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LOAN GUARANTEES: HEDGING AGAINST A DOWNTURN

John L. Hosack, Esq., Jason E. Goldstein, Esq., Michael Flynn, Esq., Mr. Rick Rodriguez
and Mr. Joffrey Long

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1000 Wilshire Boulevard, Suite 1500

Los Angeles, California 90017

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I. INTRODUCTION

In a typical loan transaction it is common practice to obtain a guaranty of payment from a third party. Frequently, the guarantor is not an unaffiliated third party, but is a business associate, friend or relative of the borrower, who was not compensated for executing the loan guaranty. Accordingly, a substantial number of cases which deal with loan guaranties arise in the context of guarantors who were not represented by counsel and who did not fully understand the extent of the obligation which they had undertaken.

A typical structure, with respect to the smaller real estate loan, is that the principal of the borrower is also the loan guarantor. Accordingly, “Mr. Developer” may be the manager of Developer, LLC, which is the borrower and, in his individual capacity, is the guarantor of the loan. This structure of a guaranty has several imperfections, including the fact that a financially strong independent third party is not guaranteeing the loan and there is the potential for confusion between whether Mr. Developer is acting individually, as a guarantor of the loan to Developer, LLC, or is acting as the manager of Developer, LLC. Frequently, this leads to the guarantor raising the “sham guarantee” defense.

I. INTRODUCTION (cont.)

The issues with the guaranty become more complex when the guaranty agreement is a printed document with waivers in which the guarantor waives all of his statutory rights and protections. Frequently, the guarantor will not be represented by counsel and may not understand the obligations which he is undertaking in his individual capacity as a guarantor.

The recent turmoil in the financial markets raises the additional issue of whether the current “bull market” cycle is nearing the end and should cause lenders to carefully review any proposed new loan guaranty and to review all existing loan guaranties, as a precaution against the day that demand must be made upon those guaranties.

II. OVERVIEW OF LOAN GUARANTY

A. What Is A Loan Guaranty?

B. Why Would a Lender Want One Or More Guarantees?

C. Wall Street Approach (Only *Bad Boy* Carve Outs).

III. DIFFERENT TYPES OF GUARANTEES (1 of 2)

- A. Absolute Express Guaranty/General Continuing Guaranty
- B. Co-Obligor**
- C. Third Party Security
- D. Conditional Guaranty
- E. Payment Guaranty**
- F. Collection Guaranty

III. DIFFERENT TYPES OF GUARANTEES (2 of 2)

- J. Performance Guaranty**
- K. Continuing Guaranty**
- L. Restricted Guaranty**
- M. Downstream Guaranty**
- N. Upstream Guaranty**
- O. Cross-Stream Guaranty**
- P. Completion Guaranty**
- Q. Non-Recourse Carve Out & Springing Recourse Guarantees**
- R. “Exploding” Guarantees**
- S. “Shrinking” Guarantees**
- T. “Creeping” Guarantees**

IV. EXAMPLES OF A DISGUISED LOAN GUARANTY

- A. Co-Obligor**
- B. Third Party Security**
- C. Loan Purchase Agreement**
- D. Master Lease on the Borrower's Encumbered Property**
- E. Unreleased Sellers of Encumbered Property**
- F. Indemnity Agreements when the Indemnitor and the Principal Obligor are Substantially the Same**
- G. Letter of Credit**

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LENDER LIABILITY: *2019 UPDATE*

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V. THE LENDER'S RIGHTS AGAINST THE GUARANTOR

- A. The Lender's right to make demand for payment on the guarantor**
- B. The Lender's right to proceed against any security which the guarantor provided to the Lender**
- C. The Lender's right to file a complaint against the guarantor**
- D. The Lender's right to obtain a prejudgment writ of attachment against the assets of the guarantor**

VI. The Guarantor's Basic Defenses (1 of 4)

- A. Lack of An Enforceable Guaranty**
- B. Lack of Adequate Consideration**
- C. Statute of Frauds**
- D. Statute of Limitations**
- E. Conditions Precedent To Liability**
- F. Express Limits on Scope of Guaranty**
- G. Revocation of Continuing Guaranty**
- H. Failure to Notify Guarantor of Debt**

VI. The Guarantor's Basic Defenses (2 of 4)

- I. Failure to Notify Guarantor of Borrower's Default**
- J. Failure to notify Guarantor of Adverse Matters**
- K. Special Disclosures to Consumer Guarantors**
- L. Material Alteration of Underlying Debt**
- M. Impairment of Collateral**
- N. Failure to Notify Guarantor of Foreclosure Sale**
- O. Deemed "inequitable"**
- P. Nondischargeability of non-debtor party**

VI. The Guarantor's Basic Defenses (3 of 4)

- Q. Failure to Hold Commercially Reasonable Foreclosure Sale**
- R. Release of Co-Guarantors**
- S. Negligent Loan Administration/Breach of Loan Agreement**
- T. Other Increases in Scope of Risk**
- U. Duty to Pursue Borrower/Exercise Collateral First**
- V. Absence of Borrower Default**
- W. Borrower Defenses on Underlying Debt**

VI. The Guarantor's Basic Defenses (4 of 4)

- X. Intercorporate Guaranty As Fraudulent Transfer**
- Y. Recovery of Preferences**
- Z. Automatic Stay**

VII. DRAFTING TIP NUMBER 1:

THE LOAN GUARANTY AND ALL OF THE OTHER LOAN DOCUMENTS SHOULD MAKE CLEAR THE EXACT CAPACITY IN WHICH IT IS EXECUTED BY THE GUARANTOR.

Example: Mary Smith, an individual, not as President of Smith Corporation

VIII. DRAFTING TIP NUMBER 2:

CLEARLY DOCUMENT THAT THE GUARANTOR HAS RECEIVED ADEQUATE CONSIDERATION FOR THE GUARANTY.

Example: Whose name is on the check?

Question: What consideration did the guarantor receive for the loan guaranty?

IX. DRAFTING TIP NUMBER 3:

CONSIDER HAVING THE GUARANTOR PROVIDE AN OPINION OF COUNSEL THAT THE GUARANTOR, AT A MINIMUM, EXECUTED THE LOAN GUARANTY AFTER HAVING RECEIVED LEGAL ADVICE.

Comment: The guarantor's representation by counsel should substantially reduce the guarantor's defenses to the Lender's enforcement of the Loan Guaranty.

X. DRAFTING TIP NUMBER 4:

WHEN THE TERMS OF THE LOAN ARE TO BE CHANGED, MODIFIED OR WAIVED . . .

- A. Inform The Guarantor**
- B. Make The Guarantor's Consent A Condition**
- C. Obtain A Reaffirmation Agreement From All Guarantors.**
- D. Avoid Using Words Such As "Supersede" Or "Replace."**
- E. Use "Amended And Restated."**
- F. If Real Property Collateral Obtain A Modification Endorsement To The Loan Policy Of Title Insurance (Also Make Your Exclusion 3(a) And *Insurance Code* § 332 Disclosures).**

XI. DRAFTING TIP NUMBER 5:

IF THE GUARANTOR IS TO PROVIDE REAL PROPERTY SECURITY TO SUPPORT THE GUARANTY, THEN A COPY OF THE PROPOSED GUARANTY SHOULD BE PROVIDED TO THE TITLE INSURER BEFORE THE GUARANTY IS EXECUTED BY THE GUARANTOR.

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XII. DRAFTING TIP NUMBER 6:

INCLUDE IN THE LOAN GUARANTY AN ALTERNATIVE DISPUTE RESOLUTION PROVISION

- A. Many loan documents have a jury waiver which has not been enforceable in California since 2005: *Grafton Partners LP v. Superior Court (2005) 36 Cal.4th 944*
- B. An ADR provision in a loan guaranty should include the following:
 - 1. A jury waiver
 - 2. A mandatory mediation before any litigation

3. Arbitration

- a) Administration of the arbitration
- b) Procedural rules for the arbitration
- c) Location of the arbitration hearing
- d) Arbitrator's powers
- e) Provisional remedies (i.e., appointment of a receiver, writ of attachment, etc.) and injunctive relief
- f) Selection of the arbitrator (a) time limit for selection
(b) "automatic" selection in the event of an impasse
(c) peremptory challenge of an arbitrator (d) foreclose challenge of an arbitrator

- g) Limits on discovery
 - h) Require the arbitrator to rely only upon admissible evidence
 - i) Require the arbitrator to apply California substantive law
 - j) Require the arbitrator issue a “reasoned” award based upon admissible evidence and substantive California law
 - k) Time limits to commence and conduct the arbitration
 - l) Time limit to issue the award
4. Judicial Reference (as alternative to arbitration)
- (a) need to file a complaint
 - (b) the selection of the referee
 - (c) the location of the hearing

XIII.POTENTIAL GUARANTORS TO BE ALERT TO:

A. Partners of a General Partnership

- *The Moral Guarantee*

B. The General Partner of a Limited Partnership

C. A Limited Partner of a Limited Partnership

- *How do you know if a limited partner changes its status to a general partner after providing a guaranty?*

D. Corporate Officers

E. Corporate Shareholders

F. Guarantor Of The Debt Of A Limited Liability Company

- By statute a member or manager of a limited liability company can separately guaranty the debt of the limited liability company. Corporations Code §17703.04(c) (“Nothing in this section shall . . . affect the liability of a member . . . to third parties . . . Pursuant to . . . a written guarantee . . .”).

- It should be anticipated that the guarantor will assert an alter ego or a “sham” guaranty defense.

G. Friends of the Borrower

H. Relatives of the Borrower

I. Business Associates of the Borrower

XIV.ONE ACTION AND ANTI-DEFICIENCY RULES DO NOT DIRECTLY APPLY TO THE GUARANTOR

A. Code of Civil Procedure § 580(a)

- Fair value rule limiting a deficiency judgment after a nonjudicial foreclosure sale.

B. Code of Civil Procedure § 580(b)

- Prohibiting a deficiency judgment on a purchase money obligation.

C. Code of Civil Procedure § 580(d)

- Prohibiting a deficiency judgment after a nonjudicial foreclosure.

D. Code of Civil Procedure § 726

- **One action and security first rules.**

XV. SHOULD THE ONE ACTION AND ANTI-DEFICIENCY RULES DIRECTLY APPLY TO GUARANTORS

Some Courts And Commentators Have Said: “Yes.”

- *Bank of S. Cal. V. Dombrow* (1996) 39 Cal.App.4th 1457 (depublished)
- *Talbott v. Hustwit* (2008) 164 Cal.App.4th 148 (concurring opinion)
- *Chequers Inv. Assocs., II v. Del Heil* (2001) 2001 Cal.App. Unpub. Lexis 1770 (not certified for publication).
- *Bernhardt, California Mortgages, Deeds of Trust and Foreclosure Litigation (Calif. Cont. Ed of the Bar, Fourth Edition) Section 9:126 et seq., “Arguments for Direct Protection of Guarantors”*

XVI. WHEN A GUARANTOR'S REAL PROPERTY SECURES THE GUARANTY

A. Does The One Form of Action Rule (*Code of Civil Procedure* § 726) Apply?

- **Yes.**

Security Pacific Nat'l. Bank v. Wozab (1990) 51 Cal.3d 991 and
Bayless v. Ames (1929) 207 Cal. 54

B. Does The Anti-Deficiency Rule (*Code of Civil Procedure* § 580(d)) Apply?

- **Unclear.**

C. Letter of Credit

D. Title Insurance

XVII. WHEN A THIRD PARTY PROVIDES COLLATERAL TO SECURE THE PRINCIPAL OBLIGOR'S LOAN

A. No Liability For Loan.

B. Not Liable For A Deficiency Judgment.

C. The One Form of Action Rule (*Code of Civil Procedure* § 726) And The Anti-Deficiency Rule (*Code of Civil Procedure* § 580(d)) **Apply.**

XVIII. THE GUARANTOR'S ABILITY TO WAIVE RIGHTS AND DEFENSES

- A. One Action And Anti-Deficiency Rights And Defenses.**
- B. Suretyship Rights And Defenses.**
- C. Election Of Remedy Rights And Defenses.**
- D. Waivers Authorized By *Code of Civil Procedure* § 2856.**

XIX. RIGHTS AND DEFENSES GUARANTORS WHICH CANNOT BE WAIVED

A. Usury And Other Illegality

WRI Opportunity Loans II, LLC v. Cooper (2007) 154 Cal. App. 4th 525

B. Equitable Defenses (i.e., unclean hands)

California Bank & Trust v. Del Ponti (2014) 232 Cal. App. 4th 162

C. Lender's Lack Of Disclosure To A Guarantor

Sumitomo Bank v. Iwasaki (1968) 70 Cal. 2d 81, 85

XX. RELEASE OF SECURITY

- A. Why Do It? Voluntary or Involuntary?**
- B. Inform All Obligors/Guarantors of Change in Circumstances and Obtain Their Written Consent and Reaffirmation of the Obligation**
- C. Construction Loans In Subdivisions.**
- D. Potential Loss Of Lien Priority To Junior Lienholders**
- E. Endorsement To Title Insurance Policy**

XXI. RELEASE OF AN OBLIGOR OR GUARANTOR

A. Why Do it? Voluntary Or Involuntary?

B. Inform All Obligors/Guarantors Of Change In Circumstances and Obtain Their Written Consent and Reaffirmation of the Obligation.

C. Death, Bankruptcy, Workout

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XXII. ACTIVE INVOLVEMENT BY THE LENDER IN STRUCTURING THE ROLES OF THE “PRINCIPAL OBLIGOR” AND THE “GUARANTOR”

A. Loan Underwriting

B. Distinction Between the Lender Structuring The Roles Of “Principal Obligor” And “Guarantor” And Informing The Borrower Why He/She/It Does Not Qualify for a Loan.

XXIII. THE “SHAM GUARANTY” DEFENSE

Question.

What is it?

Answer:

When Lender, effectively, considered the guarantor to be the primary obligor.

Question:

How *Might* You Obtain A “Waiver” Of The “Sham Guaranty” Defense (In Conjunction With An Opinion Of Guarantor’s Counsel)?

Waiver “Sham Guaranty” Defense. Guarantor acknowledges, agrees, and represents and warrants to Lender that (i) Lender was not involved with, participated in, or advised Borrower or Guarantor with respect to the ownership and/or management structure of Borrower and that such structure was previously and independently created by Borrower and/or Guarantor based upon their own decisions and otherwise based on independent advice obtained by them from their own counsel and consultants, which reasons included separating Guarantor from any liability that may be incurred by Borrower in . . .

XXIV. LSREF2 Clover Property 4, LLC v. Festival Retail Fund I LP

LSREF2 Clover Property 4 LLC v. Festival Retail Fund 1 LP, 2016 Cal.App.Lexis 824

Facts: The Guarantor itself structured the transaction and determined that its affiliate – a *Separate Legal Entity* – would take out the loan and take title to the property to be encumbered.

The Court of Appeal held:

- The borrower and the guarantor were separate legal entities formed before any involvement with the Lender.
- The guarantor could not invoke the *alter ego* or “unity of interest” doctrine because it “. . . would promote an inequitable result, exactly what the doctrine is designed to avoid”

XXV. THE LENDER SHOULD PROVIDE COPIES OF ALL LOAN DOCUMENTS TO THE ESCROW AGENT AND TITLE INSURER BEFORE THE LOAN IS CLOSED

A. Best Practices

B. Protect Yourself From Loan Policy of Title Insurance Exclusions From Coverage 3(a) (created, suffered, assumed, agreed) and 3(b) (matters not known to the insurer, etc.)

C. Methods to Provide Documents

- 1. Link To Documents**
- 2. Documents On Disc**
- 3. Offer In Escrow Instruction To Make Available**

**XXVI. STRATEGIES FOR RECOVERY ON A
GUARANTY**

- A. A Single Action Against the Borrower, All Guarantors and All Security Including the Appointment of A Receiver.**
- B. A Concurrent Non-Judicial (“Trustee Sale”) Foreclosure Sale.**
- C. A Pre-Judgment Writ of Attachment Against the Borrower and All Guarantors.**

XXVII.CONCLUSION

Conclusion

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John L. Hosack, Esq.
Buchalter
1000 Wilshire Blvd., Suite 1500
Los Angeles, California 90017
Tel: (213) 891-0700
E-mail: jhosack@buchalter.com

Mr. Joffrey Long
Southwest Mortgage
17045 Chatsworth Street
Granada Hills, California 91344
Tel: (818) 366-5200
E-mail: info@asksw.com

Michael Flynn, Esq.
Buchalter
1000 Wilshire Blvd., Suite 1500
Los Angeles, California 90017
Tel: (213) 891-0700
E-mail: mflynn@buchalter.com

Jason E. Goldstein, Esq.
Buchalter
18400 Von Karman Ave., Suite 800
Irvine, California 92612
Tel: (949) 760-1121
E-mail: jgoldstein@buchalter.com

Mr. Rick Rodriguez
Rodriguez & Associates
333 S. Grand Ave., Suite 1790
Los Angeles, California 90071
Tel: (213) 617-1163
E-mail: rick@rodriguezadvisory.com

