behalf of Army Athletic Association v. Reliance Insurance Co.*, 799 F.2d 1382 (9th Cir. 1986) (Contract alterations, including change of date of 1983 Army-Navy game and lowering principal’s share of TV revenues (but to an amount still in excess of bond), held to require exoneration of surety on $200,000.00 bond) (federal common law relying upon Calif. state law).


5. The fact that a creditor’s “alteration” is void or voidable does not prevent exoneration under Civil Code § 2819. Civil Code § 2820. Also, rescission of an unconsented alteration does not cancel prior exoneration. Civil Code § 2821.

C. Release or Discharge of Debtor.

1. General Rule: A release of debtor from liability on the underlying debt exonerates a guarantor or other surety under Civil Code Section 2819 in the absence of consent by the guarantor. However, a surety is not exonerated by discharge of the underlying debtor by operation of law without any intervention or omission by the creditor. Civil Code § 2825.

2. Expiration of Statute of Limitations. Under California law, the expiration of a statute of limitations against the primary obligor does not exonerate a guarantor or other surety. Bloom v. Bender, 48 Cal. 2d 793 (1957); Regents of the Univ. of Cal. v. Hartford Accident and Indemnity Co., 21 Cal. 3d 624 (1978) (concept is that surety proceeds on implied right of reimbursement against principal, not as subrogee of creditor. Thus, when statute “runs” as to debtor, no impact on guarantor since right of reimbursement accrues only upon payment by guarantor).

3. Debtor’s discharge in bankruptcy does not exonerate guarantor. Superior Wholesale Elec. Co. v. Cameron, 264 Cal.App.2d 488 (1968). Query: What if debtor’s filing is alleged to have been caused by conduct of creditor? Is that an “intervention”? What if creditor fails to assert claims against debtor and discharge results? “Omission”, or will 2845 & 2849 waivers moot issue?

4. Creditors should nonetheless proceed with caution in principal’s bankruptcy. Two cases have held that a creditor’s “acceptance” of property in debtor’s bankruptcy may discharge the guarantor under Civil Code Sections 2822 and 2939. Durgin v. Kaplan, 68 Cal.2d 81 (1968); Zellner v. Lasky, 13 Cal.App.3d (1971). The issue in both cases related to creditors’ attempts to speculate by taking stock from debtor’s estate and subsequently seeking to proceed against guarantor when value of stock proved negligible. These cases suggest danger in not promptly tendering such property to guarantor and commencing action on guaranty.

5. Restatement Approach Differs. Under the Restatement, both the release of the primary obligor “from a duty to pay money,” Section 39(c)(ii), and “failing to institute an action before expiration of the statute of limitations governing the underlying obligation”, Section 43, discharge a surety only “to the extent” necessary to prevent the “... impairment of recourse” from causing the secondary obligor a loss.” Restatement, Section 37(3)(a)&(e).
D. **Right To Compel Creditor to Proceed First Against Principal or Security (C.C. §§ 2845 and 2849).**


3. Failure to perfect security held not to exonerate guarantor where guarantor held to have waived any rights to require creditor to proceed against debtor’s collateral. *American Security Bank v. Clarno*, 151 Cal.App.3d. 874 (1984). The court felt the lender’s duty to perfect its security interest arises only from an express agreement to that effect by the creditor. *Ibid.*, 151 Cal.App.3d at 883-4. Section 2849 may conceivably, support a contrary view. An express waiver may be advisable.

E. **Civil Code §§ 2809 and 2810.**

1. Section 2809 provides that a guarantor’s obligations may not be larger” than the principal’s nor be more “burdensome”. Section 2810 states that a guarantor’s liability ceases if the principal is not liable at the outset or the liability of principal thereafter ceases.

2. In view of the anti-deficiency rules, § 2809 could be viewed as the “sleeping giant” of California suretyship law since it conceivably could preclude enforcement of certain claims against a guarantor. However, neither statute has served as an effective shield for guarantors in purchase-money anti-deficiency settings where argument can be made that principal debtor is never liable. *See, Riverbank America v. Diller*, 38 Cal. App. 4th 1400 (1995); *Gottschalk v. Draper*, 23 Cal.App.3d 828, 830-1 (1972); *Heckes v. Sapp*, 229 Cal.App.2d 549 (1964). Also, not only is § 2809 clearly waivable, but it has been treated with judicial hostility and given very narrow interpretation. *See, e.g., Bloom v. Bender*, 48 Cal.2d 793 (1957) (2809 deemed inapplicable to exonerate a guarantor where statute of limitations “runs” as to principal debtor); *Loeb v. Christie*, 6 Cal.2d 416, 419 (1936) (“This section has been in the Code since 1872 and its presence there has in no way influenced the disposition of cases seeking to apply CCP Section 726 to bar immediate recourse against a guarantor”); *Heckes v. Sapp*, 229 Cal.App.2d 549 (1964).
3. § 2809 has been described as inconsistent with common law suretyship rules (§ 2819 on its face permits guarantor to consent to discharge of debtor) due to its origin as part of Napoleonic Code. Bloom v. Bender, supra, 48 Cal.2d at 802. Bloom viewed § 2809 as applying only if guarantor’s obligation exceeded principal’s at outset of transaction. Ibid.

F. Other Statutory Suretyship Rights.

1. § 2846 - “equity of exoneration.” A guarantor or other surety has the right to compel the primary obligor to perform.

2. § 2847 – A guarantor or other surety who satisfies the underlying obligation may seek reimbursement from principal debtor.

3. § 2848 - Guarantor may enforce creditor’s rights against primary debtor as a subrogee of creditor after payment and/or may seek contribution from co-sureties. See, Union Bank v. Gradsky, supra, 265 Cal.App.2d at 45. But cf. Regents v. Hartford Acc. & Indem., supra; Yule v. Bishop, 133 Cal.574 (1901) (payment by guarantor extinguishes primary obligation.)

Subrogation and reimbursement rights of sureties under California law are analyzed in depth in Part X of this outline.

V. WAIVERS OF SURETYSHIP RIGHTS AND DEFENSES: CIVIL CODE SECTION 2856.

A. Amendment of 1994 Version of Statute.

In September 1996 Governor Wilson signed Assembly Bill 2585 into law. A.B. 2585 was amended several times on its way to the Governor’s desk. On April 25, 1996, a comprehensive amendment was introduced which sought to amend both Civil Code Section 2856 and Code of Civil Procedure Section 580a. The primary purposes of A.B. 2585 were two-fold:

First, to expand and clarify the existing version of Civil Code Section 2856 adopted in 1994 to overrule the holding in Cathay Bank v. Lee, 14 Cal. App. 4th 1533 (1993), which had held the following waiver language as inadequate on the ground that a waiver should set forth the basis for the defense being waived by a guarantor:

“Guarantor authorizes bank at its sole discretion … (h) exercise any right or remedy it may have with respect to the Credit or any collateral securing the Credit … including … exercise of power of sale … and Guarantor shall be liable to Bank for any deficiency resulting from the exercise by it of any such remedy, even though any rights which Guarantor may have against others might be … destroyed.”

and underscore the rights of sureties to freely waive suretyship and other defenses accorded to guarantors under California law.
Secondly, the statutory revisions were intended to abrogate the now decertified holding in *Bank of Southern California v. Dombrow*, 46 Cal. Rptr. 2d 656 (1995) which had ruled that guarantors were entitled to fair value protections under Code of Civil Procedure Section 580a. Although the proposed amendment to CCP § 580a was dropped during the committee hearing process, it is clear that any rights which may be accorded to sureties under CCP § 580a can be waived.

B. *Text of A.B. 2585*

As enacted into law, Assembly Bill 2585 provides as follows:

“SECTION 1. Section 2856 of the Civil Code is repealed.

SEC. 2. Section 2856 is added to the Civil Code, to read:

2856. (a) Any guarantor or other surety, including a guarantor of a note or other obligation secured by real property or an estate for years, may waive any or all of the following:

1. The guarantor or other surety’s rights of subrogation, reimbursement, indemnification, and contribution and any other rights and defenses that are or may become available to the guarantor or other surety by reason of Sections 2787 to 2855, inclusive.

2. Any rights or defenses the guarantor or other surety may have in respect of his or her obligations as a guarantor or other surety by reason of any election of remedies by the creditor.

3. Any rights or defenses the guarantor or other surety may have because the principal’s note or other obligation is secured by real property or an estate for years. These rights or defenses include, but are not limited to, any rights or defenses that are based upon, directly or indirectly, the application of Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure to the principal’s note or other obligation.

(b) A contractual provision that expresses an intent to waive any or all of the rights and defenses described in subdivision (a) shall be effective to waive these rights and defenses without regard to the inclusion of any particular language or phrases in the contract to waive any rights and defenses or any references to statutory provisions or judicial decisions.

(c) Without limiting any rights of the creditor or any guarantor or other surety to use any other language to express an intent to waive any or all of the rights and defenses described in paragraphs (2) and (3) of subdivision (a), the following provisions in a contract shall effectively waive all rights and defenses described in paragraphs (2) and (3) of subdivision (a):
The guarantor waives all rights and defenses that the guarantor may have because the debtor’s debt is secured by real property. This means, among other things:

(1) The creditor may collect from the guarantor without first foreclosing on any real or personal property collateral pledged by the debtor.

(2) If the creditor forecloses on any real property collateral pledged by the debtor:

   (A) The amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price.

   (B) The creditor may collect from the guarantor even if the creditor, by foreclosing on the real property collateral, has destroyed any right the guarantor may have to collect from the debtor.

This is an unconditional and irrevocable waiver of any rights and defenses the guarantor may have because the debtor’s debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based upon Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure.

(d) Without limiting any rights of the creditor or any guarantor or other surety to use any other language to express an intent to waive all rights and defenses of the surety by reason of any election of remedies by the creditor, the following provision shall be effective to waive all rights and defenses the guarantor or other surety may have in respect of his or her obligations as a surety by reason of an election of remedies by the creditor:

The guarantor waives all rights and defenses arising out of an election of remedies by the creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guaranteed obligation, has destroyed the guarantor’s rights of subrogation and reimbursement against the principal by the operation of Section 580d of the Code of Civil Procedure or otherwise.

(e) Subdivisions (b), (c), and (d) shall not apply to a guaranty or other type of suretyship obligation made in respect of a loan secured by a deed of trust or mortgage on a dwelling for not more than four families when the dwelling is occupied, entirely or in part, by the borrower and that
loan was in fact used to pay all or part of the purchase price of that dwelling.

(f) The validity of a waiver executed before January 1, 1997, shall be determined by the application of the law that existed on the date that the waiver was executed.

SEC. 3. It is the intent of the Legislature that the types of waivers described in Section 2856 of the Civil Code do not violate the public policy of this state. Additionally, the Legislature, by enacting subdivision (b), (c), and (d) of Section 2856 of the Civil Code, does not intend to address the legal requirements for waivers in a guaranty or other suretyship contract in connection with the types of transactions described in subdivision (e) of Section 2856 of the Civil Code. No inference of any kind should be drawn from the exclusion of these transactions from the application of subdivisions (b), (c), and (d) of Section 2856 of the Civil Code. These amendments are not intended to limit or otherwise affect any rights or protections currently afforded to borrowers under Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure.”

C. Scope of Statute Clarified.

1. “Guarantor or other surety”

The revised version of California Civil Code Section 2856 utilizes the terminology “guarantor or other sureties” in order to confirm that all sureties are encompassed within the protective ambit of the statute. See, e.g., Civil Code Section 2856(a) & (c). The prior version of Civil Code Section 2856 (a) (repealed effective January 1, 1997) simply referred to “guarantors.” Since virtually all of the other Civil Code provisions codifying suretyship rights and defenses refer solely to “sureties,” the prior version of Section 2856 could have been interpreted as excluding sureties who were not also guarantors, such as accommodation pledgors who hypothecate their property to secure the debt of another and are thus “sureties” within the meaning of Civil Code Section 2787.

2. Section 2856(a)(1) specifically authorizes a waiver of a surety’s rights of “subrogation, reimbursement, indemnification, and contribution ....”

The prior statutory version referred solely to “subrogation and reimbursement.” Since rights of contribution and indemnification arise under statutory provisions not found in Civil Code Sections 2787 through 2855, inclusive, the expanded statutory language insures that whatever contribution rights or duties of indemnification may be available to sureties can be waived. It should be noted, however, that the narrower statutory language set forth in the 1994 version of Civil Code Section 2856 is still found within revised Civil Code Section 2856(d) which, as noted below, retains the precise “safe harbor” waiver language contained in the prior statute.
3. **Exclusion of Residential Purchase-Money Debt.**

Civil Code Section 2856(e) provides that the broad authorization for waivers of suretyship rights and defenses is inapplicable to secured owner-occupied residential purchase-money indebtedness. The statutory language closely tracks the precise wording of the portion of Code of Civil Procedure Section 580b which renders owner-occupied residential purchase-money indebtedness non-recourse as a matter of law. Effective as of January 1, 1997, the statutory exclusion reads as follows:

“(e) Subdivisions (b), (c), and (d) shall not apply to a guaranty or other type of suretyship obligation made in respect of a loan secured by a deed of trust or mortgage on a dwelling for not more than four families when the dwelling is occupied, entirely or in part, by the borrower and that loan was in fact used to pay all or part of the purchase price of that dwelling.”

The prior (repealed effective 1/1/97) version of Civil Code Section 2856 had utilized a broader “carve-out” which excluded “… a guaranty of a loan to an individual primarily for personal, family or household purposes …” that was also secured by owner-occupied residential real property from the statutory protections. This Reg. Z-type phrasing may well have rendered the prior statute inapplicable to guaranties of loans made to individuals for purposes that can be viewed as “personal” as distinguished from business related.

4. **“A note or other obligation.”**

The revised version of Civil Code Section 2856 utilizes the phrase “a note or other obligation secured by real property or an estate for years.” The prior statutory language (repealed effective 1/1/97) simply referred to “an obligation secured by real property or an interest therein.” The use of the terminology “a note or other obligation” was added to track the precise terminology used in Code of Civil Procedure Sections 580a, 580d and 726. CCP Sections 580a and 726 both refer to “an obligation,” while CCP § 580d utilizes the narrower terminology of “a note.”

5. **“Real property or an estate for years”**

The change in terminology from “real property or any interest therein” to “real property or an estate for years” tracks the precise statutory language of Code of Civil Procedure Sections 580a, 580b, 580d and 726. The phrase “an estate for years” was added CCP Sections 580a, 580b, 580d and 726 in the late 80’s to abrogate the holding in *Taylor v. Bousierre*, which had held that leasehold mortgages were not subject to CCP § 726.

6. **“No Magic Words.”**

(a) Revised Civil Code Section 2856(b) provides as follows:

(b) A contractual provision that expresses an intent to waive any or all of the rights and defenses described in subdivision (a) shall be effective to waive these rights and
defenses without regard to the inclusion of any particular language or phrases in the contract to
waive any rights and defenses or any references to statutory provisions or judicial decisions.

(c) Cathay Bank.

Civil Code Section 2856(b) undermines the rationale of Cathay Bank by making it clear
that contractual suretyship waivers need not include “references to statutory provisions or
judicial decisions” in order to be valid. In Cathay Bank v. Lee, supra, the Court of Appeal
refused to uphold the validity of a “plain-english” waiver and held that in order to be valid the
waiver should set forth the basis for the defense being waived by a guarantor. The revised
statutory language clearly continues the purpose and intent of the prior version of Civil Code
Section 2856. The revised statutory language is also consistent with the policies articulated in
Section 48 of The Restatement of Suretyship and Guaranty in support of the ability of parties to
freely waive suretyship rights and defenses.

7. The revised statutory language refers to a “… contractual provision that
expresses an intent to waive.”

The prior statutory language (repealed effective 1/1/97) used the phrase “Any language
that expressly sets forth the waiver of suretyship rights or defenses described in subdivision (a)
…” (Emphasis added.) The prior statutory language could well have been interpreted as
requiring a particular degree of specificity in a contractual suretyship waiver by broadly
interpreting the phrase “expressly sets forth.”

The revised statutory language should be far more “user-friendly.” This formulation
should be far less susceptible of being judicially construed as a foundation for reading a
specificity requirement into the statutory language. The phrase “expresses an intent” should be
interpreted as a far less stringent standard than the prior statutory language.

8. Waivers Authorized.

Most significantly, the revised version of Civil Code Section 2856 clearly authorizes
waivers of an extremely broad array of statutory and other defenses accorded to guarantors and
other sureties under California law. The three universes of rights and defenses covered by
Subdivision (a) of Civil Code Section 2856 include the following:

(a) Civil Code Section 2856(a)(1) authorizes waiver of:

“The guarantor or other surety’s rights of subrogation, reimbursement,
indemnification, and contribution and any other rights and defenses that
are or may become available to the guarantor or other surety by reason of
Sections 2787 to 2855, inclusive.”

This language clearly authorizes waiver of each of the statutory rights and defenses
accorded to sureties under California Civil Code Sections 2787 through 2855, inclusive. In
addition, as noted above, the statute also specifically authorizes waiver of a surety’s rights of
subrogation, reimbursement, indemnification and contribution. Although subrogation and
reimbursement rights are codified within the suretyship provisions of the Civil Code, both
indemnification rights and contribution rights arise elsewhere within the Civil Code. In addition, to some degree, the language of Section 2856(a)(1) simply expands the permissible waiver language of Civil Code Section 3268 which permits waiver of statutory Civil Code provisions except to the extent that a waiver would contravene public policy.

(b) Civil Code Section 2856(a)(2) authorizes waiver of:

“When any rights or defenses the guarantor or other surety may have in respect of his or her obligations as a guarantor or other surety by reason of any election of remedies by the creditor.”

This language clearly authorizes Gradsky-waivers. The defense recognized in Union Bank v. Gradsky was an indirect application of CCP § 580d based upon a creditor’s election to conduct a trustee’s sale.

(c) Civil Code Section 2856(a)(3) authorizes waivers of:

“When any rights or defenses the guarantor or other surety may have because the principal’s note or other obligation is secured by real property or an estate for years. These rights or defenses include, but are not limited to, any rights or defenses that are based upon, directly or indirectly, the application of Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure to the principal’s note or other obligation.”

This language significantly expands and clarifies the prior statutory language. For example, the prior statutory language may have implied that guarantors do have rights and defenses under Code of Civil Procedure Sections 580a, 580b, 580d or 726. In fact, the now decertified Opinion in Dombrow the court appeared to rely upon Civil Code 726 as authority for the proposition that guarantors are entitled to “fair value” protection under CCP § 580a. See, Bank of Southern California v. Dombrow, 46 Cal. Rptr. 2d 656 (1995). The revised statutory language tries to clarify the distinction between rights granted to borrowers under CCP §§ 580a, 580b, 580d and 726 with respect to indebtedness secured by real property and the issue of whether CCP Section 580d and Section 726 provide rights to guarantors. In particular, the phrase “any rights or defenses that are based upon, directly or indirectly,” should preclude judicial interpretation of Civil Code Section 2856(a)(3) as legislative recognition of anti-deficiency or fair value defenses for guarantors and other sureties. (Note: This still remains a potentially muddled issue.) In addition, use of the phrase “directly or indirectly” should encompass rights such as the Gradsky defense which arises as the result of an indirect application of CCP § 580d.

(d) Subdivision (a)(3) clearly undermines the now decertified Dombrow decision.

In the (now decertified) decision in Bank of Southern California v. Dombrow, 46 Cal Rptr 2d 656 (1995), the Fourth District Court of Appeal held that a guarantor was entitled to assert “fair value” protection under CCP § 580a. To the extent California courts interpret CCP § 580a as providing “fair value” protections to guarantors, Civil Code Section 2856(a)(3) clearly authorizes an effective “advance waiver” of any such rights. The language of Civil Code
Section 2953 which prevents “advance waivers” of rights available under CCP §§ 580a and 726 should not apply to preclude effective waivers by guarantors of any rights that might potentially exist under CCP § 580a or 726. By its terms, Civil Code Section 2953 is specifically limited to “advance waivers” by “a borrower.”

“Any express agreement made or entered into by a borrower at the time of or in connection with the making of or renewing of any loan secured by a deed of trust, mortgage or other instrument creating a lien on real property, whereby the borrower agrees to waive the rights, or privileges conferred upon him by Sections 2924, 2924b, 2924c of the Civil Code or by Sections 580a or 726 of the Code of Civil Procedure, shall be void and of no effect.

*** Civil Code Section 2953.

D. Statutory “Safe Harbors.”

Both subdivisions (c) and (d) of the revised version of Civil Code Section 2856 include a statutory “safe harbor” waiver provision. The waiver codified in subdivision (c) is intended as a “plain English”-type of waiver which is, accordingly, somewhat imprecise. This language was added during committee hearings to placate certain members of the Senate Judiciary Committee who were troubled by a more carefully crafted form of “model waiver.” As a practical matter, the statutory “safe harbor” set forth in subdivision (c) may be of little value since sophisticated institutional creditors are likely to choose to forego inclusion of this “plain English”-type language. In any event, it is clear that parties to a contract may use “any other language to express an intent to waive any or all of the rights and defenses as described in paragraphs (2) and (3) of subdivision (a) …”.

The statutory “safe harbor” language set forth in Subdivision (d) simply restates the prior version of the statutory “safe harbor” added by the 1994 version of Civil Code Section 2856. This language was retained within the revised statute at the request of several institutional creditors who expressed concern with a possible need to discard existing printed guaranty forms if the prior “safe harbor” was repealed in its entirety.


Subdivision (f) provides that the validity of waivers executed prior to January 1, 1997 shall be determined by applying the law in existence as of the date such waiver was executed.

F. The Restatement’s Treatment of Suretyship Waivers.

1. Waivers Permissible.

Perhaps the most significant impact of the Restatement may be in promoting greater certainty in the enforceability of suretyship waivers. Much like the present version of Civil Code Section 2856, the Restatement strongly supports the ability of parties to a suretyship contract to freely waive rights and defenses which would otherwise be available. Restatement, Section 48.
In addition, the Restatement makes it clear that specific language or general language will suffice to effectively waive suretyship defenses and, perhaps most importantly, that no “magic words” are required. Restatement, Section 48 and Comment d.

2. Text of the Restatement.

Section 48 of the Restatement provides, in relevant part, as follows:

“Waiver of Suretyship Defenses”

(1) The secondary obligation is not discharged pursuant to § 39(c)(ii)-(iii), § 40(b), § 41(b)(ii), § 42(1), § 43, or § 44 to the extent that, in the contract creating the secondary obligation or otherwise, the secondary obligor consents to acts that would otherwise be the basis of the discharge, agrees that such discharges are unavailable to the secondary obligor, or waives such discharges. Consent may be express or implied from the circumstances. Such consent, agreement, or waiver, if express, may be effectuated by specific language or by general language indicating that the secondary obligor waives defenses based on suretyship.

(Emphasis added.)


Comment d to Section 48 clearly underscores the ability of a surety to waive defenses and to waive such defenses without the use of particular wording. Moreover, the Restatement clearly repudiates the tortured view of Cathay Bank, supra, which held that in order to be valid, a waiver of suretyship defenses must articulate the basis for the defense being waived by a guarantor.

“d. Waiver of suretyship defenses. Another mechanism that is commonly used to avoid discharges resulting from impairment of recourse is for the secondary obligor to forego, by agreement or otherwise, the benefit of the rules in §§ 39-44 that might otherwise result in such discharges. This may be accomplished in the contract creating the secondary obligation or otherwise. Some indication that suretyship rights are being foregone is required; thus, a statement to the effect that the duty of the secondary obligor is absolute or unconditional is ordinarily not sufficient to indicate that the secondary obligor is agreeing to forego discharges based on suretyship status. A statement to the effect that the secondary obligor does not have suretyship status, while inaccurate, is ordinarily sufficient, however, because by communicating the absence of that status, it communicates that the incidents of suretyship status, such as discharge resulting from impairment of recourse, are unavailable.

There is no requirement of specificity with respect to the language used to forego discharge. General language indicating that the secondary obligor waives defenses based on suretyship is sufficient. The secondary obligor need not waive separately each ground for discharge, nor must
the contract describe them. Moreover, this section imposes on the obligee no special duty of disclosure or explanation to the secondary obligor. In particular, there is no duty of disclosure or explanation as to the legal effect of foregoing grounds for discharge; generally available protections against overreacting and abuse, such as doctrines of good faith and fair dealing and unconscionability, are sufficient. That the secondary obligor’s agreement to forego possible grounds for discharge is usually denominated as a “waiver” does not impose any duties on the obligee beyond principles applicable to contracts generally. Indeed, analyzed closely, a clause in the contract creating the secondary obligation that foregoes the possibility of discharge due to the obligee’s impairment of the secondary obligor’s recourse is not, strictly speaking, a waiver but, rather, is simply a contract term that delineates the contours of the secondary obligation undertaken.”

(Emphasis added.)

G. Post-2856 Case Law Addressing Gradsky Waivers


In River Bank America v. Diller, the Court both upheld a guarantor’s waiver of Civil Code § 2856, relying on Civil Code Section 2856(a) and held that there was a triable question of fact as to whether the guaranty was a sham under Valinda Builders, Inc. v. Bissner, 230 Cal. App. 2d 106 (1964). In Valinda Builders, the court held that a guaranty could be a sham and unenforceable if it was part of a structure that was designed by the lender to evade the anti-deficiency protections otherwise available to the guarantor had the guarantor been borrower.

(a) Facts: The lender made two “participating” construction loans totaling $38 million secured by 1st ($36 mm) and 2nd TD’s. Prior to closing, the parties had discussed a “joint venture.”

The Borrower was a limited partnership. One limited partner is a revocable trust and the other limited partnership is a limited partnership.

There were three guarantors:

(i) The Dillers individually and as Trustees of a revocable trust which owned stock of the corporate GP of the Borrower, and is an LP of Borrower, and owned stock of 1% GP of 2nd tier LP of Borrower, and (ii) Prometheus, a 1% GP of 2nd tier LP of Borrower

Note: No Union Bank v. Dorn issues since neither guarantor was directly liable upon the debt as GP or “indirect GP” of Borrower.

Any distinction between trust and individual guarantors is non-existent due to revocable trust (both guarantors)
Civil Code Section 2809: Trial court had ruled that guarantors were insulated under § 2809 since Borrower not liable “from the inception” due to non-recourse character of debt. Court of Appeal reversed on ground that § 2809 was effectively waived.

Although Court never decided the scope of § 2809, it observed that the guarantors’ obligation was not “larger” i.e., partial guaranty ($3.8 MM) of $38 MM debt, but questioned whether “loss of funds invested in project” by Hacienda (borrower) is “more burdensome” than $3.6 MM in personal liability.

Note: This analysis contrasts significantly with the line of cases interpreting impact of § 2809 upon debts subject to CCP 580b which treat absence of personal liability as insignificant and focus on 580b as merely limiting a particular remedy; not eliminating any obligation. Although briefed, the issue was not addressed here except in FN8 which overlooks the 580b analogy. The Court did use this analysis in FN10 to reject a similar issue raised by guarantors as to § 2810.

Waiver: The Court held § 2809 had been waived without specific language referring to § 2809. Rather, opinion relied on Bloom v. Bender as supporting a waiver based on general language and a series of provisions in the guaranty authorizing no reduction by application of foreclosure proceeds, treating the guaranty as an “absolute and unconditional” obligation, and a Gradsky-type waiver.

From the perspective of standard of waiver, this case suggests a gentle and functional standard for validating waivers as expressing the “intent of parties” under Civil Code § 3268. The opinion also rejects Cathay Bank and interprets (former) CC § 2856 as “ameliorating the strict rule laid down in Cathay Bank.” 38 Cal. App. 45th at 1419.

Sham Guaranty

The Court affirmed trial court’s finding that triable issues of fact existed as to whether the guaranty was a “sham.” Reviewing facts in most favorable light to guarantors, the opinion focuses on River Bank’s alleged insistence that a shell (Prom XX) be inserted as “GP” and that Prometheus, one of the guarantors, become a “LP.”

Relying heavily in Union Bank v. Brummell, an “evasion” case, the Court found significant evidence that River Bank sought to evade the anti-deficiency rules, i.e., “… the legislative purpose of the anti-deficiency law may not be subverted by attempting to separate the primary obligor’s interests by making a related entity the debtor while relegating the true principal obligors to the position of guarantors.” 38 Cal. App. 4th at 1423 citing Brummell.
The troubling implication is that creditor did not pursue the “putative GP” in its capacity as a guarantor but sought recovery solely from the individual guarantors and their trust. To justify remand, the Court of Appeal addressed the issue of whether the “shell GP” was simply an “instrumentality” of the Dillers, thus raising the “alter ego” issue. In doing so, the Court disregarded both adherence to corporate formalities and the fact that PromXX had been in existence long prior to the transaction. The opinion emphasizes an allegation that creditor paid no attention to creditworthiness of “shell GP” and relied on the allegation that lender restructured the borrower to find triable issue of fact as to “sham guaranty.”

The Court also reversed a denial of summary adjudication as to the guarantors’ contention that consent to structural change (i.e., joint venture to participating loan) was result of economic duress concluding that evidence did not demonstrate existence of economic duress.


In Trust One, the Court of Appeals held that an agreement by a mortgage broker to indemnify the purchaser of residential mortgage loans for losses resulting from delinquencies in the first six payments under the loans constituted an indemnity rather than a “guaranty”. As a result, the Court refused to apply Union Bank v. Gradsky exonerate the broker after the purchaser’s assignee non-judicially foreclosed in Georgia upon the real property collateral securing the loans.

The relevant part of the agreement by which the loans were sold obligated the broker to:

“indemnify and hold Trust One ... harmless from and against, and shall reimburse it or them for *** any losses, *** damages, deficiencies, claims, causes of action or expenses of any nature, (including attorney’s fees), resulting from *** (d) Any delinquency during any one of the first six payments which remains delinquent for a period of sixty days.”

One borrower defaulted after a single payment while the other made three payments. Both properties were sold at a significant loss. In refusing to apply Gradsky, the court had to determine whether the language quoted above was an “indemnity” or a “guaranty”. As viewed by the Court of Appeal:

“California law recognizes a distinction between an agreement to indemnify and a guaranty. “Indemnity is a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person.” (Civ. Code, § 772.) “A surety or guarantor is one who promises to ... answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.” (Id., § 787.) A guarantor makes a direct promise to perform the principal’s obligation in the event the principal fails to perform. An indemnitor does
not make a direct promise to perform the principal’s obligation, but promises to reimburse the indemnitee for losses suffered or to hold the indemnitee harmless.

The indemnification provision of the Broker Agreement is not a direct promise by Invest America to perform the borrowers’ obligations. The indemnification provision states Invest America “shall indemnify and hold Trust One ... harmless from” any losses resulting from the identified conditions. The indemnification provision does not obligate Invest America to indemnify Trust One for all borrowers’ defaults, but only from losses resulting from the conditions listed. As Trust One points out, Invest America’s obligations under the indemnification provision might be triggered without a borrower default, for example, when the loan package contains misrepresentations about the value of the property securing the loan. Thus, the indemnification provision in the Broker Agreement is just that— an indemnification. (emphasis added & citations omitted).”

Comment: It is not clear that the analysis of the fuzzy dividing line between an indemnity and a guaranty is correct. First, even if the language quoted above covers only some of the borrower’s defaults, it is clear under California law that a guaranty exist as to some but not all of a primary obligor’s obligations to a creditor. E.g., Civil Code Section 2822. Many “partial guaranties” are commonly used in the world of finance such as “interest-only” guaranties and completion guaranties. Second, it is difficult to see how the broker’s obligation is not a “promises to ... answer for the debt, default, or miscarriage of another” and thus clearly encompassed within the statutory definition of a “surety” under California Civil Code Section 2787. Also, the “direct promise” distinction does not appear to be based on statute or case law and might well invite creative efforts to structure indirect methods to impose liability upon a party entitled to protection under CCP Sections 726 or 580d.

The opinion also distinguished Commonwealth Mortgage Assurance Co. v. Superior Court (1989) which held an indemnity agreement signed by a borrower in favor of a mortgage insurer was unenforceable because it served the same purpose as a guaranty and thus was a device to circumvent the borrowers’ protections against a deficiency judgment under CCP Section 580d. The Court of Appeal viewed Commonwealth as premised upon the fact that the borrower/indemnitor was already liable on the debt. Since the broker was not otherwise liable for the debt, the Court perceived no “sham” to evade anti-deficiency protections.

Query: Does this case impact the enforceability of unsecured environmental indemnity agreements typically obtained from borrowers and others on real property loans? Are such agreements truly an “indemnity” or a type of guaranty encompassed within Civil Code Section 2787? With respect to third-parties executing such agreements, the inclusion of suretyship waivers and Gradsky waivers appears essential.
VI. **CONTINUING GUARANTY.**

A. **Defined.**

Section 2787 treats continuing guaranties as a form of suretyship obligation governed generally by suretyship rules. This was added by the 1939 amendments to the Civil Code suretyship provisions which generally abolished distinctions between guarantors and sureties. *Bloom v. Bender*, 48 Cal. 2d 793 (1957). Civil Code Section 2814 defines a “continuing guaranty” as a guaranty relating to a future liability of the principal, *under successive transactions*, which either continue his liability or from time to time or renew it after it has been satisfied. …” (Emphasis added.)

B. **Revocation.**

1. Continuing guaranties are revocable as to “future transactions,” unless continuing consideration exists and is not renounced. *Civil Code* Section 2815.

Section 2815 of the California Civil Code provides:

> “A continuing guaranty may be revoked at any time by the guarantor, in respect to future transactions, unless there is a continuing consideration as to such transaction which he does not renounce.”


C. **“Future Transactions.”**

1. **Revocation.**


2. **Waiver of Revocation Rights.**

*Pearl v. General Motors Acceptance Corp.*, 13 Cal. App. 4th 1023 (1993), holds that a surety may waive its right to revoke a continuing guaranty. This issue is addressed in detail below. See also, *Civil Code Section 2856.*
D. Pearl v. General Motors Acceptance Corp.: Possible Expansion of Revocation Rights

1. Implications of Pearl.

In Pearl v. General Motors Acceptance Corp., 13 Cal. App. 4th 1023 (1993), the Court of Appeal held that a third-party pledgor who owned 25% of the stock of the underlying borrower had effectively revoked a security agreement pledging unrelated stock collateral to secure revolving debt of a motor vehicle dealer three weeks after closing. Although the opinion seems fairly straightforward at first blush, the implications of Pearl are profound.

(a) First, the analysis in Pearl of a surety’s rights to revoke a continuing guaranty/pledge with respect to further advances of revolving credit (see Civil Code Section 2815, supra) may dramatically expand the universe of “future transactions” as to which revocation rights may exist.

(b) Secondly, after finding that the language of the pledge agreement was not specific enough to constitute a waiver of the pledgor’s rights to revoke its continuing guaranty/pledge, the Court held, as a matter of law, that a waiver by a guarantor of the right to revoke a continuing guaranty would not violate public policy.

(c) Third, the Court treated a series of continuing advances under a revolving credit line as involving “successive transactions”, thereby rendering the third-party pledge a “continuing guaranty”. There is no discussion in the opinion which analyzes whether the advances were committed or otherwise obligatory in nature as of the time that the pledge agreement was delivered. If so, the “successive transactions” analysis and “continuing guaranty” conclusion are questionable.

2. Third-Party Collateral as Suretyship.

The opinion relies upon Civil Code Section 2787 which states, in relevant part, that

“A surety or guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor. Guaranties of collection and continuing guaranties are forms of suretyship obligations and, except in so far as necessary in order to give effect to provisions specifically relating thereto, shall be subject to all provisions of law relating to suretyships in general.”

Based on Section 2787, the court held Pearl was a “surety” as a function of having hypothecated property as security for the debts of another.

3. Revolving Advances/“Future Transactions”.

Since the pledge agreement was executed, inter alia, to secure revolving debt, the Court of Appeal reasoned that the pledge constituted a “continuing guaranty” within the meaning of California Civil Code Section 2814 which provides that:
“A guaranty relating to a future liability of the principal, under successive transactions, which either continue his liability or from time to time renew it after it has been satisfied, is called a continuing guaranty.”

Although the pledge agreement did, in fact, recite that it secured all present and future obligations of the vehicle dealer, thereby bringing the pledge agreement within the scope of the statutory definition of a “continuing guaranty,” the Court’s analysis that the pledge agreement constitutes a “continuing guaranty” because it secured revolving debt is troubling in several respects.

(a) First, there is no analysis as to whether GMAC was obligated to make further advances of revolving credit. To the extent that GMAC’s making of additional advances was not discretionary, but mandatory, there is a significant question as to whether such advances constitute a “future liability of the principal … under successive transactions” within the meaning of Civil Code Section 2814. In other words, would a third-party pledge be a “continuing guaranty” merely because it secured revolving debt or any other loan which was to be made by a series of advances without regard to whether the advances are obligatory? The opinion implies that the mere presence of “future advances” (a term not used in the relevant statutes) is enough.

(b) Even assuming that mandatory revolving advances could constitute a “future transaction,” the court’s treatment of Pearl’s right to revoke his guaranty as to “future advances” may dramatically expand the universe of revocation rights accorded to continuing guarantors under California law.

(c) Civil Code Section 2815 provides that:

“A continuing guaranty may be revoked at any time by the guarantor, in respect to future transactions, unless there is a continuing consideration as to such transactions which he does not renounce.” (Emphasis added.)

The third-party pledgor purported to revoke the pledge agreement three weeks after closing the revolving credit arrangement. The opinion in Pearl does not indicate that the parties recognized the issue of whether the so-called “future advances” as to which the revocation was held to be effective constitute “future transactions” within the meaning of Civil Code Section 2815. In other words, had GMAC continued to make obligatory, as distinguished from discretionary, advances after the purported revocation, it would appear that such advances would not constitute “future transactions” as to which a right of revocation exists.

Query: Would a creditor’s obligation to continue to make future revolving advances constitute “continuing consideration” under Civil Code Section 2815?


After concluding that Mr. Pearl had a right to revoke the pledge agreement, the Court reviewed the language of the pledge agreement to determine whether, as contended by GMAC, he had effectively waived his revocation rights. Although the Court ultimately concluded that the contractual language was not sufficiently specific to support GMAC’s contention regarding
waiver, the Court held that public policy would not preclude waiver of the right to revoke a continuing guaranty, relying upon two Civil Code provisions, Sections 3268 and 3513, for the concept that Civil Code protections may be waived “unless such waiver would be against public policy.”

5. Public Policy Analysis.

The Court’s holding that the right to revoke a continuing guaranty may be waived, while sound, especially in light of the subsequently adopted Civil Code Section 2856, was somewhat surprising in light of the historical hostility of California courts towards waivers of suretyship defenses.

(a) First, in many jurisdictions, the right to revoke a guaranty as to “future transactions” is not waivable, see Ruda, Asset-Based Financing, a Transactional Guide, (Matthew-Bender 1985).

(b) The one exception to this rule may be with regard to the automatic revocation effected by the death of a continuing guarantor. See, e.g., American City Bank v. Tourtelot, 86 Cal. App. 3d 585 (1985) (renewal of debt following death of guarantor held not to exonerate guarantor where guaranty expressly permitted renewal before or after revocation). See generally, Restatement of the Law: Suretyship and Guaranty, Section 16 (a continuing guaranty “may be terminated by the continuing guarantor by notice to the obligee. If the continuing guarantor is a natural person, the continuing guaranty is terminated by the death of the continuing guarantor unless the continuing guaranty provides otherwise”).

(c) Secondly, the possibility that a guarantor might be able to effectively waive its right to revoke as to “future transactions” does seem to raise profound public policy issues. If Pearl v. GMAC is followed and waivers of the right to revoke become commonplace in “continuing guaranties,” it is conceivable that “continuing guaranties” might become perpetual obligations which can only be discharged in bankruptcy. If the continuing guaranty contains a sufficiently specific waiver of the right to revoke, the guarantor could, conceivably, remain liable as to “future transactions” for decades thereafter. Although these risks may be blunted to some degree by the duty of disclosure required under Sumitomo Bank v. Iwasaki, infra, there would at least be some question as to whether a duty of disclosure exists when a guarantor has no right to revoke. This seems, notwithstanding Pearl, to be at odds with sound public policy.

Query: Does the adoption of Civil Code Section 2856 authorize waiver of a right to revoke?

VII. CREDITOR’S DUTY OF DISCLOSURE.

A. Sumitomo. Sumitomo Bank of California v. Iwasaki, 70 Cal.2d 81, 90-1 (1968) requires disclosure where three factors are present:

1. Lender has reason to believe that facts within its knowledge materially increase the risk beyond that which guarantor intends to assume;
2. Lender has reason to believe that facts are unknown to guarantor; and Lender has a reasonable opportunity to communicate the facts to guarantor.

B. Continuing Duty of Disclosure. The duty of disclosure exists, if at all, both at outset of transaction, and as to each additional advance if continuing guaranty used, due to guarantor’s right to revoke under Civil Code § 2815. Also, consider broad judicial view of “future transaction” See, Southern Cal. First Nat’l Bank v. Olsen, 41 Cal.App.2d 234 (1974) (renewal of existing debt after revocation by guarantor deemed to be a “future transaction”). Query: Does “optional/obligatory” advance dichotomy in mechanics’ lien context possibly apply to render an optional advance under a construction loan a “future transaction,” even though still within original loan amount. What if the creditor is waiving a right it may have to accelerate the debt by ignoring a potential default; must that be disclosed to guarantor?

(a) There is a reduced burden of disclosure on the creditor where borrower solicits the guaranty. See, e.g., Beverly Hills Nat’l Bank v. Glynn, 267 Cal.App.2d, 854, 866 (1968). See also, Bank of Santa Ana v. Molina, 1 Cal.App.3d 607 (1969) (Vice-president/guarantor of corporate debtor failed in Sumitomo attack due to burden of showing Bank’s reasonable belief that existence of overdraft unknown to V.P.)

(b) Where debt is secured, especially by real property, analogy to debtor’s condition at outset may be made with regard to initial and subsequent value of collateral. What if contemplated security is not properly perfected? Must this be disclosed to guarantors? American Security Bank v. Clarno, 151 Cal.App.3d 874 884 (1984), suggests the answer is “no”. However, unperfected security in Clarno viewed as tangential by court. Counsel should consider express waiver.

C. Sumitomo Waivers. Waivers of Sumitomo duty may be extremely problematic as to duty of disclosure since the duty can be viewed as arising under the implied covenant of “good faith and fair dealing.” If so, public policy may preclude effective waiver. One possible alternative may be to draft around knowledge issue by requiring debtor’s periodic delivery of information to “outside” guarantor or by documenting factors which might negate existence of three preconditions to duty.

VIII. COMPLETION GUARANTIES

A. Construction lenders often obtain completion guaranties from principals or affiliates of a borrower. Completion guaranties can be extremely broad and can even be “disguised” payment guaranties. Some forms impose liability for interest and property taxes yet fail. If so, the guarantor should seek language which terminates liability for interest after the lender realizes upon its security in order to “cap” an otherwise theoretically perpetual liability.

B. Although most completion guaranties are phrased in terms of “cost to complete,” the leading California case limits damages for breach of a guaranty of completion to “the value which the improvements, had they been completed, would have added to the security . . . . In other words, Glendale was entitled to damages only to the extent noncompletion of the improvements impaired its security interest.” Glendale Federal S&L Ass’n. v. Marina View Heights Development Co., 66 Cal.App.3d 101, 124 (1977).
The Court of Appeal expressly refused to award damages after non-judicial foreclosure equal to the reasonable cost of completion, which, in *Glendale*, substantially exceeded the actual value to be added by such improvements. *Ibid.* at 124-5. Although the “benefit of the bargain” is used widely in contract law to calculate damages, such damage measure is proper for an owner and *Glendale* was only a lender at time guaranty was delivered. The creditor’s post-foreclosure ownership status was thus deemed irrelevant since foreseeability of damages is ascertained as of time of contracting.

C. Damages for breach of a completion guaranty also are limited by the value of the security. *Glendale Federal v. Marina View, supra*, 66 Cal.App.3d at 124. Thus, if (a) lender is “fully secured” at time of foreclosure, or (b) lender is fully repaid, lender “would have suffered no damage and manifestly could not have successfully prosecuted an action for breach of the completion guarantee agreement.” *Ibid.*

The analysis is premised on the concept that the lender’s expectation interest is to get its loan repaid in full. As a result, any combination of payments or collateral value which equals the debt should preclude the existence of damages to a lender. Full payment terminates the lender’s interest in the collateral and extinguishes its interest in any collateral by operation of law. *Westcott v. Fidelity & Deposit Co.*, 87 A.D. 497 (1903) (lender only entitled to be paid, not profit from failure to complete bonded improvements); *1633 Associates v. Uris Buildings Corporation*, 66 A.D. 2d 237 (1979) (Full credit bid by lender at foreclosure sale bars action by assignee of debt to recover on completion guaranty).

D. Some practitioners have viewed that completion guaranties as entirely distinct from payment guaranties for purposes of the one action and anti-deficiencies rules. The *Glendale* analysis that damages for breach of completion guaranty are limited to lower of diminution in value or degree of “undersecurity” seems to suggest the existence of a close relationship between payment and completion guaranties for purposes of interpreting a possible application of the California anti-deficiency statutes. Also, many completion guaranties are so broad in scope as to approximate a guaranty of payment.

IX. RECOLUSE GUARANTIES, SPRINGING GUARANTIES & INDEMNITIES

A. Recourse Guaranties. The term “Recourse Guaranties” is intended to encompass a type of guaranty where, in lieu of the guarantor being liable for the entirety of the debt under all circumstances as would be the case with a payment guaranty, the guarantor is obligated solely if certain events or acts occur for which “personal liability” or recourse is imposed. Recourse guaranties will typically track the language of “recourse carve-outs” in an underlying loan agreement or promissory note executed by a borrower. The recourse events, if they arise, trigger exposure for both the guarantor and the primary obligor. However, in an era of single-asset real estate owners, the concept of recourse against a borrower whose sole asset is already subject to a lien in favor of that creditor is generally meaningless. Thus, the party to whom “recourse to” will be relevant is the guarantor.

Recourse guaranties have come to be used more frequently by institutional creditors who are not engaged in CMBS originations. Rather than being driven by rating agency mandates based upon perceived levels of insulation against a chapter 11 reorganization filing, these
creditors may be opting to use a “recourse guaranty” structure as a device to deter certain unwelcome behavior (e.g., a BK filing) in the context of a troubled loan much like the CMBS universe relies upon the “springing guaranty”. The issue of adherence to SPE-covenants seen in CMBS structures will often be absent here so long as the underlying primary obligor is not required to be formally structured as a SPE.

B. Springing Guaranties.

The term “springing guaranty” is a somewhat imprecise term used commonly to describe a type of guaranty in which the guarantor is obligated to pay the underlying indebtedness upon the occurrence of a specified event. “Springing guaranties” are most commonly used to provide, as an example, that if a borrower should commence a case under the Bankruptcy Code, the guarantor will be required to pay the underlying indebtedness in full. Thus, the obligation of the guarantor under an instrument of this nature “springs” into existence upon the occurrence of the specified event. Fraud, misrepresentation and diversion of collateral are sometimes also treated as “triggers” which would cause liability to “spring”.

The universe of “full recourse” triggers where the entire debt becomes due in most “springing guaranties” will often include:
1. Voluntary reorganization or bankruptcy filings
2. Collusive involuntary reorganization or bankruptcy filings
3. “Purely” involuntary reorganization or bankruptcy filings
4. Violations of SPE covenants
5. Transfers of the Property both direct & indirect
6. The creation or existence of liens.

As discussed in more detail below, some of these “triggers” are or may become matters outside the capacity of a guarantor to control or cause but, unless modified in the negotiation process, will nonetheless impose liability for the entire debt. Several of the provisions typically embodied in standardized CMBS documentation can impose liability for the debt in settings where the “disincentive” function of a “springing guaranty is absent. These should be fertile grounds for negotiations.

C. Indemnification provisions.

“Springing guaranties” typically include additional provisions by which the obligor agrees to indemnify the lender for any “loss” or “damage” arising from various specified actions or misconduct on the part of the underlying borrower. These are commonly referred to as “bad boy” or “bad person” guaranties. For example, provisions of this nature typically obligate the guarantor under a “springing guaranty” to repay any loss suffered by a lender from diversion of project cash flow, failure to pay property taxes, etc.
These indemnification provisions, although structured as guaranties, appear to also constitute an indemnity under California Civil Code Section 2772. Section 2772 provides that:

“Indemnity is a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person.”

The party executing a “springing guaranty” is also a “surety” because it is answering for the “debt, default or miscarriage of another” and thus falls within the statutory definition of a “surety” under Civil Code section 2787.

The narrow dividing line between “suretyship” and “indemnity” was addressed in 2005 by an appellate court in Trust One v. Invest America, 134 Cal App 4th 1302 (2005), discussed below.

Notwithstanding Trust One, many obligations labeled as “indemnities” will readily confer status as a “surety” upon a so-called “indemnitor” and thereby render the arsenal of suretyship rights and defenses codified in Civil Code section 2787 through 2855, inclusive, available to assert if not waived.

Indemnification provisions of this nature appear to generally require a lender to prove the amount of damages caused by the specified event in order to compute the “loss”. These indemnification provisions differ materially from the “entire debt” obligations of a “springing guaranty” as to which the occurrence of the underlying event obligates a guarantor to repay the entire indebtedness and thus eliminate issues relating to collateral value and calculation of damages. The effort to prove the existence of a loss arising from an act specified in the “bad boy” section of a “springing guaranty” requires demonstrating that the collateral is worth less than the unpaid debt. That will not be the case for many assets and, even if the facts do reflect a shortfall in value, a creditor engages in risky conduct if it pleads its status as undersecured since admissions of that nature can be used as a factual base upon which to “cramdown” an undersecured creditor or deny “adequate protection” under the Bankruptcy Code.

Negotiations can also sometimes result in shifting some of the triggers identified above from the “full recourse” category to the “loss indemnity” part of a “springing guaranty”. Given the nature of an “indemnity” and the need to both prove the existence of a “loss” and establish a causal link between damages and the occurrence in order to recover, a shift of this nature may effectively undermine the efficacy of a particular “trigger”. (e.g., a voluntary BK filing).


In Trust One, the Court of Appeals held that an agreement by a mortgage broker to indemnify the purchaser of residential mortgage loans for losses resulting from delinquencies in the first six payments under the loans constituted an indemnity rather than a “guaranty”. As a result, the Court refused to apply Union Bank v. Gradsky to exonerate the broker after the
purchaser’s assignee non-judicially foreclosed in Georgia upon the real property collateral securing the loans.

The relevant part of the agreement by which the loans were sold obligated the broker to:

“indemnify and hold Trust One ... harmless from and against, and shall reimburse it or them for *** any losses, *** damages, deficiencies, claims, causes of action or expenses of any nature, (including attorney’s fees), resulting from *** (d) Any delinquency during any one of the first six payments which remains delinquent for a period of sixty days.”

One borrower defaulted after a single payment while the other made three payments. Both properties were sold at a significant loss. In refusing to apply Gradsky, the court had to determine whether the language quoted above was an “indemnity” or a “guaranty”. As viewed by the Court of Appeal:

“California law recognizes a distinction between an agreement to indemnify and a guaranty. “Indemnity is a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person.” (Civ. Code, § 2772.) “A surety or guarantor is one who promises to … answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.” (Id., § 2787.) A guarantor makes a direct promise to perform the principal’s obligation in the event the principal fails to perform. An indemnitor does not make a direct promise to perform the principal’s obligation, but promises to reimburse the indemnitee for losses suffered or to hold the indemnitee harmless.

The indemnification provision of the Broker Agreement is not a direct promise by Invest America to perform the borrowers’ obligations. The indemnification provision states Invest America “shall indemnify and hold Trust One ... harmless from” any losses resulting from the identified conditions. The indemnification provision does not obligate Invest America to indemnify Trust One for all borrowers’ defaults, but only from losses resulting from the conditions listed. As Trust One points out, Invest America’s obligations under the indemnification provision might be triggered without a borrower default, for example, when the loan package contains misrepresentations about the value of the property securing the loan. Thus, the indemnification provision in the Broker Agreement is just that--an indemnification. (emphasis added & citations omitted).”

Comment: It is not clear that the analysis of the fuzzy dividing line between an indemnity and a guaranty is correct. First, even if the language quoted above covers only some of the borrower’s defaults, it is clear under California law that a guaranty exist as to some but not all of a primary obligor’s obligations to a creditor. E.g., Civil Code Section 2822. Many “partial guaranties” are commonly used in the world of finance such as “interest-only” guaranties and completion guaranties. Second, it is difficult to see how the broker’s obligation is not a “promises to … answer for the debt, default, or miscarriage of another” and thus clearly encompassed within the statutory definition of a “surety” under California Civil Code Section 2787. Also, the “direct promise” distinction does not appear to be based on statute or case law and might well invite creative efforts to structure indirect methods to impose liability upon a party entitled to protection under CCP Sections 726 or 580d.
The opinion also distinguished Commonwealth Mortgage Assurance Co. v. Superior Court (1989) which held an indemnity agreement signed by a borrower in favor of a mortgage insurer was unenforceable because it served the same purpose as a guaranty and thus was a device to circumvent the borrowers’ protections against a deficiency judgment under CCP Section 580d. The Court of Appeal viewed Commonwealth as premised upon the fact that the borrower/indemnitor was already liable on the debt. Since the broker was not otherwise liable for the debt, the Court perceived no “sham” to evade anti-deficiency protections.

Query: Does this case impact the enforceability of unsecured environmental indemnity agreements typically obtained from borrowers and others on real property loans? Are such agreements truly an “indemnity” or a type of guaranty encompassed within Civil Code Section 2787? With respect to third-parties executing such agreements, the inclusion of suretyship waivers and Gradsky waivers appears essential.

F. DRAFTING ISSUES

Most “springing guaranties” are drafted in a manner that clearly distinguish between the existence of an obligation and the point in time at which the creditor has the right to enforce such obligation. Under these instruments, the creditor may not enforce the obligation until the specified event has taken place. Other “springing guaranties” may muddle the distinction between when an obligation arises and when an obligation becomes enforceable.

Set forth below, are a couple of examples of verbiage excerpted from three different “springing guaranties”. At least one of the following examples appears to raise an issue as to whether an obligation exists on the part of the guarantor as of the time of execution.

EXAMPLE #1

- In addition, Indemnitor hereby unconditionally guarantees and shall become fully liable for repayment of the Loan in full in the event [certain full-recourse events occur, including (1) “Borrower, Sole Member or Indemnitor shall voluntarily file any petition or commence any case or proceeding under any provision or chapter of the Bankruptcy Code or any other federal or state law relating to insolvency, bankruptcy or reorganization; or (2) an involuntary proceeding shall be commenced against Borrower, Sole Member or Indemnitor under any provision or chapter of the Bankruptcy Code or any federal or state law relating to insolvency, bankruptcy or reorganization that is not dismissed within ninety (90) days of the filing”].

EXAMPLE #2

- In addition, Guarantor hereby unconditionally and irrevocably guarantees payment of the entire Debt if any of the following occurs after the date hereof: (i) a voluntary bankruptcy filing by, or an involuntary bankruptcy filing against, Borrower or any general partner or managing member or majority shareholder of Borrower; or (ii) the Property becomes an asset in any bankruptcy proceeding.
EXAMPLE #3

- Guarantor hereby irrevocably, absolutely and unconditionally guarantees to Lender the full, prompt and complete payment when due of the Guaranteed Obligations. “Guaranteed Obligations” means (i) Borrower’s Recourse Liabilities [as defined in the Loan Agreement] and (ii) from and after the date that any Springing Recourse Event [as defined in the Loan Agreement] occurs, payment of all the Debt as and when the same is due in accordance with the Loan Documents (and whether accrued prior to, on or after such date)

Note: The first two examples impose “full recourse” liability for purely involuntary filings under the Bankruptcy Code. This is an example of a risk that is beyond the capacity of a guarantor to control or mitigate. While a guarantor or sponsor who controls a Borrower may be able to mandate whether or not a voluntary reorganization filing is to be made, the guarantor cannot prevent the filing of an involuntary petition if the Borrower has the requisite number of creditors holding unsecured claims.

G. ENFORCEABILITY

1. Inherent Enforceability Issues.

There does not appear to be anything inherently suspect about the validity of a payment guaranty in which one party agrees to pay the debt of a third party presumably controlled by the guarantor should such third party commence a bankruptcy case. Much like a discretionary judgment made by a creditor as to whether to require a payment guaranty when making a loan, an agreement between parties to a transaction in which the risk of bankruptcy on the part of a borrower is shifted to a third party through a “springing guaranty”, does not appear to violate or otherwise impact any fundamental legal issues as a matter of law.

There are others who have argued vehemently that “springing guaranties” are or should be invalid under public policy because a primary goal of these instruments is to dissuade resort to the bankruptcy courts by imposing liability for the entire debt if a borrower were to commence a case under the Bankruptcy Code. To date, that viewpoint has gotten little traction in the courts. See, UBS Commercial Mortgage Trust 2007-FL1, Commercial Mortgage Pass-through Certificates, Series 2007-FL1, and Normandy Reston Office, LLC v. Garrison Special Opportunities Fund L.P., 2011 WL 4552404 (N.Y. Sup., March 8, 2011). Also, most “springing guaranties” and related SPE-covenants do not preclude a Borrower from filing a bankruptcy case; rather, they impose hurdles or conditions (i.e., approval by an Independent Director) on insolvency filings and thus leave open the possibility that a voluntary filing could occur and thereby trigger a claim against a guarantor for the entire debt. In such a setting, a court could view the retention of the capacity to file, albeit subject to conditions, as providing the guarantor with the functional equivalent of an election whether to proceed with an insolvency filing and trigger exposure or not do so and avoid the imposition of personal liability. This, in turn, can also raise potential issues to the extent a guarantor in this setting is a fiduciary in respect of the potential filer.
2. **Contract Language/Existence of Obligation.**

Nonetheless, depending upon the *contractual language* of a “springing guaranty”, it is possible that some enforceability issues could arise:

(i) To the extent that the language of a “springing guaranty” can be construed as not giving rise to the existence of an obligation on the part of the guarantor until the underlying bankruptcy filing or other event occurs, there may be a serious, if not fatal, issue with respect to the existence of consideration. To the extent a “springing guaranty” does not constitute an obligation until the time of the bankruptcy filing, there may be an argument as to the need for independent consideration to support what would otherwise appear to be a guaranty of “pre-existing” indebtedness. Such a guaranty would be outside the statutory presumption of consideration set forth in Civil Code Section 2792 which conclusively finds the existence of consideration when a guaranty “is entered into at the same time” with the primary obligation. The presumption does not apply with respect to a guaranty of pre-existing debt. *See, Oakland Bank of Commerce v. Washington*, 6 Cal.App.3d 793, 796 (1970).

(ii) In addition to issues involving the existence of consideration, there may be fraudulent transfer defenses that arise as a function of the absence of “reasonably equivalent value” being paid to the guarantor if a deferred obligation “springs” into existence. Although the Uniform Fraudulent Transfer Act indicates that an obligation is incurred under the UFTA when a writing is delivered to the obligee, it is possible that an awkwardly drafted “springing guaranty” might present issues of this nature.

Neither of these two issues would appear to apply with respect to any “springing guaranty” verbiage which clearly imposes an obligation as of the time such instrument is executed but simply defers the duty to pay or a right to enforce such duty until the relevant underlying event has occurred.

3. **UNINTENDED RISKS IMPOSED UPON “SPRINGING GUARANTORS” BY SPRINGING GUARANTIES.**

**Disincentive to Engage in Certain Conduct.**

As a practical matter, springing guaranties seem to be structured to create a disincentive to engage in certain behavior or cause a borrower to perform or fail to perform in a certain manner. Thus, as an example, most springing guaranties trigger a claim for the entire debt if the underlying Borrower commences a Chapter 11 reorganization case. Clearly, the goal of the creditor in seeking such a guaranty is to discourage a borrower from ever voluntarily using the Bankruptcy Code as a weapon to halt a foreclosure or other remedy by imposition of the “automatic stay” which arise upon commencement of a case under Title 11 of the United States Code. Similarly, by imposing liability for fraud, diversion of income or other “bad acts”, the creditor is trying to assure itself that the inappropriate conduct that would trigger exposure by the Guarantor will be avoided in order to allow the Guarantor to avoid exposure for losses incurred from such conduct or for repayment of the entire debt.
Exposure to Risks Beyond Guarantor’s Capacity to Control

Despite the apparent goal of discouraging certain behavior by imposing recourse liability if certain conduct occurs or if a voluntary filing under the U.S. Bankruptcy Code is made, the precise wording of many springing guaranties can result in claims against a Guarantor where the underlying event or conduct is well beyond the capacity of a Guarantor to control. Certain cases discussed below illustrate this potential. However, many guarantors and their counsel may not fully recognize or identify all of the circumstances in which acts that a guarantor has no ability to control or prevent but could trigger exposure for indemnity/loss claims or recourse for the entire amount of unpaid debt. These areas of exposure can arise in several ways:

a. a springing guarantor can be rendered liable for acts undertaken by a Borrower at a point in time when the guarantor is not in control of the borrower. As an example, in a setting where a mezzanine loan is made and results in a “change of control” when, following a default, the mezzanine lender enforces its collateral under Article 9 of the UCC and succeeds to ownership of the mezzanine collateral. Once that occurs, a voluntary Chapter 11 filing made by the Borrower (which is then controlled by the mezz lender or another successor owner) can result in the assertion of a “full recourse” claim for the entire debt under the “senior loan” against the original Guarantor unless the Guaranty itself insulates the Guarantor for “bad acts” or prohibited conduct which occurs after a “change in control”. The solution to being rendered liable in this manner for conduct a Guarantor cannot control is to add language which makes clear the Guarantor is exposed solely for “bad acts” or prohibited conduct while it remains in “control” of the Borrower.

b. Certain conduct, particularly compliance with SPE covenants, covered by many springing guaranties is also beyond the capacity of a Guarantor to influence, control or prevent. Most springing guaranties will impose some degree of liability on a Guarantor if the Borrower fails to comply with a series of covenants typically labeled as “SPE covenants”. The vast majority of these provisions are intended to diminish or eliminate any material risk of “substantive consolidation” of a Borrower with a sponsor or other related affiliate by preventing conduct that might lead third-parties to view the assets of a Borrower and its affiliate as available to satisfy the debts of both. Thus, prohibitions on guaranteeing or securing the debts of others are very common as are covenants which govern how assets are vested. However, many of these SPE covenants typically include provisions which obligate a Borrower to remain solvent or “pay its debts as they come due”. The problem with this language is that the status of “solvency” and the capacity to pay one debts as they come due are generally a function of economic factors which a guarantor cannot control. Thus, a project may be unsuccessful as an economic proposition simply because rent rates or sales prices fall short of expected ranges or targets and result in an absence of cash flow with which to service debt and other liabilities. Equally, an unsuccessful project can wind up with a valuation lower than its liabilities and thereby fail to be solvent. While a lack of solvency caused by a sponsor looting a project of its cash flow should remain a trigger for a recourse claim, a guarantor’s counsel should seek to negotiate the language of SPE covenants to eliminate a situation where the absence of solvency arising from purely economic external events can result in recourse exposure for the entire debt.
This is precisely the issue which arose in the infamous Cherryland case discussed below. The parties seeking to evade liability were forced to argue that the parties did not intend the springing guaranty to result in payment as a function of economic failure unrelated to the parties’ conduct as the language of the underlying documents did appear by their express terms to impose liability if the Borrower failed to remain solvent.

c. The language of many spring guaranties and the underlying definitions in loan documents often include the existence of triggers which are not within the capacity of the Borrower or a Guarantor to control. These include the existence of certain types of liens (e.g., mechanics liens & judgment liens) which arise involuntarily but can be encompassed within broad definitions of “Lien” or “Transfer”. Similarly, “insolvency events” that trigger exposure for “full recourse” can include involuntary bankruptcy filings not dismissed within a specified time frame. Since a purely involuntary filing under the U.S. Bankruptcy Code is not an event that can be prevented on an absolute basis as to any Borrower that falls within the definition of a “person” under the Code, some focus is needed to insure that the ultimate assertion of jurisdiction by a bankruptcy court in an involuntary case despite efforts to resist that will not trigger unanticipated exposure on an absolute basis.

H. Cases Seeking to Enforce Springing Guaranties:

1. Case Law.

Set forth below is a list in chronological order of many of the cases which have adjudicated claims seeking to enforce springing guaranties. A few of these cases are noteworthy and discussed in detail below.


FDIC v. Prince George Corp., 58 F.3d 1041 (4th Cir. 1995)


Diamond Point Plaza Limited Partnership v. Wells Fargo Bank, N.A., 929 A.2d 932 (Md. 2007)


ING Real Estate Finance (USA) LLC and Swedbank AB, New York Branch, Plaintiffs, vs. Park Avenue Hotel Acquisition, LLC, Aby Rosen, Michael Fuchs, HHC Lexington Avenue, Inc. and Shangri-La Asia Limited, 2010 N.Y. Slip Op. 50276 (u)[26 Misc. 3d 1226(a)]


111 Debt Acquisition Holdings LLC v. Six Ventures, Ltd. et al., 413 F. Appx. 824 (6th Cir. 2011)


2. Noteworthy Opinions.

Many of the reported cases appear to mechanically enforce the provisions of springing guaranties without much critical analysis. Some of the more interesting analyses are found in the following decisions:

a. Blue Hills Office Park LLC, v. J.P. Morgan Chase Bank, 477F. Supp. 2d 366 (2007). In Blue Hills Office Park LLC, the Court enforced a “springing guaranty” where the borrower transferred cash proceeds of a settlement constituting collateral to its affiliates in violation of a provision mandating the “Lender’s prior written consent to any assignment, transfer, or conveyance of the Mortgaged Property or any interest therein...”. Liability was also imposed under the Guaranty when the Borrower commingled its funds and thus rendered the guarantor liable “for the full amount of the Debt” because of the failure by the Borrower “to maintain its status as a single purpose entity”. To further buttress its findings, the court found a violation of a covenant to maintain an independent director by the borrower.

Ironically, the guarantors sought to evade liability for diverting settlement proceeds by arguing that their conduct was encompassed within the indemnity provisions of the Guaranty and thus they should not be liable for the entire debt. When the court rejected that contention, the guarantors unsuccessfully argued that their conduct was less egregious than the acts for which only liability for losses existed under the Guaranty rather than full exposure for the whole loan. The court rejected this argument on the basis of the express language of the document.

b. California Bank & Trust v. Lawlor, 222 Cal App. 4th 625 (2013). In Cal. Bank & Trust v. Lawlor, the Fourth District Court of Appeal rejected a claim by a group of guarantors who argued that their close relationship with the underlying LLC-borrowers made them primary obligors on the loans rather than “true guarantors”, and therefore insulated by California’s anti-deficiency laws from exposure to a deficiency judgment.

Large portions of the opinion address procedural matters arising from the trial court’s refusal to consider a “sham guaranty” defense as it had not been pled as an affirmative defense. Where the case may be potentially relevant to the enforceability of “springing guaranties” is the basis used by the appellate tribunal in an appeal of a sustained demurrer to refuse to apply prior cases (River Bank America v. Diller, 38 Cal.App.4th 1400 (1995); Torrey Pines Bank v Hoffman, 231 Cal App 3d 308 (1991); Valinda Builders, Inc. v. Bissner, 230 Cal.App.2d 106 (1964); & Union Bank v. Brummell, 269 Cal.App.2d 836 (1969)) applying “sham guaranty” & “true guarantor” concepts to prevent enforcement of a payment guaranty after completion of a trustee’s sale.
As noted by the DCA:

“Here, Defendants failed to offer any evidence showing that ... [the Lender] requested, required, or otherwise had any involvement in selecting the entities, or the form of the entities, that were the borrowers and primary obligors. Defendants offered no evidence showing they were the primary obligors on the loans or that [the lender] *** attempted to separate Defendants’ interests in the loans by making *** [the Borrowers become] the borrowers while relegating Defendants to the position of guarantors. *** In River Bank, the evidence showed the bank required the developer to form a new entity to act as the borrower so the developer and his corporation could be characterized as guarantors who were unprotected by the antideficiency law. ***Similarly, in Union Bank, the lender required the individual to use a corporation as the borrower so the individual could be characterized as a guarantor who was unshielded by the antideficiency law. ***Without some evidence to show Alliance had a role in structuring the transactions to make Defendants appear as guarantors rather than primary obligors, this case is indistinguishable from Talbott. Indeed, without that evidence, the record shows Defendants formed [the Borrower LLC’s] *** to protect themselves from those entities’ liabilities. In now arguing we should disregard the legal separation those entities provided, Defendants seek to obtain the benefits of a course of action they did not follow.

Defendants also contend [the Borrower LLC’s] *** were formed to hold title to the real property security for the loans and that shows they were formed to make Defendants appear as guarantors rather than primary obligors. We disagree. Without evidence showing Alliance had some role in the formation of [the Borrower LLC’s] ***, there is no basis for the conclusion those entities were designed to conceal Defendants’ status as the primary obligors. Moreover, the evidence suggests Defendants formed [the Borrower LLC’s] *** for their own purposes independent of the loans. Indeed, Defendants formed [one of the Borrower LLC’s] *** eight months before the first loan and over two and one-half years before the second loan.” (Emphasis added.)

Commentary:

The DCA’s basis for factually distinguishing the “sham guaranty” claims from River Bank and other prior case law may sow the seeds of trouble if applied in the context of a challenge to a springing guaranty executed to support a CMBS loan. In many CMBS loans, the borrower is either a newly-formed LLC or amends and restates its existing operating agreement, using a form provided by the originating lender. Equally, the requirement that an SPE be formed or an existing entity be transformed into an SPE typically emanates from the lender. Thus, the language quoted above can be used to distinguish the holding on Lawlor and potentially support an assertion that a “spring guaranty” is somehow invalid as a “sham guaranty”.

Equally unfortunate is the DCA’s decision to publish this opinion (which was initially not certified for publication) at the request of the lender and its counsel. As a consequence, Lawlor can now be cited and used to haunt lenders in many settings, including CMBS loans. Given the broad scope of waivers authorized under Civil Code section 2856, the “sham guarantor” defense may be especially invaluable as a tool in a guarantor’s arsenal to try to undermine the enforceability of an otherwise effective guaranty that broadly waives all rights and defenses a guarantor might have, consistent with the public policy embodied within section 2856.
c. **Wells Fargo Bank, N.A. v. Cherryland Mall Limited Partnership**, No. 304682, 812 N.W.2d 799 (Mich. Ct. App. 2011). *Cherryland* involved an unsuccessful project where, following a foreclosure, the lender sought to recover the remainder of the unpaid debt on the ground that the Guarantor was liable for the entire debt as a function of the breach of an SPE-covenant in which the Borrower agreed to pay its debts as they came due & remain solvent. In affirming a trial court’s grant of summary judgment in favor of the lender, the appellate court focused on the precise wording of the SPE covenants and concluded a violation had occurred when the Borrower became insolvent. The court rejected arguments that the parties had not intended to shift the risk of commercial success to the guarantor in a non-recourse loan with language of this nature and, while noting the purpose of non-recourse financing found that the language of the documents unambiguously required the Borrower “to remain solvent”.

*Note:* Both *Cherryland* and a similar case decided contemporaneously, **51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC**, were ultimately mooted when the Michigan Legislature subsequently adopted a statute which made it unlawful to impose liability upon a guarantor of a non-recourse loan for a failure to maintain solvency. Despite the adoption of this statute in Michigan, the risk of pure economic failure imposing liability for non-recourse debt upon a guarantor remains in light of the language widely used in SPE covenants.


In contrast to *Cherryland*, this case presents an example of a court treating apparently unambiguous language in a “bad-boy” guaranty as ambiguous and relying upon the apparent intent of the parties to eliminate liability for a Guarantor in connection with involuntary liens on the lender’s collateral. In a footnote, the Court noted the absence of a definition of a “bad-boy guaranty” and observed, relying upon declarations and deposition testimony, that “While there is not a precise meaning of bad-boy guaranty or precise actions that are forbidden under such a guaranty, the concept is not to act badly. A bad-boy guaranty often forbids fraud, the misallocation of funds, and a voluntary bankruptcy filing, among other prohibitions”.

A series of mechanics’ liens were filed against the Property by the general contractor and at least three subcontractors. The GC’s lien ultimately ripened into a judgment lien for $1.578 million. The Property also became subject to a substantial lien in favor of the HOA for delinquent dues.

Requested modifications of language to restrict “springing recourse” for the full debt only to “voluntary, material Indebtedness” were not embodied in the final document. As executed, section 1.2(b)(iv) of the Guaranty imposed “full recourse against Defendant ‘if Borrower fails to obtain Lender’s prior written consent to any Indebtedness (provided such Indebtedness exceeds $250,000 or if any such Indebtedness is in the form of mezzanine debt or preferred equity) or voluntary Lien encumbering the Property (to the extent such consent is required under the Loan Agreement’)”.

The Loan Agreement, in turn, defined the terms “Indebtedness” and “Lien”. “Indebtedness” expressly included “a) all indebtedness or liability . . . (including, without limitation, amounts for borrowed money and indebtedness in the form of mezzanine debt or preferred equity) . . . and (g) obligations secured by any Liens, whether or not the obligations
have been assumed (other than the Permitted Encumbrances and Permitted Equipment Financing).” “Lien” was defined as “any mortgage, deed of trust, lien, pledge, hypothecation, assignment, security interest, or any other encumbrance, charge or transfer of, on or affecting Borrower, the Property, any portion thereof or any interest therein, including, without limitation, any conditional sale or other title retention agreement, any financing lease having substantially the same economic effect as any of the foregoing, the filing of any financing statement, and mechanic’s, materialmen’s and other similar liens and encumbrances.”

After a trustee’s sale was held by the buyer of the delinquent Note, suit was filed against the Guarantor seeking at least $110 million under the Guaranty on the basis of three “full recourse” claims relating to the existence of a Lien, the occurrence of a “Transfer” & the existence of “Indebtedness”.

The District Court first rejected the claim based on language in the Guaranty which imposed recourse if “Borrower fail[ed] to obtain Lender’s prior written consent to any . . . voluntary Lien encumbering the Property (to the extent such consent is required under the Loan Agreement)on the ground that the liens were not “voluntary” The Court specifically rejected a contention that the liens were “voluntary” because the Borrower had the funds to pay these amounts as “specious”.

The effort to treat the “disputed liens” as the equivalent of a Transfer (“acts that mortgage, . . . encumber, pledge, [or] assign,” interests in the Property” was also rejected by the Court, despite recognition that the liens did constitute “Transfers” under their “plain meaning”. The court also refused to rely upon language allocation “loss” exposure for breaches of SPE covenants as preventing the broad construction of the term “Transfer”, finding that the definitions in the “full recourse” provisions were controlling in lieu of the “general SPE provisions for loss recourse”. After concluding the language was ambiguous, despite a finding that the “plain meaning” of “transfer” did encompass these liens, the court analyzed the “extrinsic” evidence to determine what the parties intended. The Court focused on the deletion of certain language in drafts that were intended to eliminate recourse exposure for mechanics’ liens as overriding the retention of the term “encumber” in the definition of “Transfer”. The Court also relied upon this analysis to avoid “an interpretation also avoids reading the contract in a commercially unreasonable or absurd manner” as a function of its view that CA law allows a mechanic’s lien to be filed even when payment is not past due.

Note: The Court made an extensive examination of the negotiations and drafts of the Guaranty as it evolved from the first draft through the final version executed when the loan closed. The degree of focus upon the parties’ negotiations and statements relative to the scope of liability intended to arise under the Guaranty is unusual and may well be at odds with the integration clauses typically embodied in the final document. To allow use of this evidence, the Court found the language of the Guaranty to be ambiguous despite its otherwise apparently clear meaning. The degree of judicial inquiry in this case is unusual and may have been spurred by a view that the result sought was “commercially unreasonable or absurd....”. Despite the failure of the claim asserted by the buyer of the delinquent debt, the case illustrates the risk of exposure for events which may be outside the capacity of a springing guarantor to control.
The contrast with the mechanical application of contract language in the next case is striking.

e. **CSFB-2001—CP-4 Princeton Park Corporate Center v. SB Rental 1, LLC, 980 A.2d 1 (N.J. Super. Ct. App. Div. 2009).** This case imposed liability upon a springing guarantor where the Borrower, in violation of prohibitions upon other financing, had placed a second mortgage on the senior lender’s collateral. Even though the junior lien was repaid in full 7 months after recording and prior to the existence of a payment delinquency and subsequent foreclosure, the court focused on the literal wording of the springing guaranty and affirmed a judgment in favor of the creditor. Among other contentions, the guarantor unsuccessfully argued that the lender had not been damaged by the short-term existence of the unconsented junior lien. The court rejected this contention as well as an attack upon the guaranty as an unenforceable liquidated damages provision.

   *Note:* The application of the literal wording of a springing guaranty to impose liability on the debt for breach of a prohibition upon junior financing even where the junior lien had been quickly (i.e., 7 months) repaid in full and appears to have had no impact upon the ultimate default is more typical than *CP III Rincon Towers* in terms of the absence of critical inquiry by courts asked to enforce such instruments.

   f. **UBS Commercial Mortgage Trust 2007-FL1, Commercial Mortgage Pass-through Certificates, Series 2007-FL1, and Normandy Reston Office, LLC v. Garrison Special Opportunities Fund L.P., 2011 WL 4552404 (N.Y. Sup., March 8, 2011).** This case is noteworthy as a function of the court’s rejection of a fundamental attack upon the legality of springing guaranties. Among the contentions rejected by the trial court was the assertion that a springing guaranty is an unenforceable *in terrorem* device at odds with public policy as it allowed creditors to get results not otherwise available given the terms of the Bankruptcy Code. The recourse claim for the debt was made after a mezz lender took control of the borrower, executed a replacement springing guaranty and, shortly thereafter, commenced a chapter 11 reorganization case under the Bankruptcy Code to halt a mortgage foreclosure. The trial court used a summary procedure available under NY with certain types of commercial instruments to impose a $111 million judgment on the guarantor 42 days after the case was filed.

**X. SUBROGATION AND REIMBURSEMENT RIGHTS OF GUARANTORS UNDER CALIFORNIA LAW**

**A. Scope of Subrogation.**

1. Payment by a guarantor of the underlying debt appears to entitle guarantor to proceed as a subrogee of the creditor and avail itself of:

   (a) the creditor’s rights to recover from the principal debtor on the primary obligation; and

   (b) the security held by the creditor for the principal debtor’s obligations.
2. In essence, a guarantor or surety who satisfies the underlying debt by payment “stands in the shoes” of the original creditor and should, subject to the uncertainties of California law, infra, succeed by operation of law to the creditor’s rights and remedies against the underlying debtor and in respect of any collateral held to secure the underlying debtor’s obligations. In re Steve’s Furniture Warehouse, 46 B.R. 80, 82 (S.D. Cal. 1985) (“In effect, the guarantor acquires any right against the principal that the creditor previously had, which is why subrogation is often referred to as an assignment by operation of equity.”).

B. Statutory Codification.

The subrogation rights accorded to a guarantor or other surety under California law are codified in the Civil Code.

1. Civil Code Section 2848: “A surety, upon satisfying the obligation of the principal, is entitled to enforce every remedy which the creditor then has against the principal to the extent of reimbursing what he has expended . . . .” (Emphasis added.)

2. Civil Code Section 2849: “A surety is entitled to the benefit of every security for the performance of the principal obligation held by the creditor . . . , whether the surety was aware of the security or not.”

C. Full Payment Required

In order for a guarantor or other surety to become subrogated to the rights and remedies of the creditor and any security held to secure the underlying debt, the guarantor/surety must pay the underlying obligation in full. Civil Code Section 2848 specifically conditions the exercise of subrogation rights upon full satisfaction of the primary obligation. See, Civil Code Section 2848, supra.

1. The requirement of full payment as a condition to subrogee status means, by definition, that a guaranty of part of an obligation (i.e., a partial guaranty) will generally not give rise to the right to succeed to the primary creditor’s position with respect to any security or collateral held in respect of the underlying obligation. Perhaps the only exception would arise in a setting where the creditor has recovered a sufficient portion of the underlying debt to reduce the unpaid primary obligation to an amount within the limit of the partial guarantor’s liability at a point in time when other, as yet unexhausted, collateral still exists.

2. The absence of pro tanto subrogation rights should also minimize the possibility of conflicts arising between the holder of the underlying debt and the partial guarantor in their mutual pursuit of the common debtor. In light of the equitable nature of subrogation, the absence of partial subrogation seems to be intended to insure that the underlying debt is paid before a guarantor may obtain the benefit of any collateral which secures the underlying debt. In addition, the absence of subrogation rights following a partial payment also avoids creating a setting in which the guarantor could be viewed, much like a loan participant, as the holder of an undivided percentage interest in the underlying debt and security. Since guarantors, unlike most compensated sureties, are affiliated with the underlying debtor, the possibility of significant and potentially insuperable conflicts between the guarantor/subrogee and the creditor regarding
enforcement of the balance of the unpaid debt would be profound if a partial guarantor succeeded to rights in the underlying obligation prior to payment in full.

D. The Regents Case: Does Subrogation Really Exist In California?

1. In Regents v. Hartford Acc. & Indem. Co., 21 Cal. 3d 624, 637 (1978), the California Supreme Court refused to exonerate a surety from liability under a performance bond in respect of alleged construction defects following expiration of the statute of limitations as to the underlying obligation and the corresponding destruction of the surety’s status as a subrogee, holding, *inter alia*, that a surety’s payment of the principal debt extinguishes that obligation and precludes enforcement of the principal obligation by the surety as a subrogee of the original creditor. Relying upon Berrington v. Williams, 244 Cal. App. 2d. 130 (1966) which, in turn relied upon Yule v. Bishop, 133 Cal. 574 (1901), for the questionable proposition that the surety’s payment discharges the underlying debt to the extent that no rights of subrogation or “equitable assignment” exist, the Supreme Court viewed a surety’s action against the debtor to recover payments made upon the underlying debt as founded upon an implied right of reimbursement and not based upon subrogation rights under Civil Code Section 2848. *Ibid.*, at 638. This appears to be flatly inconsistent with Civil Code Section 2848 and at odds with numerous California cases holding that a guarantor is subrogated to the underlying creditor’s rights against the principal debtor after the guarantor’s payment of the primary debt. *E.g.*, *In re Bozzo*, 693 F.2d 90, 91 (9th Cir. 1982); *Cf.*, Associated Indemnity Corp. v. Pacific Southwest Airlines, 128 Cal. App. 3d 898, 906 (1982).

2. Apart from the apparent exile of subrogation rights from California jurisprudence, the opinion in Regents also muddled other areas of California law considerably. At issue in Regents was whether expiration of the statute of limitations on the debtor’s underlying obligation exonerated the surety and barred any recovery under a bond issued by a surety. Had the Court recognized the value of a surety’s subrogation rights and focused upon the impairment of such rights by the running of the statute of limitations, a different result might have been reached as to exoneration. However, to bolster this holding, the Supreme Court incorrectly described the leading case of Union Bank v. Gradsky, 265 Cal. App. 2d 40, 44-5 (1968), as premised upon impairment of a guarantor’s implied right of reimbursement, not destruction of a guarantor’s subrogation rights. This conceptual confusion was furthered in Krueger v. Bank of America, 145 Cal. App. 3d 204, 210 (1983) which similarly mischaracterized Gradsky as a case in which “the bank had elected to pursue the remedy of a nonjudicial sale of the security and had thereby destroyed the guarantor’s right to obtain reimbursement from the principal debtor,” as distinguished from impacting upon the guarantor’s subrogation rights.

3. The Regents “analysis” may even undermine the holding in Gradsky which was based upon the apparent destruction of a guarantor’s subrogation rights as a result of a creditor’s election to conduct a non-judicial trustee’s sale prior to proceeding against a guarantor:

   a. If satisfaction of the underlying debt by a guarantor extinguishes the primary obligation, isn’t the security therefore also arguably destroyed?

   b. If so, would there be any difference whether the guarantor satisfies the debt before or after the creditor’s recourse to real property security?
4. **Query:** Are the policies inherent in statutes of limitation frustrated by permitting reimbursement action by guarantor against primary obligor where original creditor’s claims (and, therefore, guarantor’s claims as a subrogee) are barred?

5. **Query:** What if the California anti-deficiency statutes (Code of Civil Procedure Sections 580a, 580b, 580d, 726) are involved?

   Although the guarantor’s reimbursement claim against the debtor would generally appear to be an unsecured claim and, at least arguably, not involve anti-deficiency issues, the ultimate result of *Gradsky* should probably not change due to strong public policy behind the two key components of California’s statutory anti-deficiency scheme, Code of Civil Procedure Sections 580d and 726. *Cf.*, *Regents*, *supra*, note 11 at 640. The overwhelming public policies inherent in such statutes should presumably prevent enforcement of an unsecured post-payment reimbursement claim by a guarantor whenever the creditor’s direct recovery from the debtor would be forbidden. *E.g.*, payment of deficiency by guarantor after creditor’s trustee sale under deed of trust securing primary debtor’s obligations. *See*, *Commonwealth Mortgage Assurance Co. v. Superior Court*, 211 Cal. App. 3d 508 (1989) (mortgage insurer’s contractual indemnity claim against home owner barred under CCP § 580d following insured lender’s completion of a trustee’s sale). *Cf.*, *First Nat’l Park Bank v. Johnson*, 553 F.2d 599, 601-2 (9th Cir. 1977) (debtor’s defense under UCC § 9504(3) against a creditor’s attempt to obtain a deficiency after the creditor’s failure to conduct a “commercially reasonable” UCC sale should be available against guarantor proceeding on reimbursement claim).

**E. What Is the Effect of a Guarantor’s Satisfaction of the Underlying Debt?**


2. *Collection Control Bureau v. Weiss*, *supra*, which strongly criticizes the *Yule v. Bishop* line of cases, and *Flojo International, supra*, are the only cases which attempts to harmonize (or even acknowledge) the existence of the contrary lines of authority.
3. The *Regents* and *Yule v. Bishop* view that payment by a guarantor extinguishes the underlying debt would undermine one of the primary benefits of subrogation: the surety’s right to rely upon any collateral held to secure the underlying debt. The tortured view of *Regents* (and the other progeny of *Yule v. Bishop*) run afoul of the two statutes which codify subrogation rights of guarantors.

4. *Yule/Regents* doctrine is rejected by Article 3 of the UCC with respect to negotiable instruments. See, Section 3415(5). (“An accommodation party is not liable to the party accommodated and if he pays the instrument has a right of recourse on the instrument against such party.”) This distinction between the discharge of an obligor and the discharge of the instrument itself is far more solicitous to the doctrine of subrogation.

**F. Reimbursement Rights Of Guarantors Under California Law**

(A). Reimbursement Triggered by Payment


2. *Civil Code Section* 2847 codifies a surety’s right to obtain reimbursement as follows:

“If a surety satisfies the principal obligation, *or any part thereof*, whether with or without legal proceedings, the principal is bound to reimburse what he has disbursed, including necessary costs and expenses; but the surety has no claim for reimbursement against other persons, though they may have been benefited by his act, except as prescribed by . . . [Section 2848].” (Emphasis added.)


One significant conceptual distinction between reimbursement rights and subrogation principles is that a reimbursement claim would appear generally to be a purely unsecured claim. This differs from the result of subrogation in a setting where the underlying debt is itself secured. See, *Civil Code Section* 2849 (“A surety is entitled to the benefit of every security for the performance of the principal obligation held by the creditor. . . .”).

4. *Partial Payment Triggers Reimbursement Claims.*

Unlike subrogation, a partial payment by a guarantor gives rise to a right to reimbursement on the part of a guarantor or other surety. See, Civil Code § 2847.
(B).  **Secured Reimbursement Claim**

1. If a guarantor of a secured debt is sufficiently troubled by the holding of *Regents* and wishes to maximize the likelihood that it will be subrogated to the creditor’s secured position upon payment, the guarantor may seek to secure the guarantor’s contingent reimbursement claim with a junior deed of trust upon the property which secures the primary obligor’s debt.

2. If the guarantor paid the guaranteed obligation (i.e., the debt secured by the senior trust deed), the guarantor should be subrogated to the senior lienor’s position under Civil Code Section 2904 even if *Regents* is followed. Civil Code Section 2904 provides:

   “One who has a lien inferior to another, upon the same property, has a right:

   1. To redeem the property in the same manner as its owner might, from the superior lien; and,

   2. To be subrogated to all the benefits of the superior lien, when necessary for the protection of his interests, upon satisfying the claim secured thereby.”

3. In addition, even though the reimbursement claim is contingent, California law clearly recognizes the present creation of a present lien upon real property to secure a contingent obligation. See, Civil Code Section 2884 (“A lien may be created by contract, to take immediate effect, as security for the performance of obligations not then in existence.”). Also, the hostility toward subrogation rights of sureties exhibited in the *Regents* case by the California Supreme Court should probably not undermine a surety’s ability to rely upon Section 2904 as a junior lienor. Not only does the lien secure the reimbursement claim of the surety, but the rights available under Section 2904 cover a far broader universe of parties than sureties. Consequently, securing a contingent reimbursement claim in this manner should preserve the possibility of subrogee status for a surety/guarantor in terms of collateral held by the creditor.

XI. **PARTIAL GUARANTIES**

A series of issues arise in the context of a partial guaranty. Some of these issues arise as a function of contract interpretation. Other issues arise by statute.

A.  **Contract Interpretation Issues Raised By Partial Guaranties.**

Provisions limiting a guarantor’s liability to cover only a portion of the underlying debt may give rise to a series of fundamental contract interpretation issues. In the absence of language addressing these concepts, the following types of issues may arise.
1. **Expenses of Collection.**

   (a) If the guaranty limits a guarantor’s liability to a specified dollar amount, are expenses of collection (e.g., attorneys’ fees and court costs) incurred by the creditor in enforcement of the guaranty against the guarantor included as part of the limit?

   (b) Are collection, enforcement and/or foreclosure expenses incurred in connection with the underlying indebtedness covered by the dollar limit?

   **Note:** If collection and enforcement expenses incurred in pursuit of a guarantor are subject to a contractual liability limit, the creditor is, in essence, subsidizing the guarantor’s litigation efforts to avoid liability under the guaranty.

2. **Principal.**

   Does a stated dollar limitation upon a guarantor’s liability apply to all indebtedness and obligations existing in respect of the underlying indebtedness? Or, alternatively, is a stated dollar limitation simply a limit upon the guarantor’s exposure for the principal balance of the underlying debt?

3. **Interest Limitations.**

   Assuming that a specified dollar limitation is intended to apply to the underlying principal balance, is the guarantor responsible for accrued and unpaid interest upon the entire principal balance or will the guarantor only be liable for delinquent interest accrued in respect of the portion of the principal balance covered by the guaranty?

4. **Allocation of Payments.**

   Significant issues may also exist with regard to the allocation of payments made upon the underlying loan. For example, do principal payments made by the underlying obligor apply to reduce the guarantor’s liability? To the extent that the unpaid principal balance, after application of a principal payment by the underlying borrower, remains in excess of the amount covered by the limited guaranty, this may well be a significant issue. **Note:** Language in the underlying loan documents providing for the allocation of payments may also impact significantly on the outcome of these questions.

5. **Foreclosure Proceeds/”Credit Bid.”**

   Similar issues may arise if the creditor forecloses upon collateral securing the underlying borrower’s obligations. Thus, if the creditor makes a “partial credit bid” or receives actual foreclosure sale proceeds, do these amounts reduce the guarantor’s liability under the guaranty? This issue may also be significantly impacted by language in the underlying loan documents providing for the application of foreclosure sale proceeds.
6. **Guaranties of Interest.**

Creditors often obtain a guaranty of interest as distinguished from a guaranty of principal. **Query:** Is a guaranty of interest a guaranty of “a portion of an obligation” within the meaning of Civil Code Section 2822(a)? In other words, can interest be viewed as a separate “obligation” for purposes of Section 2822(a) or will the entire loan be treated as the “obligation”?

Also, guaranties of interest can raise a unique issue in a setting where the creditor forecloses upon its collateral by making a “partial credit bid.” Since the principal balance has not been fully satisfied and remains outstanding, at least in part, interest theoretically continues to accrue in accordance with the underlying loan documents. If so, does the “interest-guarantor” continue to incur liability even though the creditor may then own the collateral?

**B. Statutory Issues: Civil Code Section 2822.**

1. **Civil Code Section 2822.**

Civil Code Section 2822, as amended in 1993, provides the option to a borrower to determine which portion of a partially guarantied obligation has been satisfied by payment. This statutory provision raises perplexing issues for a creditor holding an obligation where a third-party has guaranteed some, but not all, of the obligation.

Civil Code Section 2822 provides:

“(a) The acceptance, by a creditor, of anything in partial satisfaction of an obligation, reduces the obligation of a surety thereof, in the same measure as that of the principal, but does not otherwise affect it. However, if the surety is liable upon only a portion of an obligation and the principal provides partial satisfaction of the obligation, the principal may designate the portion of the obligation that is to be satisfied.

(b) For purposes of this section and Section 2819, an agreement by a creditor to accept from the principal debtor a sum less than the balance owed on the original obligation, without the prior consent of the surety and without any other change to the underlying agreement between the creditor and principal debtor, shall not exonerate the surety for the lesser sum agreed upon by the creditor and principal debtor.” (Emphasis added.)

2. **Impact of Guarantor’s Reimbursement Claim.**

A primary obligor is obligated by statute (see, Civil Code § 2847) to reimburse a guarantor or other surety as to amounts paid by the guarantor. As a result, a borrower has a strong incentive to elect to apply payments to the portion of the indebtedness covered by the guaranty under Civil Code Section 2822(a) in order to reduce both its exposure to the creditor and the surety.
3. **Scope of Statute.**

(a) “Partial Satisfaction.”

Civil Code Section 2822(a) refers to “partial satisfaction.” This phrase is clearly broad enough to encompass (i) volitional payments, (ii) amounts bid and/or received at a foreclosure sale, and (iii) proceeds of collateral applied to the underlying debt (e.g., rents or amounts received upon exercise of collection rights under UCC § 9502).

(b) Civil Code § 2822(a) confers a right upon the borrower. Provisions in a guaranty dealing with “allocation of payments” and “allocation of foreclosure proceeds” are likely to only reach contract interpretation issues at the guarantor level.

4. **Waiver.**

(a) Validity of a waiver of Section 2822(a) by a borrower is subject to Civil Code Section 3268 which establishes a “public policy” standard. Civil Code Section 3268 provides as follows:

> “Except where it is otherwise declared, the provisions of the foregoing titles of this part, in respect to the rights and obligations of parties to contracts, are subordinate to the intention of the parties, when ascertained in the manner prescribed by the chapter on the interpretation of contracts; and the benefit thereof may be waived by any party entitled thereto, unless such waiver would be against public policy.”

(Emphasis added.)

(b) A creditor seeking to extinguish a borrower’s rights under Civil Code Section 2822(a) should obtain waivers from both the borrower and the guarantor. In light of the significant impact upon a guarantor of any election by a borrower under Section 2822 in terms of the guarantor’s liability, a guarantor’s involvement in the waiver process is critical. The guarantor’s waiver should presumably be structured as a consent to the borrower’s waiver and a waiver of any rights the guarantor otherwise has under Section 2822.

(c) Note: Waivers by a guarantor of its rights under Civil Code Section 2822(a) are also encompassed by the broad “pro-waiver” language of newly amended Civil Code Section 2856. This should enhance the validity of a waiver by the guarantor. However, Section 2856 only refers to waivers by a guarantor.

5. **Contribution Claims.**

(a) It is unclear whether an election by a borrower under Civil Code Section 2822(a) which reduces or extinguishes a surety’s obligations under a partial guaranty of the underlying debt similarly reduces the partial guarantor’s liability for contribution claims asserted by other guarantors. If multiple guarantors have each guarantied the same portion of the underlying debt, no significant issue is likely to arise.
(b) However, where a creditor obtains a total guaranty from one guarantor and one or more partial guaranties, the extent to which contribution claims among multiple guarantors are affected can become material. *Note:* this issue also can arise in the context of two or more partial guaranties if the liability of one guarantor covers a larger portion of the underlying indebtedness than the remaining guarantors.

(c) To the extent that contribution claims among and between multiple guarantors can be reduced by virtue of an election under Civil Code Section 2822(a), a creditor may wish to obtain a consent and waiver to the borrower’s waiver of its rights under Section 2822(a) from all guarantors, including a third-party that has guaranteed the entire debt.

C. *Reimbursement Rights of Partial Guarantors.*

1. *Possible Absence of Subrogation Rights.*

   In order for a guarantor or other surety to become subrogated to the rights and remedies of the creditor and any security held to secure the underlying debt, the guarantor/surety must satisfy the underlying obligation in full. Civil Code Section 2848 specifically conditions the exercise of subrogation rights upon full satisfaction of the primary obligation. *Civil Code Section 2848,* provides, in relevant part, that a “... surety, upon satisfying the obligation of the principal, is entitled to enforce every remedy which the creditor then has against the principal to the extent of reimbursing what he has expended ….” (Emphasis added.)

   (a) The requirement of full payment as a condition to subrogee status means, by definition, that a guaranty of part of an obligation (i.e., a partial guaranty) will generally *not* give rise to the right to succeed to the primary creditor’s position with respect to any security or collateral held in respect of the underlying obligation. Perhaps the only exception would arise in a setting where the creditor has recovered a sufficient portion of the underlying debt to reduce the unpaid primary obligation to an amount within the limit of the partial guarantor’s liability at a point in time when other, as yet unexhausted, collateral still exists.

   (b) The absence of *pro tanto* subrogation rights should also minimize the possibility of conflicts arising between the holder of the underlying debt and the partial guarantor in their mutual pursuit of the common debtor. In light of the equitable nature of subrogation, the absence of partial subrogation seems to be intended to insure that the underlying debt is paid before a guarantor may obtain the benefit of any collateral which secures the underlying debt. In addition, the absence of subrogation rights following a partial payment also avoids creating a setting in which the guarantor could be viewed, much like a loan participant, as the holder of an undivided percentage interest in the underlying debt and security. Since guarantors, unlike most compensated sureties, are affiliated with the underlying debtor, the possibility of significant and potentially insuperable conflicts between the guarantor/subrogee and the creditor regarding enforcement of the balance of the unpaid debt would be profound if a partial guarantor succeeded to rights in the underlying obligation prior to payment in full.
2. **Reimbursement Triggered by Payment.**

   (a) Reimbursement rights arise only upon payment of all or a portion of the primary debt by a guarantor. *Regents v. Hartford Acc. & Indem. Co.*, 21 Cal. 3d 624, 638 (1978). *See, United States v. Frisk*, 675 F.2d 1079 (9th Cir. 1982) (government agency which paid third-party’s debt entitled under common law to proceed on reimbursement claim against primary obligor of student loan despite running of statute of limitations barring enforcement of original creditor’s claims as a subrogee).

   (b) Unlike subrogation, a *partial payment* by a guarantor gives rise to a right to reimbursement on the part of a guarantor or other surety. *See, Civil Code Section 2847.*

3. **Statutory Right to Reimbursement.**

   *Civil Code Section 2847* codifies a surety’s right to obtain reimbursement as follows:

   “If a surety satisfies the principal obligation, or any part thereof, whether with or without legal proceedings, the principal is bound to reimburse what he has disbursed, including necessary costs and expenses; ….”

   (Emphasis added.)

4. **Reimbursement Is An Unsecured Claim.**

   One significant conceptual distinction between reimbursement rights and subrogation principles is that a reimbursement claim would appear generally to be a purely unsecured claim. This differs from the result of subrogation in a setting where the underlying debt is itself secured. *See, Civil Code Sections 2848, supra, and 2849* (“A surety is entitled to the benefit of every security for the performance of the principal obligation held by the creditor.…”).

5. **Secured Reimbursement Claim.**

   (a) As noted above, a partial guarantor will generally not possess subrogation rights. Although a partial guarantor will have a statutory reimbursement claim upon payment of any part of the guaranteed debt, a guarantor’s reimbursement claim is *unsecured.*

   (b) If a partial guarantor wants to improve its ultimate chances of recovery upon its reimbursement claim, a guarantor may seek to secure the guarantor’s contingent reimbursement claim.

   (c) Although a reimbursement claim is contingent, California law clearly recognizes the present creation of a present lien upon real property to secure a contingent obligation. *Civil Code Section 2884* (“A lien may be created by contract, to take immediate effect, as security for the performance of obligations not then in existence.”).

   (d) Alternatively, if a partial guarantor satisfies a secured debt in a setting where the guarantor obtains a junior lien upon collateral held by the creditor, the
guarantor may create an alternative basis for subrogation, even if its payment exceeds the amount of its obligation. Civil Code Section 2904 provides:

“One who has a lien inferior to another, upon the same property, has a right:

1. To redeem the property in the same manner as its owner might, from the superior lien; and,

2. To be subrogated to all the benefits of the superior lien, when necessary for the protection of his interests, upon satisfying the claim secured thereby.”

(e) Note: In a bankruptcy context, the reimbursement claim of a guarantor is subordinated by statute to the creditor’s claims. Bankruptcy Code Section 509(c).

D. The Effect Of Assignment By A Co-Obligor

Under California law, a co-obligor is precluded from proceeding as an assignee unless the co-obligor can establish a right to proceed on the basis of subrogation. In Meyers v. Bank of America, 11 Cal. 2d 92 (1938), the Court barred a surety from enforcing an assigned claim:

[T]he conclusion seems inevitable that one who asserts a right of subrogation, whether by virtue of an assignment or otherwise, must first show a right in equity to be entitled to such subrogation, or substitution, and that where such a right is clearly shown by the application of equitable principles, an assignment adds nothing thereto. Otherwise stated, where by the application of equitable principles, a surety has been found not entitled to subrogation, an assignment will not confer upon him the right to be so substituted in an action at law upon the assignment. His rights must be measured by the application of equitable principles in the first instance, his recovery being dependable upon a right in equity, and not by virtue of an asserted legal right under an assignment.

11 Cal. 2d at 96-97 (emphasis added); see also Golden Eagle Ins. Co. v. First Nationwide Fin’l Corp., 26 Cal. App. 4th 160, 167 (1994) (relying on Meyers, the court held that “whether or not there is a formal assignment, the nature and extent of the rights against third parties of the surety who pays a mechanics’ lien claim are determined by the law of subrogation”); Accord American Alliance Ins. Co. v. Capital Nat’l Bank, 75 Cal. App. 2d 787 (1946).

Under California law, five factors must be met before subrogation will be permitted:

(1) Payment must have been made by the subrogee to protect his own interest. (2) The subrogee must not have acted as a volunteer. (3) The debt paid must be one for which the subrogee was not primarily liable. (4) The entire debt must be paid. (5) Subrogation must not work any injustice to the rights of others.

XII. THIRD-PARTY COLLATERAL.

Pearl v. General Motors Acceptance Corp., supra illustrates some of the issues that arise in the context of third-party collateral.

A. Waivers are Critical

1. Accommodation Pledgors as Sureties.

Any third-party who pledges property, whether real or personal, to secure the debts of another is clearly a “surety” within the statutory definition set forth in Civil Code Section 2787.

2. Suretyship Defenses.

In the absence of an appropriate set of suretyship waivers, a third-party providing collateral to secure the debt of another, such as an “accommodation pledgor,” has the ability to assert all of the various suretyship defenses codified in Civil Code Sections 2787 through 2855, inclusive. These defenses include, inter alia, the right to require the creditor to first proceed against the primary obligor or any collateral provided by the primary obligor. In addition, where both the surety and the primary obligor have provided collateral, another Civil Code provision provides the “accommodation pledgor”/surety with the additional right to require that the primary obligor’s primary be pursued before recourse is sought against the surety’s collateral. If waivers of these defenses are absent, the benefits seemingly provided by the surety’s hypothecation of collateral may be lost.

3. Real Property Collateral.

The concern with regard to suretyship waivers is especially critical when a surety has provided real property collateral to secure the obligations of another. If adequate suretyship waivers are not included within the deed of trust executed by the surety, there is a significant possibility that a creditor might be confronted with a debt as to which enforcement may be difficult, if not impossible.

(a) First, it is clear that the “one form of action” rule applies to protect a borrower whose obligations are secured by California real property, even if the real property collateral belongs to a third party. Gnarini v. Swiss American Bank, 162 Cal. 181, 184 (1912). Since the “security-first” exhaustion of collateral mandate of the “one form of action” rule requires a creditor to exhaust its real property before proceeding against a borrower, Security Pacific National Bank v. Wozab, 51 Cal. 3d 991 (1990), a creditor holding third-party real property collateral must proceed against such collateral prior to pursuit of the primary obligor.

(b) However, if the surety has not effectively waived its right to require the creditor to proceed first against the primary obligor, the surety should, by asserting its rights under Civil Code Section 2845, be able to stalemate an attempt by the creditor to pursue judicial foreclosure against the surety’s property. If the creditor then seeks to proceed against the
primary obligor without first having exhausted the real property collateral, the primary obligor should be able to successfully assert an affirmative defense under CCP Section 726. In sum, the absence of suretyship waivers in a third-party collateral setting involving real property creates a significant conflict between two important policies embodied in California law: the statutory suretyship rights and defenses codified in Civil Code Sections 2787 through 2855 and the California anti-deficiency rules.

B. Use of Non-Recourse Guaranty.

Whenever third-party collateral is to be used in a setting where the third-party is not required to guaranty repayment of the debt, consideration should be given to having the third-party collateral secure a non-recourse guaranty as distinguished from having the third-party collateral directly secure the obligations of the primary obligor. There appear to be several benefits in using this structure.

1. Presence of Waivers.

First, the use of a non-recourse guaranty insures the presence of the various suretyship waivers which would typically be contained in a guaranty, thereby obviating the possibility that the creditor might fail to include waivers in a deed of trust or security agreement executed by the surety to “directly secure” the primary obligor’s indebtedness.

2. Automatic Stay.

Secondly, this structure may permit recourse against the surety’s collateral more readily in a setting where the primary obligor has commenced a bankruptcy or reorganization case. To the extent that the third-party collateral directly secures the borrower’s obligation, the debtor-in-possession would appear to be a “necessary party” in any judicial foreclosure action involving the third-party’s collateral. If so, the automatic stay imposed under Section 362 of the Bankruptcy Code would preclude joinder of the primary obligor/debtor-in-possession in the absence of relief being granted. Subject to the possibility of an injunction under Section 105 of the Bankruptcy Code, the use of a non-recourse guaranty to separate the third-party collateral from the primary obligor’s obligations may well obviate these issues entirely.

3. Anti-Deficiency Issues.

In a setting where the third-party surety provides real property collateral, the use of a non-recourse guaranty as the obligation to be secured by the surety’s trust deed avoids providing the primary obligor with gratuitous defenses and rights under Code of Civil Procedure Section 726.


In light of the possible (and unwarranted) expansion of the universe of “future transactions” as to which the rights to revoke a continuing guaranty may exist, the use of a non-recourse guaranty secured by the guarantor’s collateral might minimize the possibility of lien priority issues arising in the context of real property financings. To the extent that “future advances” might provide a “accommodation pledgor” with revocation rights under Civil Code
Section 2815, junior lienors and other intervening lienors might try to characterize such “future advances” as optional rather than obligatory in nature so that priority could be lost or impaired if the senior lienor has knowledge of the junior liens. Since a valid real property lien can be created to secure a contingent obligation, Civil Code Section 2884, a creditor might, conceivably, reduce the availability of the optional/obligatory dichotomy by relying upon a non-recourse guaranty as the obligation secured by the third-party real property collateral to support the view that the potentially optional character of an advance to the primary obligor does not diminish the effectiveness or priority of the lien securing the admittedly contingent obligation evidenced by the non-recourse guaranty.