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**SHAM GUARANTY DEFENSE
AVOIDING UNENFORCEABLE GUARANTIES**

(Business Advisory No. 12)

Banks and other lenders typically require guaranties on real estate loans. If the guarantor(s) for such a loan are the same person(s) or entity(s) that comprise the primary borrower for the loan, the guaranty is unenforceable and the guarantor(s) cannot be held liable for the real estate loans deficiency after foreclosure. This is generally called the sham guaranty¹ defense. It can apply when a partnership, corporation, trust or other venture is the borrower and their principals (partners, shareholders, trustees, etc.) are the guarantors.

This Advisory will explore this loan defense as it has developed under California law; indicating situations where it may apply and methods for lenders to avoid the assertion of the sham guaranty defense.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the mere distribution of this Advisory.

Basic Principles. A guarantor is a person or entity that guarantees the debt of another i.e. the borrower. If the borrower and the guarantor on a loan are one and the same, the borrower and guarantor should have all of the statutory protections afforded by California law to borrowers on such loans, that limits recoveries beyond the real estate securing such loans.

California law treats guarantors differently from a borrower on a real estate loan. A borrower has the protection of California's anti-deficiency legislation --- meaning that if there is a real estate loan default, a lender is generally limited to recovering the real estate (or its value) securing the loan. The lender cannot obtain a deficiency judgment if the real estate is not sufficient to fully repay the loan.

¹ "Guaranty" and "Guarantee" have the same meaning. You may see these words used interchangeably.

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California has a strong public policy limiting recoveries on real estate loans to the real estate securing the loan. The borrower cannot be compelled (allowed) to waive the statutory protections enforcing California's public policy. This public policy is firmly supported by California's courts. *Roseleaf v. Chierghno* 59 Cal. 2d 35 and is embedded in California statutes Cal. Code of Civil Procedure §§ 580a, 580b, 580d, and §§ 726, all of which protect borrowers from deficiency judgments and limit lenders to one method of recovery ("one form of action"). In contrast, these same protections do not extend to guarantors, *Talbott v. Hustwit*, 164 Cal. App., 4d 148. --- and guarantors can waive all anti-deficiency protections.

Key Inquiry. If a guaranty is provided in conjunction with a real estate loan, is it enforceable against the guarantor if the borrower is protected by the anti-deficiency statutes and aligned court cases. Courts have stated that:

- If the borrowers and guarantors are essentially the same, the guaranty is unenforceable; it is a sham guaranty, an improper method attempting to subvert California's strong public policy protecting borrowers on real estate loans.
- If the borrower and guarantor are not essentially the same, the guaranty is valid and is enforceable against the guarantor.

Lenders should be careful and not elicit sham guaranties on real estate loans, recognizing that they are restricted to the recovery of the real estate or its value upon a borrower's default in payments. Guarantors on sham guaranties (and their borrower, since they are essentially the same) should utilize the sham guaranty defense upon a default to gain favorable workout terms on the loan or failing such effort, attempt to defeat, by motion or trial, any deficiency, restricting their lender to the real estate.

Applications. A sham guaranty arises when a borrower and the guarantor on a real estate loan are substantially identical. The courts have recognized the sham guaranty defense and exonerated guarantors in the following situations:

- *Partnerships.* If a guarantor is also a member of the partnership or a general partner of a limited partnership, and the partnership was the borrower, the guaranties are shams, the individual guarantors are not liable, and the recoveries of the lender are restricted to the real estate security.
- *Corporations.* When the guarantors are the shareholders and/or officers for a loan by their corporation, or the reverse, California courts have stated that the sham

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guaranty defense is applicable, relieving the guarantor of all liability on the real estate loans. The borrower on the loan and the guarantor are one and the same.

- *Joint Ventures.* In appropriate circumstances, the California courts have released guarantors of joint venture real estate loans, when the lender was attempting to avoid the application of the anti-deficiency statutes.
- *Trusts.* If a trust is a borrower, a sham guaranty defense exists if the guarantors are the trustors, trustees and primary beneficiaries. But if the guarantors are secondary beneficiaries, the defense would not apply as there would not be a substantial identity of the borrower and guarantor(s).

Conclusion. At the initiation of a real estate loan, the parties, the lender, borrower, and guarantor, should be knowledgeable of the terms they desire and the enforcement possible, given the California public policy and statutes providing anti-deficiency protection and one form of action (judicial or non-judicial foreclosures). Lenders should investigate all the parties to the transaction and insure that there is not substantial identity between the borrower and guarantor, possibly gaining covenants assuring the bank of the difference. Lenders might also be willing to forgo warranties to streamline the transaction, stay within the parameters of the law and not cause unnecessary litigation, rather than having unenforceable guaranties just to have guarantors.

If there has been a default on the real estate loan and if the lender has required sham guaranties with a substantial identity between the borrower and guarantor, the guarantor (and borrower) should utilize the sham guaranty defense to work out the loan's repayment on favorable terms (based on the value of the real estate security) and as to completely eliminate the guaranty and limit the lender to recovery of the real estate through foreclosure.

As always, you should be sure that additional legislation has not been enacted or court decisions rendered, that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. You should discuss your individual situation with us or your own attorney. We look forward to being of assistance to you.

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This Advisory is one of a series of business and tax advisories prepared by the attorneys at the Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author listed above.

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