Loyola of Los Angeles Law Review

Volume 41
Number 3 *Developments in the Law: Complex Litigation in California and Beyond*

Article 7

3-1-2008

Guaranteed Confusion: The Uncertain Validity of Suretyship Defense Waivers in California

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GUARANTEED CONFUSION: THE UNCERTAIN VALIDITY OF SURETYSHIP DEFENSE WAIVERS IN CALIFORNIA

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If you want a guarantee, buy a toaster.
– Clint Eastwood[1]

I. INTRODUCTION

What happens when a borrower's credit is weak, negative, or nonexistent? The lender's conventional response to such uncertainty is to increase interest rates;[2] alternatively, the lender may swiftly deny the loan application.[3] Another time-honored solution for creative lenders and borrowers is the inclusion of a third party with deep pockets or better credit to act as "guarantor" or "surety" in the transaction.[4] The guarantor—perhaps motivated by familial or

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1. THE ROOKIE (Warner Bros. Pictures 1990).

2. One truism of the market is the direct relationship between credit risks and interest rates. *See* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1149 (1979) ("The price a creditor charges for extending credit—the interest his debtor must pay for the privilege of borrowing—varies directly with the riskiness of the loan itself.").

3. *See* Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1568 (1995) (noting that banks "prefer to deny loans to borrowers they perceive as high-risk"); *see also* Brunner v. N.Y. State Higher Educ. Servs. Corp. (*In re* Brunner), 46 B.R. 752, 756 (S.D.N.Y. 1985) ("[O]rdinary commercial lenders . . . may, after investigating their borrowers' financial status and prospects, choose to deny as well as grant credit . . . according to their judgment as to the likelihood of repayment.").

4. The California Civil Code considers the terms "surety" and "guarantor" to be synonymous. *See* CAL. CIV. CODE § 2787 (West 2008) ("The distinction between sureties and guarantors is hereby abolished.").

commercial ties—promises to pay the lender any remaining loan balance if the borrower ultimately defaults.[5]

The suretyship contract frequently proves useful to entrepreneurial borrowers as well.[6] Lines of credit, construction loans, or real property purchases are financed via the entrepreneur's corporate entity.[7] The entrepreneur, who is often a majority shareholder in the corporation, will then personally guarantee the corporation's debts, often "collateralizing" his guaranty by hypothecating other real or personal property.[8]

California suretyship law explicitly grants legal rights and defenses to sureties. These are generally encompassed by sections 2787 to 2855 of the California Civil Code ("Civil Code").[9] But while these provisions are theoretically available, lenders have historically used their financial leverage to request (read: demand) that the statutory defenses be waived.[10] Virtually every guaranty executed in California contains suretyship defense waivers.[11]

Waivers are omnipresent because lenders are reluctant to fund transactions where both primary and secondary obligors may escape repayment liability, the former by insolvency and the latter by operation of law. Consensually limiting the surety's rights and defenses assures the lender of *some* recovery in the event of the principal debtor's default.

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5. *See id.* ("A surety or guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.").

6. *See* Roy S. Geiger & Michael A. Allen, *Fool With a Pen: The Use of Single Purpose Entities in Real Estate Loans has Raised New Issues for Lenders and Guarantors Alike*, L.A. LAW., Jan. 2006, at 35, 38 (noting that a "large proportion of real estate loans today are made to single purpose entities (SPEs)"). A major consideration in transactions involving entrepreneurial borrowers is the so-called "sham guaranty." A sham guaranty might appear where the entrepreneur has merged his distinct personal and corporate identities, neglecting the strictures of corporate decision making and management. *See* Valinda Builders, Inc. v. Bissner, 40 Cal. Rptr. 735 (1964). If the surety and principal debtor are actually alter egos, the surety may seek to claim protection under California's debtor-protection statutes. *See* River Bank America v. Diller, 38 Cal. App. 4th 1400 (1995).

7. *See* Geiger & Allen, *supra* note 6, at 35.

8. The secured guaranty is a longstanding feature of California real property finance. *See* Garretson Inv. Co. v. Arndt, 144 Cal. 64 (1904).

9. *See* CAL. CIV. CODE §§ 2787–2856 (West 2008).

10. *See* Andrew A. Bassak, Comment, *Secured Transactions Guarantors in California: Is It Time to Reevaluate the Validity and Timing of Waivers of Rights?*, 32 SANTA CLARA L. REV. 265, 280 (1992).

11. CAL. BANKERS ASS'N, SENATE FLOOR BILL ANALYSIS: A.B. 3101, at 3 (1994) (analyzing A.B. 3101, S. 1993-1994, Reg. Sess. (Cal. 1994)).

Because guaranties with defense waivers are widely used, California lenders have made extensive efforts to ensure waiver enforceability through legislative action.[12] But historically, judicial review of these waivers has not been lender-friendly, at times operating to limit enforceability and restore statutory rights to embattled sureties.[13] An atmosphere of uncertainty has traditionally surrounded these provisions, and recent events have worked to increase this confusion.

Part II of this Note examines the history of California suretyship defense waivers since the mid-twentieth century and discusses the historical uncertainty surrounding waiver validity. It also details the California legislature's 1994 efforts to ensure lender-friendly decisions in waiver contests. Part III argues that the legislature's hopes for strong suretyship waivers have not come to fruition. A recent decision by the California Court of Appeal, *WRI Opportunity Loans II, LLC v. Cooper*,[14] restores some of the "traditional" uncertainty surrounding defense waivers. Part IV proposes draft legislation to reaffirm the enforceability of these provisions and ameliorate the confusion in this arena—at least in part.

II. LEGAL FRAMEWORK

A. Judicial Evaluation of Suretyship Defense Waivers Through 1994

The surety's obligation is not of recent vintage, though its precise heredity is somewhat unclear. According to Oliver Wendell Holmes's history of contract doctrines in *The Common Law*, the suretyship contract has been enforceable at law since at least the reign of King Edward III in the fourteenth century.[15] Holmes remarks that "the surety of ancient law was the hostage" and that "one of Charlemagne's additions to the *Lex Salica* speaks of a

12. *See generally* CAL. CIV. CODE § 2856 (West 2008). Unless otherwise indicated, all textual references to "sections" are intended to indicate the equivalent portions of the California Civil Code.

13. *See infra* notes 30-69 and accompanying text.

14. 65 Cal. Rptr. 3d 205 (Ct. App. 2007).

15. *See* OLIVER WENDELL HOLMES, THE COMMON LAW 249 (Little, Brown and Co. 1923) (1881), *available at* http://biotech.law.lsu.edu/Books/Holmes/claw_c.htm.

freeman who has committed himself to the power of another by way of surety."[16]

Historically, courts of equity developed numerous defenses for sureties from whom payment was sought.[17] California codified these rights and defenses in 1872, basing them on the Field Code, which was itself a product of the common law.[18] Some of the key suretyship rights and defenses included in the California Civil Code are:

(1) Section 2809 (exonerating a surety if the surety's obligation exceeds that of the principal debtor);[19]

(2) Section 2819 (exonerating a surety if the creditor alters the principal debtor's obligation or the creditor impairs his own rights against the principal debtor);[20]

(3) Section 2845 (exonerating the surety if the creditor does not pursue the principal debtor first, or impairs the surety's subrogation rights);[21] and,

(4) Section 2848 (affirming that the surety has the right of "subrogation,"; allowing the surety to exercise every remedy against the principal debtor that had been available to the creditor after the surety satisfies the principal obligation).[22]

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16. *See id.* To illustrate the historical ties between the taking of hostages and suretyship, Holmes describes a medieval story involving Charlemagne:

> In the old metrical romance of Huon of Bordeaux, Huon, having killed the son of Charlemagne, is required by the Emperor to perform various seeming impossibilities as the price of forgiveness. Huon starts upon the task, leaving twelve of his knights as hostages. He returns successful, but at first the Emperor is made to believe that his orders have been disobeyed. Thereupon Charlemagne cries out, "I summon hither the pledges for Huon. I will hang them, and they shall have no ransom."

Id. at 248. As Holmes points out, to secure his performance of the "seeming impossibilities," Huon has "produc[ed] some of his friends as hostages." *Id.* Essentially, the hostages *guaranteed* Huon's performance with their lives—quite a secondary obligation!

17. *See* Geiger & Allen, *supra* note 6, at 35.

18. *See* U.C.C. COMMITTEE, CAL. STATE BAR, 2002 CALIFORNIA COMMENTARY ON RESTATEMENT OF THE LAW THIRD, SURETYSHIP AND GUARANTY 1 (2002), *available at* http://www.calbar.ca.gov/calbar/pdfs/sections/buslaw/ucc/2002_california-commentary-on-restatement-of-the-law-third-suretyship-and-guaranty.pdf.

19. *See* CAL. CIV. CODE § 2809 (West 2008).

20. *See id.* § 2819.

21. *See id.* § 2845.

22. *See id.* § 2848.

Another key defense appears in section 2810.[23] Section 2810 generally operates to relieve the surety of the debt if the principal debtor was not liable for performance at the time the principal obligation was formed.[24]

The California Supreme Court most notably cited section 2810 in an illegal-contract claim.[25] In *Wells v. Comstock*,[26] the court found a certain primary obligation to be an illegal contract provision and concluded that the principal debtor could never be held liable for performance.[27] Citing section 2810 as authority, the court then relieved both principal debtor *and* surety of any obligation.[28] The language of section 2810 seems to justify the result in *Wells*, providing that a surety is generally "not liable if . . . there is no liability on the part of the principal" upon contract formation.[29]

In addition to the statutory defenses, certain key defenses have arisen from California case law. A defining decision in this regard was *Union Bank v. Gradsky*.[30] The *Gradsky* decision is notable both for the "*Gradsky* defense" it formulated and for its analysis affirming the validity of certain contractual waiver provisions.

In *Gradsky*, a lender furnished construction financing, taking real property security from the principal debtor and a personal guaranty from the project contractor, Max Gradsky.[31] Gradsky's guaranty documents contained only a very general waiver provision, stating "I waive . . . any right to require the holder of this within instrument to proceed against [me] . . . or to apply any security it

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23. *See id.* § 2810.

24. Section 2810 states in pertinent part:

> A surety is liable, notwithstanding any mere personal disability of the principal . . . but he is not liable if for any other reason there is no liability upon the part of the principal at the time of the execution of the contract, or the liability of the principal thereafter ceases . . . .

Id.

25. Wells v. Comstock, 297 P.2d 961 (Cal. 1956).

26. *Id.*

27. *See id.* at 964 (noting that "the principal obligation of the contract is unenforceable because of illegality").

28. *See id.* (citing, inter alia, section 2810 to conclude that "[s]ince the principal obligation of the contract is unenforceable because of illegality, the guaranty too is unenforceable").

29. CAL. CIV. CODE § 2810 (West 2008).

30. 71 Cal. Rptr. 64 (Ct. App. 1968).

31. *See id.* at 66.

may hold or to pursue any other remedy."[32] After the principal debtor defaulted, the lender sold the real property at a trustee's sale and sought to collect the remaining loan balance from Gradsky.[33]

The *Gradsky* court began its decision by rewinding history and untangling the transaction. Its first task was to determine the scope of Gradsky's rights when the principal debtor initially defaulted.[34] A key determination in that regard was the scope of the waiver in Gradsky's guaranty.[35] With very little analysis, the court adopted a relatively wide construction of the language. Although the waiver made no reference to statutory defenses, it was held to effectively waive *both* sections 2809 and 2845.[36] The court stated:

> Civ[il] Code §§ 2809 and 2845 . . . respectively, provide that a surety's obligation must not be more burdensome than that of the principal obligor, and a surety has the right to require the creditor to exhaust his remedies against the debtor and any security before he pursues the surety or guarantor. [Gradsky] specifically waived the benefits of those sections in his guarantee agreement in the Bank's favor. That waiver effectively foreclosed him from asserting those statutory rights . . . .[37]

Thus, the court determined that at the time of the principal debtor's default, the bank had an immediate remedy: demanding full payment of the remaining loan balance from Gradsky.[38] Thanks to Gradsky's waiver of sections 2809 and 2845, he was powerless to require any initial pursuit of the principal debtor and/or security.[39]

The court then considered the state of the parties' rights if the bank had immediately pursued Gradsky and collected the full remaining loan balance.[40] If Gradsky had paid the bank, the court

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32. *Id.*

33. *See id.*

34. *See id.* at 68 (determining that "the rights [Gradsky] would have acquired from the Bank had [he] paid [the principal]'s debt to the Bank before the Bank resorted to the security").

35. *See id.* at 67 n.3.

36. *See id.*

37. *Id.*

38. *See id.* at 67.

39. *See id.* (noting that the bank "could have sued [Gradsky] upon his guarantee for the full amount of the unpaid balance . . . without proceeding against either [the principal debtor] or the security").

40. *See id.* at 67–68.

observed that he would have been subrogated to the bank's rights against the principal debtor.[41] As such, Gradsky would have "acquired all of the rights which the Bank had against" the principal.[42] Because the bank held real-property security, the rights acquired by Gradsky would have included the right to foreclose—whether through a judicial action or under power of sale in the trust deed.[43]

In addition to citing these considerations, the court set forth the bank's alternative remedies at the time of the principal debtor's default. The court noted that rather than collecting from Gradsky immediately, the bank had two other available options. One alternative for collection could have been a judicial foreclosure action, joining both Gradsky and the principal debtor.[44] Another option would have been a trustee's sale.[45]

Next, in a key portion of the opinion, the court determined that each of the bank's three collection alternatives would have different effects on Gradsky's post-subrogation rights.[46] If the bank proceeded to immediately collect from Gradsky, he would have had robust rights after subrogation.[47] Gradsky also would have maintained post-subrogation rights in the event that the bank judicially foreclosed, joining Gradsky and the principal debtor.[48] The judicial action would have preserved Gradsky's rights by allowing him to file a cross-claim for contribution against the principal debtor.[49]

The court determined, however, that the bank's third collection option—a nonjudicial sale of the property—would irreparably damage Gradsky's post-subrogation rights.[50] Under section 580d of the California Code of Civil Procedure,[51] a creditor and his assigns are forever barred from further debt collection efforts (also called a

41. *Id.* at 68.

42. *Id.*

43. *See id.* (stating that Gradsky "would have obtained by subrogation the right to pursue either judicial or nonjudicial sale of the security").

44. *Id.* at 67.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.* at 67–68.

49. *Id.*

50. *Id.* at 68.

51. CAL. CIV. PROC. CODE § 580d (West 2008).

"deficiency judgment") after the creditor elects to satisfy an unpaid debt through a nonjudicial sale of the real-property security.[52] Thus, through the operation of section 580d, the bank's nonjudicial sale of the real-property security would fully destroy the future rights of any creditor, including the subrogated Gradsky.[53]

In light of these considerations, the court ruled in Gradsky's favor.[54] In sum, the court found that the bank had a selection of potential remedies and that certain remedies would have preserved Gradsky's rights.[55] However, the bank selected the one remedy that destroyed Gradsky's post-subrogation rights, a nonjudicial sale of its security. Thus, "[u]pon the Bank's electing to pursue a remedy which destroys both the security and the possibility of the surety's reimbursement from the principal debtor, the creditor is thereafter estopped from pursuing the guarantor . . . ."[56] The estoppel-based "*Gradsky* defense" was born, and Gradsky was exonerated.[57]

In the wake of *Gradsky*, lenders began to alter the waivers included in guaranty documents, drafting them with the *Gradsky* defense in mind. With valid *Gradsky*-defense waivers, lenders aimed to ensure that choosing nonjudicial foreclosure would not impact their ability to collect debt payment from a surety. Until the lender-heartburn-inducing decision in *Cathay Bank v. Lee*,[58] lenders believed that their drafting was effective.

In *Cathay Bank*, a bank loaned $5.2 million to a corporate debtor, securing the principal obligation with both real property and a personal guaranty from one of the corporation's directors, Tom Y. Lee.[59] In a series of events similar to *Gradsky*, the corporation defaulted on its obligation. The lender then foreclosed, sold the real property at a private sale, and obtained summary judgment against Lee for the balance of the loan.[60]

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52. *Gradsky*, 71 Cal. Rptr. at 68–69.

53. *See id.* at 69 ("Because of section 580d neither the Bank nor the guarantor can recover a personal judgment from the debtor after a nonjudicial sale of the security.").

54. *Id.*

55. *See id.* at 68–69.

56. *Id.* at 69.

57. *Id.* at 70.

58. 18 Cal. Rptr. 2d 420 (Ct. App. 1993).

59. *See id.* at 420.

60. *See id.*

On appeal, Lee asserted the *Gradsky* defense.[61] In response, Cathay Bank presented the detailed and extensive suretyship waiver provisions, which were seemingly designed in contemplation of the *Gradsky* defense.[62] The key provision of Lee's guaranty documents stated:

> Guarantor authorizes bank at its sole discretion . . . to: . . . exercise any right or remedy it may have with respect to . . . any collateral . . . [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.[63]

The provision might appear to waive chapter and verse of *Gradsky*.[64] However, the appellate court stated that "it [was] not an easy question" to determine whether the provision was an "explicit" *Gradsky* waiver.[65] The court read *Gradsky* to permit sureties a "*defense* based on estoppel."[66] Because the language in Lee's guaranty referred only to Lee's "rights" and "[did] not provide the reader with any actual awareness of the *Gradsky* defense" or section 580d of the California Code of Civil Procedure,[67] the court construed

61. *See id.*

62. *See id.* at 421.

63. *See id.* at 421 n.4.

64. The language of Lee's waiver provision echoes passages of the *Gradsky* holding. The *Gradsky* court explicitly disfavored "the Bank's . . . remedy which *destroys* both the security and the possibility of the surety's reimbursement . . . ." Union Bank v. Gradsky, 71 Cal. Rptr. 64, 69 (Ct. App. 1968) (emphasis added). Compare the *Cathay Bank* waiver, stating that "[g]uarantor authorizes bank at its sole discretion . . . [to] exercise any right or remedy . . . . even though any rights which Guarantor may have against others might be . . . *destroyed*." *Cathay Bank*, 18 Cal. Rptr. 2d at 421. (emphasis added).

65. *Cathay Bank*, 18 Cal. Rptr. 2d at 422.

66. *See id.* at 423.

67. *See id.* at 425. Ironically, the *Gradsky* holding included an expansive reading of a bland, brief suretyship defense waiver. However, *Cathay Bank*, a case centrally focused on *Gradsky*, presupposed a narrow reading of an extensive, detailed waiver. *See supra* notes 29–30 and accompanying text.

the waiver in Lee's favor,[68] relieving him of any obligation to the bank.[69]

*B. Legislative Intent Post-*Cathay Bank*: The Addition of Section 2856*

It is difficult to overstate lenders' concern regarding suretyship defense waivers in the wake of *Cathay Bank*.[70] From a lender's perspective, the *Gradsky* decision can hardly be labeled a clear resource for gauging waiver effectiveness. It was less than specific about the nature of enforceable waiver language. While finding that broad language was sufficient to waive certain statutory defenses, the court also validated a new form of suretyship waiver based in the operation of section 580d of the California Code of Civil Procedure.[71]

After lenders responded by drafting waivers including the *Gradsky* defense, the *Cathay Bank* decision compounded their confusion. If the numerous, detailed provisions in Lee's guaranty were insufficiently explicit to waive certain defenses, how might courts construe the waivers in virtually every other California guaranty?[72] These concerns extended beyond the waivers examined in the specific factual contexts of *Gradsky* and *Cathay Bank*, to include worries about all forms of suretyship waivers.

Lenders noted that it would be impossible to draft reliable suretyship documents with no clear guidance on future judicial review and intervention.[73] Even Cathay Bank's relatively careful

68. In another ironic twist, the *Cathay Bank* court found the challenged waiver provision to be *both* excessively thorough and insufficiently specific. Initially, the court found that the waiver did not specifically explain the *Gradsky* "*defense*." *Cathay Bank*, 18 Cal. Rptr. 2d at 423 (emphasis in original). Yet the court also remarked that the waiver's details were "hard[] to understand . . . . We dare say the average person would never figure it out." *Id.* at 425.

69. Rather than remanding the case for further findings about whether Lee's *conduct* might have constituted a *Gradsky* waiver, the California Court of Appeal reversed the trial court's judgment. *See Cathay Bank*, 18 Cal. Rptr. 2d at 425.

70. *See, e.g.*, CAL. BANKERS ASS'N, *supra* note 11, at 4 ("[T]he ability of lenders was shattered by the *Cathay* decision.").

71. *See supra* notes 36-39 and accompanying text.

72. *See* CAL. BANKERS ASS'N, *supra* note 11, at 4 (observing that "commercial lenders taking a security interest in California real estate are now essentially clueless regarding what magical wording for a *Gradsky* waiver" would be enforceable at law).

73. *See id.* (noting that lenders were "clueless" regarding "what the next [waiver] decision is likely to hold").

drafting was ineffective to ensure waiver enforceability.[74] The concern and criticism regarding *Cathay Bank* moved lenders and legislators to take responsive action.[75]

In May 1994, the California State Assembly Committee on Banking and Finance considered A.B. 3101, introduced by Assemblyman Louis Caldera.[76] The bill proposed an amendment to the California Civil Code through the addition of section 2856.[77]

Under the then-proposed section 2856(a) (now enacted as law), sureties would be expressly permitted to waive the *Gradsky* defense and all common law rights and defenses (embodied in sections 2787 to 2855 of the California Civil Code).[78] They would also be permitted to waive other additional rights based on subrogation and contribution.[79]

Under the proposed section 2856(b) (also currently-enacted), broad suretyship waivers of the rights and defenses in 2856(a) would be considered presumptively valid. Indeed, the goal was to make these waivers "effective whether or not [they] contain[ed] references to specific statutory provisions or judicial decisions."[80]

As the bill passed through the California Assembly and Senate, legislators were privy to key bill analyses explaining the effect and intent of the measure.[81] Certain key analyses pointed with alarm to the *Cathay Bank* decision and discussed only the uncertainty surrounding *Gradsky* waivers.[82] However, their language also hints at legislative aims to reinforce and strengthen the validity of all suretyship defense waivers—whether the surety's defenses were grounded in *Gradsky*, the California Civil Code, or elsewhere.

In the state senate, one bill analysis noted that "[i]n the absence of legislative guidance, the use of a guaranty . . . is a very risky proposition since the adequacy of *any waiver language* cannot be reasonably predicted and may not be known until tested in

74. *See id.*

75. *See id.* at 2, 3 (citing *Cathay Bank v. Lee* as an explicit justification for the addition of section 2856 to the California Civil Code).

76. *See id.* at 1.

77. 1994 Cal. Stat. 1422.

78. *See* CAL. CIV. CODE § 2856(a) (West 2008).

79. *See id.*

80. CAL. CIV. CODE § 2856(b) (West 2008).

81. *See* CAL. BANKERS ASS'N, *supra* note 11.

82. *See id.*

court . . . ."[83] This remark points to the legislature's more general concern with all types of suretyship waivers, beyond just the *Gradsky/Cathay Bank* context. Combined with other portions of the bill analyses, these remarks justify viewing section 2856 as a remedial action to end uncertainty about the viability of *all* suretyship defense waivers.

Another justification for viewing section 2856 as a sweeping measure—altering California law as to all suretyship defense waivers—appears in the same legislative analysis highlighted above. The analysis considered the potential effects of the proposed section 2856(b), stating:

> Under existing law, when a contract is interpreted, any uncertainty will be interpreted against the party who has written the contract.
>
> Usually, guaranties are written by the lender . . . . This bill would allow a waiver to stand even if it is not explicit as to what defenses are being waived. Thus, contrary to existing law, uncertainties will be decided in favor of the lender who has drafted the contract.[84]

This passage indicates that section 2856(b) was a provision that broke with the current state of the law, causing suretyship waivers to be presumptively interpreted in the lender's favor. But more importantly, the analysis also points out that the intent was to strengthen all suretyship defense waiver provisions.[85] Waivers would be validated without regard to their specific language, their citations to case law, or their reference to statutory provisions.[86] Thus, a broadly worded suretyship defense waiver, which might otherwise have triggered exacting scrutiny for proper phrasing and explanations, would be validated under the new section 2856.

The legislative analyses of the proposed section 2856 outlined an expansive vision for suretyship defense waivers. Although the legislature's uncodified intent language indicated that the amendment would not alter existing law,[87] the text of the bill

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83. *See id.* at 5.

84. *See id.* at 6 (citations omitted).

85. *Id.*

86. *Id.*

87. *See* WRI Opportunity Loans II, LLC v. Cooper, 65 Cal. Rptr. 3d 205, 221 (Ct. App. 2007) (deferring to legislative statement that section 2856 was "declarative of existing law").

analyses sends a different message. At the time the measure was considered, the changes proposed were indeed "contrary to existing law."[88] They aimed to cement the validity of all suretyship defense waivers—even where specific defenses were not referenced in the transaction documents—and to limit the interpretation of waivers in a lender-unfriendly manner.

III. CRITIQUE OF EXISTING LAW

Following the addition of section 2856, the validity of suretyship defense waivers was generally uncontested. Yet despite lenders' seemingly strong position, a recent decision by the California Court of Appeal, *WRI Opportunity Loans II, LLC v. Cooper*,[89] promises to renew lender uncertainty in this arena.

In *WRI*, the court allowed a surety to assert an "illegality" defense—heretofore believed to be derivative of rights in section 2810—in the face of a clear section 2810 waiver.[90] The surety was allowed to avoid liability under a theory barring "the enforcement of illegal transactions."[91] Therefore, the result calls into question the validity of guaranties in transactions where the primary obligation is (or could be) so invalidated.

Because section 2856 aimed to reduce uncertainty and generally produce lender-friendly outcomes in waiver contests, the decision in *WRI* is a clear departure from these goals.

A. Understanding WRI

The *WRI* dispute concerned a typical property development transaction. Ronald and Ellen Cooper formed an entity, Cooper Commons, LLC, for the purpose of developing sixty-two condominiums.[92] WRI Opportunity Loans II, LLC ("WRI") provided $2.5 million of Cooper Commons's project financing.[93] WRI's loan to Cooper Commons was secured by both a junior lien

88. CAL. BANKERS ASS'N, *supra* note 11, at 7.
89. 65 Cal. Rptr. 3d 205 (Ct. App. 2007).
90. *Id.* at 219.
91. *Id.* at 221.
92. *Id.* at 209.
93. *Id.*

on the development property and individual personal guaranties from the Coopers.[94]

Approximately two years after WRI's initial loan, Cooper Commons agreed to significantly increased interest rates and a complex additional sum based on the satisfaction of certain contingencies.[95] The Coopers again signed personal guaranties for the amended Cooper Commons obligations.[96] The personal guaranties included provisions explicitly waiving the Coopers' statutory suretyship defenses, including section 2810.[97]

By 2002, Cooper Commons had paid neither interest nor principal to WRI.[98] WRI turned to the Coopers, seeking payment on their personal guaranties.[99] When the Coopers failed to pay, WRI filed suit for breach of the guaranties.[100] After WRI obtained a summary judgment of approximately $6.6 million,[101] the Coopers appealed.

At summary judgment and on appeal, the Coopers asserted a usury defense, claiming that WRI had charged Cooper Commons usurious interest on its primary obligation.[102] WRI responded by: (1) claiming that the Cooper Commons obligation was not, in fact, usurious; and (2) arguing that the Coopers' usury defense was encompassed by section 2810, a statutory defense the Coopers had specifically waived.[103]

B. The Decision in WRI

The Second District Court of Appeal initially examined the nature of WRI's loan to Cooper Commons and concluded that the loan was usurious.[104] But in the most interesting portion of the

94. *See id.*

95. *See id.*

96. *See id.*

97. *See id.* The provision in question stated, "Guarantor affirms its intention to waive all benefits that might otherwise be available to Guarantor or Borrower under . . . Civil Code Sections 2809, 2810 . . . among others." *Id.*

98. *See id.* at 210.

99. *Id.*

100. *See id.*

101. *See id.*

102. *See* Brief of Appellants at 20–21, *WRI*, 65 Cal. Rptr. 3d 205 (No. B191590).

103. *See* Brief of Respondent at 2, 32, *WRI*, 65 Cal. Rptr. 3d 205 (No. B191590).

104. *See WRI*, 65 Cal. Rptr. 3d at 218.

opinion, the court examined the interaction between the Coopers' usury defense and section 2810.

In this second portion of *WRI*, the court stated that at the time section 2856 was added, "existing law" permitted sureties an illegality defense based on a common law "rule against . . . illegal transactions" that was not grounded in the California Civil Code.[105] Because the legislature did not intend to alter "existing law" when it enacted section 2856,[106] the illegality defense survived to the Coopers' arsenal in *WRI*.[107] The court reasoned that because the illegality defense existed independently from section 2810, WRI's section 2810 waiver arguments were inapposite.

To identify the "existing law" at the time the legislature was debating section 2856, the court cited a sentence of the *Wells v. Comstock* decision, finding that the Coopers' usury defense was based on a "public policy" rule "against the enforcement of illegal transactions."[108] In *Wells*, the Supreme Court did exonerate a guarantor by holding that "[s]ince the primary obligation was illegal and unenforceable, the guaranty too is unenforceable."[109] However, the Supreme Court cited *both* section 2810 *and* section 117 of the First Restatement of Security as authority.[110]

The *WRI* court seized upon the *Wells* string citation to section 117.[111] The court located a passage in comment d to section 117 that, they claimed, provided an "independent" rationale for allowing guarantors to assert illegality defenses and, by extension, usury defenses.[112] The portion of comment d so identified stated that "[w]here the principal's promise is itself illegal in its inception, and the performance of the surety's contract is subject to the laws of the same jurisdiction . . . it is against public policy to give legal effect to the surety's obligation."[113]

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105. *Id.* at 221 (citing Wells v. Comstock, 297 P.2d 961, 964 (Cal. 1956)).

106. *Id.*

107. *See id.* ("[T]he Coopers' waiver of their defenses . . . was ineffective regarding their usury defense.").

108. *Id.* at 220–21.

109. *Wells*, 297 P.2d at 964.

110. *See id.* In addition to citing the authorities discussed, the *Wells* court also cited *Jack v. Sinsheimer*, 58 P. 130 (Cal. 1899).

111. *WRI*, 65 Cal. Rptr. 3d at 220.

112. *Id.* at 221.

113. *See id.* at 220 (citing RESTATEMENT (FIRST) OF SECURITY § 117 cmt. d (1942)).

This mere comment to the Restatement of Security, dignified by the *WRI* court as a "rule against the enforcement of illegal transactions," apparently served as the linchpin of the court's analysis.[114] With comment d to section 117 of the Restatement as their major premise, the court reasoned that the Coopers did not waive their usury defense.[115]

C. Re-Evaluating Section 2856: Was the Statute "Declarative of Existing Law"?

The first and most distinct area of concern in the *WRI* decision is the court's approach to analyzing section 2856. After determining that pre-1994 California law permitted sureties a usury defense based on common law, the court examined the effects of section 2856—an amendment enacted to clarify suretyship defense waivers.[116] Concluding that the addition of section 2856 did not displace the Coopers' usury defense, the court relied on the legislature's statement that section 2856 was merely "declarative of existing law" at the time.[117]

Such reliance was unwarranted. As the California Supreme Court remarked, "[a] legislative declaration of an existing statute's meaning is neither binding nor conclusive."[118] When interpreting an ordinance prefaced with language declaring existing law, the California Court of Appeal remarked that "[t]his statement is the beginning, but not the end, of our analysis."[119]

As the legislative history of section 2856 indicates, there is reason to doubt the legislature's statement that section 2856 was merely declarative of existing law. The legislative analyses examining the proposed bill specifically expressed concern about reinterpretation of all types of waiver provisions.[120] Additionally, the language of section 2856(b) contravened prior California court decisions regarding waivers by trying to ensure lender-friendly

114. *Id.*

115. *See id.* at 221–222 (noting that WRI "failed to establish a valid waiver of the Coopers' usury defense").

116. *Id.* at 221.

117. *Id.*

118. W. Sec. Bank v. Superior Court, 933 P.2d 507, 514 (Cal. 1997).

119. Riley v. Hilton Hotels Corp., 123 Cal. Rptr. 2d 157, 161 (Ct. App. 2002).

120. *See supra* notes 85-86 and accompanying text.

results in waiver contests.[121] The legislative analyses identified section 2856 as a measure intended to move beyond simply restating suretyship law.

If the *WRI* court had examined the records predating the enactment of section 2856, it may have reached a different conclusion about the statute's intended effects, rather than simply deferring to legislative pronouncements. If anything, it appears that section 2856 was enacted with the goal of *enhancing* lenders' abilities to enforce suretyship defense waivers, preventing sureties from avoiding their contractual commitments.[122]

D. Evaluating WRI

In addition to general concerns about the court's interpretation of section 2856, the *WRI* decision also raises concerns for its particular approach to statutory construction. To reach its result, the court was necessarily forced to construe section 2810.

The pertinent language of section 2810 reads: "A surety is liable, notwithstanding any mere personal disability of the principal . . . but he is not liable if for any other reason there is no liability upon the part of the principal at the time of the execution of the contract."[123] A literal reading of this language yields only one interpretation: section 2810 relieves a surety of liability *whenever* the principal debtor is not liable for performance at the time of contracting, except in cases of personal disability.

But the *WRI* court did not adopt a literal reading, instead construing section 2810 narrowly. In their view, section 2810 did not operate to relieve a surety's liability in every case where the principal debtor was not liable for performance. An exception to section 2810's operation was carved out for illegal transactions.[124] In the subset of cases where the principal transaction was illegal, the court stated that sureties could maintain a defense based outside of section 2810, protecting themselves with the common law "rule against enforcing illegal transactions."[125]

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121. *See id.*

122. *See supra* notes 70-86 and accompanying text.

123. CAL. CIV. CODE § 2810 (West 1993).

124. WRI Opportunity Loans II, LLC v. Cooper, 65 Cal. Rptr. 3d 205, 221 (Ct. App. 2007).

125. *Id.*

Thus, section 2810's operation was constrained, and it was considered inapplicable in certain situations. Even though the principal debtor in *WRI* was not liable for performance because of the illegality of the underlying loan agreement, an illegality defense was not "available" to the Coopers as sureties "by reason of" section 2810.[126]

While the *WRI* court's efforts to narrowly construe section 2810 were necessary to its holding, they were also an unwarranted weakening of the statute. Mandatory case authority in California is unmistakable: "[w]hen statutory language is . . . clear and unambiguous there is no need for construction, and courts should not indulge in it."[127]

The language in section 2810 is crystal clear: if the principal debtor is not liable "for any . . . reason" besides personal disability, the surety is exonerated at common law.[128] The phrase "for any reason" is very broad. By using this phrase, the statute distinguishes between two scenarios that may face the guarantor. In cases of the principal debtor's personal disability, the guarantor will not be exonerated. But in any other case where the principal debtor is exonerated (including illegality), the surety will also be exonerated. Furthermore, prior suretyship law also supports the view that section 2810 encompasses illegality defenses.[129]

By clear statutory language, the guarantor should be exonerated if the underlying obligation in a transaction is unenforceable due to any form of illegality, including usury. The illegality defense is thus properly subsumed within section 2810, and section 2810 occupies the entire field of exoneration in California. With such clear language as "for any . . . reason," there is no room for an alternate reading of the statute and no precedent to support one.[130]

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126. *Id.*

127. People v. Lance W. (*In re* Lance W.), 694 P.2d 744, 752 (Cal. 1985) (citing Solberg v. Superior Court, 561 P.2d 1148 (Cal. 1977)); *see also* Cal. Sch. Employee Ass'n v. Governing Bd., 878 P.2d 1321, 1327 (Cal. 1994) (noting that when "the statutory language is clear and unambiguous . . . [courts] follow the plain meaning").

128. CAL CIV. CODE § 2810 (West 2008).

129. *See* Barbara B. Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes*, 17 UCLA L. REV. 245, 293 (1969) ("[O]ne defense [was] expressly made applicable to the guarantor by Section 2810 of the Civil Code—illegality of the principal obligation . . . .").

130. CAL CIV. CODE § 2810 (West 2008).

Beyond its construction of section 2810, a fallback concern about the *WRI* decision remains. There are ample reasons to doubt the *WRI* court's finding that section 2856 did not alter pre-1994 California suretyship law. Even if section 2856 *were* intended only to preserve pre-1994 law, that "existing law" permitted waiver of all statutory defenses, including section 2810.[131] Under either conception of section 2856—whether it is read as a waiver-strengthening measure or as an effort to restate existing law—waivers of section 2810 should be properly enforceable.

In one notable pre-1994 case, *Engelman v. Bookasta*,[132] a surety argued that waivers of the rights in section 2845 of the California Civil Code should be prohibited on grounds of public policy. The court disagreed, stating that "[r]ights of sureties under sections 2845 and 2849 have existed ever since they were created in 1872 and *the Legislature has not included such rights with others that cannot be waived.*"[133] Thus, under *Engelman*, section 2810 waivers (along with waivers of all other common-law suretyship rights) would appear to be permissible, even under pre-1994 "existing" California law.

While *Engelman* is perhaps the most strongly worded authority on point, the 1957 California Supreme Court decision in *Bloom v. Bender*[134] also generally supports enforcement of suretyship defense waivers.[135] In *Bloom*, a principal debtor was released from his obligation by a creditors' committee.[136] The surety sought to avoid liability on her contingent obligation by asserting rights under section 2809 of the California Civil Code, which requires that the "obligation of a surety must be . . . reducible in proportion to the principal obligation."[137] After finding that the guarantor's initial contract included a section 2809 waiver, the court remarked, "carrying out the expressed intent of the parties [to a surety agreement] accords with the basic rules of suretyship law."[138]

131. *See infra* note 135.

132. 71 Cal. Rptr. 120 (Ct. App. 1968).

133. *See id.* at 122 (emphasis added).

134. 313 P.2d 568 (Cal. 1957).

135. For a summary of decisions, including California Supreme Court authority, supporting the enforcement of suretyship defense waivers, *see* Bassak, *supra* note 10, at 280 n.87.

136. *Bloom*, 313 P.2d at 570.

137. CAL CIV. CODE § 2809 (West 2008).

138. *Bloom*, 313 P.2d at 573.

E. Public Policy: In WRI *and Beyond*

A central theme of *WRI* is its public policy preference favoring sureties and principal debtors against creditors.[139] But there are equally compelling policy arguments to support suretyship waivers of the usury defense and all other surety defenses.

First and foremost, it is useful to consider California's relatively weak public policy against usury. California law against usury is riddled with loopholes and exceptions. Even as early as 1964, it was observed that:

> California does not have such a strong public policy against any and all contracts which would be usurious . . . . [T]he constitutional prohibition of usury . . . exempts from its provisions banks, building and loan associations, industrial loan companies . . . and several other kinds of lenders, and gives the Legislature the right to prescribe maximum limits for the exempted lenders. A strong public policy, based on a settled concept of justice or morality would not be meshed with such alterable rates as the legislature might choose to impose.[140]

Yet even presuming that the usury law inures to some slight public benefit, this benefit could easily be maintained without damaging sureties' freedom of contract. If anything, usury law is aimed at protecting "unwary and necessitous borrowers"[141] from "the money lender, who would prey upon misfortune and wring [funds] from the needy . . . ."[142] But these considerations should not operate to protect sureties.

Whether or not they are considered in the usury context, sureties are not victims or unsophisticated parties whose judgment the law may doubt. They are instead "professional suretyship compan[ies] receiving a fee for providing . . . credit support or . . . principal[s] of a development entity [supporting] the entity's project."[143] The

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139. *See* WRI Opportunity Loans II, LLC v. Cooper, 65 Cal. Rptr. 3d 205, 221 (Ct. App. 2007) ("[T]he usury defense rests on the rule against the enforcement of illegal transactions, which is founded on considerations of public policy . . . independent of sections 2809 and 2810.").

140. Ury v. Jewelers Acceptance Corp., 38 Cal.Rptr. 376, 382 (Ct. App. 1964).

141. Del Mar v. Caspe, 272 Cal. Rptr. 446 (Ct. App. 1990).

142. *In re* Washer, 248 P. 1068 (Cal. 1926); *see also* Brief of Respondent, *supra* note 103, at 39 n.33.

143. *See* Brief of Respondent, *supra* note 103, at 39.

legislature is perfectly willing to treat sureties with respect, allowing them greater freedom of contract. Section 2856 allows sureties to waive various legal protections, including the "one action rule"[144] and the "fair value rule."[145] But section 2953 prohibits similar waivers by the principal debtor.[146]

Practical experience and legislation demonstrate that sureties are responsible entities who deserve considerable freedom of contract, not judicial paternalism.[147] A public policy favoring usury-defense waivers—indeed, favoring waivers of all statutory defenses—already exists.

IV. PROPOSED LEGISLATION

To avert damage to California suretyship law from the *WRI* decision, it is important to learn from history. After the lender uncertainty created by *Cathay Bank*, the California Legislature moved to amend the Civil Code, clearly indicating a preference for waiver enforceability.[148] By enacting section 2856 in 1995 (and the "safe harbor" waiver language introduced in 1996), the legislature apparently wished to disfavor the result in *Cathay Bank* and prevent court invalidation of suretyship waivers.[149]

As recent scholarship notes, section 2856 is highly lender friendly and pushes California courts in the direction of waiver enforcement.[150] Therefore, effectively invalidating the *WRI* court's holding and ensuring the continued validity of suretyship defense waivers would seem possible via the same strategy of Civil Code amendment.

To that end, interested parties may wish to consult the following sample amendment to section 2856. This proposed language could

144. *See* CAL. CIV. CODE § 2856(a)(3) (West 1996) (referencing CAL. CIV. PROC. CODE § 726 (West 1976)).

145. *See id.* (referencing CAL. CIV. PROC. CODE § 580a (West 1976)).

146. *See* CAL. CIV. CODE § 2953 (West 2008).

147. *See* Kaiser Steel Corp. v. Westinghouse Elec. Corp., 127 Cal. Rptr. 838, 845 (1976) ("Judicial paternalism is to loss shifting what garlic is to a stew—sometimes necessary to give full flavor to statutory law, always distinctly noticeable in its result, overwhelmingly counterproductive if excessive, and never an end in itself.").

148. *See supra* note 77.

149. *See supra* notes 85–86 and accompanying text.

150. For an excellent discussion of the lender-friendly effects of section 2856, see Geiger & Allen, *supra* note 6, at 37 ("Section 2856 contains user-friendly safe-harbor language that the courts can construe only one way—in favor of a waiver.").

be added as part (c) of section 2856, with parts (c) to (f) re-lettered accordingly:

> (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 the guarantor or other surety's rights and defenses to liability described in Section 2810 (including, without limitation, the defense of illegality of the principal's obligation), the following provisions in a contract shall effectively waive such rights and defenses:
>
> > The guarantor waives all rights and defenses that the guarantor or other surety may have because the debtor's obligation is illegal. This means, among other things, that:
> >
> > (1) The creditor may collect from the guarantor or other surety notwithstanding any usurious provision(s) in the contract between the debtor and the creditor;
> >
> > (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 or other surety even if the creditor, by foreclosing on the real property collateral, has destroyed any right the guarantor may have to collect from the debtor.
> >
> > (3) This is an unconditional and irrevocable waiver of the debtor's rights and defenses to liability which may also be available to the guarantor or surety through the operation of Section 2810 (including, without limitation, the defense of illegality of the debtor's obligation).

By enacting the above proposed legislation, the legislature can reemphasize its support for enforcing suretyship defense waivers and lender-friendly interpretations. Using "safe-harbor" language is

particularly well suited to this task because it offers an *objective* means for determining waiver existence. If the clear statutory language appears in a guaranty contract, a valid waiver of section 2810 is presumed. As a result, waiver-related litigation wiould be reduced because guarantor challenges are less likely in the face of unassailable, objective evidence of a waiver's existence.[151]

Market actors, including creditors and other interested parties, would have incentives to disseminate new "form guaranties" containing the language because they rely on waiver enforceability.[152] Thus, in the vast majority of guaranty transactions, the prospect of waiver uncertainty could be effectively eliminated, whether counsel is present or absent. The current safe-harbor language was rapidly incorporated into suretyship contracts after 1996,[153] and there are no additional barriers to form redistribution today.

V. CONCLUSION

Guaranty contracts are a fundamentally important tool in many loan transactions, and they are particularly useful in the commercial setting. For entrepreneurs and commercial lenders, personal guaranties are frequently paired with loans to corporate entities, creating an attractive means for extending entrepreneurial credit.[154] Faced with judicial challenges to guaranty enforceability in the mid-1990s, the legislature sensibly worked to safeguard their viability, and section 2856 was a step forward in the process.[155]

Yet since the *WRI* ruling, unpredictable judicial examination of suretyship defense waivers has again become a concern, and the legislature should act quickly once again. By adding additional safe-harbor language to the California Civil Code, the legislature could significantly reduce judicial review of defense waivers. If the

151. Scholarship indicates that objective legal tests are less litigant friendly as compared with subjective tests. *See* Dan S. Schechter, *Judicial Lien Creditors Versus Prior Unrecorded Transferees of Real Property: Rethinking the Goals of the Recording System and Their Consequences*, 62 S. CAL. L. REV. 105, 166 (1988). Objective rules are highly praised in 2 GRANT GILMORE, SECURITY INTEREST IN PERSONAL PROPERTY § 34.2 (1999) ("Unless there is an overwhelming policy argument . . . it is always wise to . . . make decision turn on some easily determinable objective event . . . .").

152. *See* Bassak, *supra* note 10, at 280.

153. *See* Geiger & Allen, *supra* note 6.

154. *Id.* at 38.

155. *Id.* at 37.

legislature fails to act, uncertainty will continue to surround California's widespread, highly useful surety contracts.