Enforcing Loan Guarantees In An Anemic Economy: Beware Of The Sham

It is no secret that lenders require loan guarantees in a wide variety of situations. Enforcing the guarantees, however, is becoming tougher in the current economic environment. The guarantor may have signed with optimism, a comfortable net worth or income, and the belief that chances were minimal the guarantee would really be called upon. Of course, few people foresaw the historically significant economic storms of the recent past or the negative effect they would have on the financial strength of borrowers and guarantors. Much has changed. As lenders look to guarantors to help repay loans, guarantors are predictably and increasingly questioning the enforceability of the guarantees.

This article offers some suggestions to minimize the likelihood guarantees will be successfully attacked, particularly as a "sham" in instances where the loan is secured by real estate. The tips offered below are intended to be useful for future transactions as well as instructive for taking remedial measures on existing loans.

The Guarantor's Strategy

Guarantors inclined to push back when a lender calls on the guarantee may claim it is unenforceable for many reasons, including lack of consideration or a lender's failure to follow requirements set forth in California's statutes concerning guaranteed obligations. These direct attacks occur in both commercial (corporate/business) and real estate transactions. The guarantor argues that some failure by the lender cuts off the guarantor's separate liability. Such claims can be often be contained or rendered toothless by careful drafting and ensuring proper waivers are inserted in the guarantee.[1]

A uniquely different strategy drives a "sham guarantee" claim by the guarantor. It arises

[1] The writer assumes, for purposes of this paper, that the form of guarantee contains customary terms, including waiver provisions, found in the forms of most institutional lenders. A thorough discussion of lender liability claims and waivers in guarantees is beyond the scope of this paper.

in real estate transactions where state statutes governing a lender's recourse against the borrower come into play. The guarantor seeks to sidestep the broad obligations of the guarantee by claiming that he, she or it (for simplicity, referred to as "he") actually stands in the shoes of the borrower. California's statutes afford strong anti-deficiency protection to borrowers and limit the lender's recourse rights, particularly after foreclosure. Case law holds that if a sham guarantee claimant can successfully establish himself as a borrower in different clothes, he too is cloaked with these anti-deficiency protections.[2] The lender then loses the guarantor as a secondary source of repayment for the loan unless a judicial foreclosure is undertaken. This will be a blow, as the lender probably took the guarantee because it wanted a means of recovering any deficiency after sale of the real estate collateral under the deed of trust.[3]

Tips For Lenders

The following are some key ways lenders can protect themselves from common attacks on their guarantees, with a particular focus on sham guarantee claims.

Always Document New Consideration If There Is Pre-Existing Debt.

Unless the guarantee is taken at the inception of the transaction, new consideration distinct from that previously given is always needed.[4] Boilerplate language in form guarantees often omits reference to new consideration or provides only a non-descriptive statement that adequate consideration exists, which may be insufficient if challenged. To avoid disputes and support enforceability later, the consideration for a new guarantee should be recited in the loan documents at the time it is being taken. Such consideration often includes a forbearance or waiver of defaults by the lender.

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[2] *River Bank America v. Diller,* 38 Cal.App.4th 1400, 1420 (1995); citing *Union Bank v. Dorn*, 254 Cal.App.2d 157, 158-159 (1967); *Valinda Builders v. Bissner*, 230 Cal.App.2d 106, 112 (1964).

[3] The result can be even worse, however, if the "guarantor" can show the lender violated single action rules imposed by state statutes, in which case the lien on the real estate collateral also may be lost. *In re Prestige Limited Partnership-Concord,* 205 B.R. 427, 429-430 (Bankr. N.D. Cal. 1997; Aff'd. 234 F.3d 1108 (9th Cir. 2000)

[4] California Civ. Code §2792.

<u>Head Off a"Sham Guarantee" Argument If The Loan Is Secured By Real Estate.</u>

The question of whether a guarantee is a "true" guarantee or a "purported" (a.k.a. "sham") guarantee, which cannot be enforced, involves more than simply confirming that different names have been placed on the note and the guarantee. If disputed, a court may look further to determine that a promissory note and a guarantee really represent separate obligations. The factors mentioned below, no one of which is, by itself, determinative, have been assessed by courts when addressing the sham guarantee question.

- *Factor: Was the Lender directing the structure of the transaction? Did the lender engineer a change in the borrowing entity and then require the initially proposed "borrower" to execute a guarantee?*

A lender may establish the credit requirements for a loan (e.g., a requirement that the borrower be a special purpose entity and/or that certain principals guarantee a loan), but should be consistent in its approach and communicate requirements to the borrower early. A lender should also be cautious about overtly requiring, in an ad hoc manner, the replacement of a strong borrowing entity with a financially weak or shell entity to stand in as borrower of a loan, and then requiring the displaced deep pocket party to sign a guarantee. The problem is most acute if the lender first discusses required changes in loan structure late in the process or shortly before a planned closing, when an argument of duress can be raised, or when the newly created borrower does not even hold the real estate. Some courts have expressed the view that this constitutes financial engineering of a type that improperly circumvents anti-deficiency laws.[5]

- *Factor: Whose cash flow will service the loan and whose financial wherewithal is analyzed by the lender?*

[5] *River Bank America v. Diller,* supra, 38 Cal.App.4th at 1423; *Union Bank v. Brummell,* 269 Cal.App.2d 836, 838 (1969).

The lender should document that it is relying primarily on the cash flow of the borrower for repayment. Analysis of the borrower's historic (if it is not a newly formed entity) and future cash flow should be done and the borrowing entity established as the primary source of repayment. A lender should not simply assess the strength of the guarantor. If funds for repayment are going to be augmented by a guarantor, a lender should consider requiring a cash infusion to the borrower.[6]

- *Factor: Is the guarantor already obligated on the loan?*

A borrower's structure can be important here. A trustee will be deemed to have direct liability on a loan to a revocable trust where he also is a trustor. A general partner will have direct liability on a loan to a limited or general partnership. Any guarantees they give will be considered shams.[7] LLC members are not direct obligors under California law and their guarantees are presumed to be separate obligations.[8] Entity structures and relationships, however, are often complicated so the analysis may have wrinkles. For example, in an instance where the settlors of a borrowing trust created a separate LLC, which they controlled, to be the trustee of the borrowing trust, a court found the guarantees of the individual settlors were effective and enforceable.[9]

- *Factor: Is the borrower merely the alter ego of the guarantor?*

This is a variation of the factor above. Alter ego claims require a showing that such a unity of interest and ownership exists that the separateness of entities has ceased. Numerous factors may be assessed to reach a determination that one entity is the alter-ego of another. These include: commingling of funds and other assets among the entities; the failure to maintain corporate or entity formalities (meetings, minutes, etc.); and one person holding out that

[6] *River Bank America v. Diller,* supra, 38 Cal.App.4th at 1421-1423.
[7] *Torrey Pines Bank v. Hoffman,* 231 Cal.App.3d 308, 319, 320 (4th Dist. 1991); *Cadle Company II v. Harvey,* 83 Cal.App.4th 927, 933 (4th Dist. 2000).
[8] *NFT Parcel A LLC v. Marix*, 2009 US Dist Lexis 120331 (C.D. Cal 2009).
[9] *Talbott v. Hustwit,* 164 Cal.App.4th 148, 153 (4th Dist. 2008).

he or she is directly responsible for the liabilities of the other entity.[10] It is helpful for the lender to document the separateness of the borrowing and guarantying entities by showing separate financial statements, accounts, and requirements that organizational formalities be maintained. In the event a guarantor asserts the existence of an alter-ego, the lender's purported knowledge of the connections between the entities will also be important.

- *Factor: Are the documents ambiguous? For example, because of carelessness, does one document indicate a person is a borrower and another document state the person is a guarantor?*

When ambiguity in the documents exists, additional evidence can be admitted to explain the discrepancy. This often works against a lender, however. It is highly advisable that the documents consistently designate a party's proper role as either borrower or guarantor.[11]

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[10] *Associated Vendors, Inc. v. Oakland Meat Company, Inc.*, 210 Cal.App.2d 825, 837, 839 (1962).
[11] *Lane V. Gamboa,* 2003 WL 1827297 (Cal.App. 6 Dist.).