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California Bank & Trust v. Lawlor: A More Certain Future for California's Sham Guarantee Defense

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**CALIFORNIA BANK & TRUST v. LAWLOR: A
MORE CERTAIN FUTURE FOR
CALIFORNIA’S SHAM GUARANTEE DEFENSE**

*Brett D. Young**

I. INTRODUCTION

During the Great Depression, California enacted a series of statutes, known as the antideficiency statutes, designed to protect borrowers from aggressive bank actions in collecting debts.¹ California Code of Civil Procedure sections 580b through 580d are part of this statutory scheme and prevent deficiency judgments against borrowers when certain conditions are met.² A potential “sham” guarantee arises when the primary obligor on the loan is also the guarantor.³ This sometimes occurs when the primary obligor and the guarantor in the transaction are the same entity. When the guarantee is later determined to be a sham, usually after a nonjudicial foreclosure sale, the lender is prevented from seeking a deficiency judgment against both the guarantor and the obligor because they are the same party, and thus, both are protected by section 580d.⁴ By

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1. *Westinghouse Credit Corp. v. Barton*, 789 F. Supp. 1043, 1045 (C.D. Cal. 1992) (citation omitted).

2. CAL. CIV. PROC. CODE §§ 580b, 580d (West 2012), amended by 2014 Cal. Legis. Serv. Ch. 71 (West) (S.B. 1304); *id.* § 580c. 1 MILLER & STARR CAL. REAL EST. DIGEST Deeds of Trust § 45 (3d ed. 2014). “If the security is insufficient, the creditor’s right to a judgment against the debtor for the deficiency may be limited or barred by Code Civ. Proc., §§ 580a, 580b, 580d, or 726.” *Id.*

3. *Id.* “The sham guaranty defense arises from the concept that that a borrower cannot also be the guarantor of its own debt.” Eric J. Rans & David J. Williams, *A Lender’s Guide for Avoiding Sham Guaranty Claims—The Devil Is in the Details*, 128 BANKING L.J. 483, 485 (2011).

4. *River Bank Am. v. Diller*, 45 Cal. Rptr. 2d 790, 801 (Ct. App. 1995).

successfully asserting this sham guarantee defense, guarantors are able to avoid personal liability despite the promises in the guarantee.

California courts and the state legislature have treated this defense inconsistently. The combined failure of the state legislature and courts to articulate a clear-cut rule has created chaos in the application of the sham guarantee defense. In the recent California case of *California Bank & Trust v. Lawlor*,⁵ the California appellate court's analysis of the sham guarantee defense moved California toward a more definitive approach to determine when a guarantee is a sham.⁶ The court limited the defense's use to situations where a true sham was present, and eliminated the possibility a business owner could escape liability for a self-created sham.

This Comment addresses the problematic use of the sham guarantee defense by guarantors and argues that courts should follow the recent *Lawlor* decision. Part II details the court's decision in *Lawlor*. Part III explains the inconsistent application of the sham guarantee defense through an assessment of three important California cases. Part IV assesses the importance of the *Lawlor* court's limitation of the application of the sham guarantee defense to true sham situations. Furthermore, this part argues that the *Lawlor* decision will help future lenders avoid lending to potential sham guarantors. Finally, Part V concludes that the court's ruling, while unfavorable toward guarantors, creates necessary precedent for lenders.

II. STATEMENT OF THE CASE

In December 2004, Alliance loaned approximately \$2 million to Cartwright Properties, LLC ("Cartwright"), a limited liability company formed by Jerry Smith, Smith's wife, and David Lawlor (collectively, "Defendants").⁷ Alliance subsequently made a second

5. 166 Cal. Rptr. 3d 38 (Ct. App. 2013), *as modified* (Dec. 20, 2013).

6. *See generally id.* at 48. The court stated that to determine the existence of a sham guaranty, the court must look to the "parties' agreement to determine whether the guaranties constitute an attempt to circumvent the antideficiency law and recover deficiency judgments when those judgments otherwise would be prohibited." *Id.* (citations omitted). "This requires [the court] to examine whether the legal relationship between the guarantor and the purported primary obligor truly separated the guarantor from the principal underlying obligation, and whether the lender required or structured the transaction in a manner designed to cast a primary obligor in the appearance of a guarantor." *Id.*

7. *Id.* at 40.

loan to Cartwright in October 2006.⁸ In exchange, Cartwright signed promissory notes and gave Alliance trust deeds in Cartwright's office building as security for the loan.⁹ Additionally, Alliance required Defendants to execute commercial guarantees for the loans.¹⁰

Defendants were involved in other transactions with Bank. Smith and Lawlor also owned Covenant Management ("Covenant"), which was the general partner of two business entities collectively labeled by the court as Heritage Orcas.¹¹ Heritage Orcas obtained a loan from Alliance for approximately \$10.5 million in June 2008 in exchange for a promissory note and deeds of trust in two properties owned by Heritage Orcas.¹² Smith, Lawlor, Covenant, and another company owned by Smith and Lawlor executed a continuing guaranty on the loans.¹³

California Bank & Trust (the "Bank") came into possession of the notes and deeds of trust in 2009.¹⁴ After Heritage Orcas and Cartwright defaulted on the loans, the Bank elected to foreclose on the properties and enforce the commercial guarantees signed by Defendants.¹⁵ The Bank purchased both properties at nonjudicial foreclosure sales for partial-credit bids.¹⁶ The outstanding balance on the loans totaled approximately \$15 million.¹⁷

The Bank subsequently filed motions for summary judgment on its breach of guaranty claims in order to obtain deficiency judgments against Defendants in their roles as guarantors.¹⁸ In order to avoid liability, Defendants argued that the guarantee was a sham because they were actually the primary obligors on the loans and not true guarantors.¹⁹ The trial court refused to allow Defendants to use the sham defense because they had not raised it affirmatively in their answer.²⁰

8. *Id.*

9. *Id.*

10. *Id.* at 40–41.

11. *Id.* at 40.

12. *Id.* at 41.

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

Defendants appealed the trial court's action, and once again sought protection under California's antideficiency statutes as sham guarantors.²¹ The appellate court affirmed the trial court's decision to grant the summary judgment.²² However, the appellate court also stated that there was no evidence the guarantees were actually a sham.²³ The court found that there was sufficient legal separation between Defendants' business entities and the Defendants as individuals so as to not qualify the guarantees as shams.²⁴

III. A HISTORICAL PERSPECTIVE: COMPARING CALIFORNIA COURTS' TREATMENT OF SHAM GUARANTEES

Sham guarantee defense cases have troubled California courts for decades. A brief analysis of three relevant cases will highlight the courts' inconsistencies when faced with sham guarantees. *Torrey Pines Bank v. Hoffman*²⁵ sets the legal standard courts have struggled to apply when facing a possible sham guarantee while *River Bank America v. Diller*²⁶ and *Valinda Builders, Inc. v. Bissner*²⁷ provide conflicting precedent for California courts to comply with.

A. *Torrey Pines Bank v. Hoffman*

Torrey Pines Bank presents a perfect case study of how courts have traditionally applied the sham guarantee defense. Jerome and Naomi Joy Hoffman (the "Hoffmans") purchased a parcel of property and received construction financing from Torrey Pines Bank to build a ninety-two-unit apartment complex.²⁸ The borrower on the note was a revocable family trust in which the Hoffmans were the trustees and beneficiaries.²⁹ The bank required the Hoffmans to personally guarantee the loan.³⁰ The trust eventually defaulted on the loan, and the bank nonjudicially foreclosed on the property.³¹ The bank sought a deficiency judgment against the Hoffmans as the

21. *Id.*

22. *Id.* at 40.

23. *Id.* at 48.

24. *Id.* at 49.

25. 282 Cal. Rptr. 354 (Ct. App. 1991).

26. *River Bank Am. v. Diller*, 45 Cal. Rptr. 2d 790 (Ct. App. 1995).

27. *Valinda Builders, Inc. v. Bissner*, 40 Cal. Rptr. 735 (Ct. App. 1964).

28. *Torrey Pines*, 282 Cal. Rptr. at 356-57.

29. *Id.* at 357.

30. *Id.*

31. *Id.*

guarantors on the note.³² The trial court found for the Hoffmans on the theory that their guarantee was a sham, and the bank appealed.³³

The appellate court began its discussion by defining a guarantor as one who “promises to answer for the debt.”³⁴ The court stated that a sham guarantee was designed to subvert California’s antideficiency laws by structuring the deal in a way that made the primary obligor liable for deficiency judgments.³⁵ The court held that there was not sufficient legal separation between the trust, as the primary obligor, and the Hoffmans, as guarantors, because the paperwork and financial information presented to the bank on behalf of the trust as the borrower and the Hoffmans as guarantors was “substantially the same.”³⁶ On these facts the court found that the guarantor and obligor were similar, if not identical, creating a sham guarantee.³⁷

B. Valinda Builders, Inc. v. Bissner

In *Valinda*, a court of appeal muddied the water surrounding California’s sham guarantee defense. The defendants in *Valinda* purchased land from Valinda Builders, Inc. (“Valinda”) as individuals.³⁸ The defendants later formed a corporation and, without the lenders consent, took title to the land in the name of the corporation.³⁹ The corporation, not the individual defendants, issued the promissory note and deed of trust securing the property.⁴⁰ The defendants as individuals then personally guaranteed the loan.⁴¹

The appellate court held that the guarantee was a sham because the corporation was merely an instrument of the defendants.⁴² The court concluded that the defendants as individuals were always liable on the loan, regardless of whether the corporation was the primary obligor and a separate legal entity.⁴³ Consequently, the court held there was not sufficient legal separation between the borrower and

32. *Id.* at 358.

33. *See id.*

34. *Id.* at 360.

35. *See id.* at 361.

36. *See id.*

37. *See id.*

38. *Valinda Builders, Inc. v. Bissner*, 40 Cal. Rptr. 735, 735–36 (Ct. App. 1964).

39. *Id.* at 736.

40. *Id.*

41. *Id.*

42. *See id.* at 737.

43. *Id.*

the guarantor to constitute a legitimate guarantee.⁴⁴ The court stated, perhaps in dicta, that “one who contracts to buy land does not alter his identity and relation as purchaser by a purported guaranty of performance of his own obligation to pay the purchase price.”⁴⁵ Therefore, the guarantee was a sham and the defendants had no personal obligation on the loan.⁴⁶ This is a clear departure from how courts had traditionally viewed the sham guarantee defense.

C. River Bank America v. Diller

In *River Bank*, the appellate court took a position that was more favorable toward lenders.⁴⁷ Sanford Diller and his wife were the sole trustees of the DNS trust, which owned all of the stock in Prometheus Development (“Prometheus”).⁴⁸ Prometheus, with Diller as the principal officer, obtained construction loans for an apartment complex with River Bank America (“River Bank”).⁴⁹ River Bank, as a condition of the loan, required Diller to use another limited partnership under his control to act as the borrower, and Diller to act as the guarantor on the loan.⁵⁰

After the primary obligor defaulted on the loan, River Bank nonjudicially foreclosed on the property.⁵¹ A deficiency of \$12.9 million was left after the property was sold, and River Bank commenced an action against Diller as the guarantor for a deficiency judgment.⁵² The trial court granted Diller’s motion for summary judgment, denying the enforcement of the guarantee.⁵³

In reviewing the trial court’s ruling, the appellate court found that the loan’s financial structure created triable issues of fact concerning whether the sham guarantee defense applied.⁵⁴ One can infer from the court’s holding that if the lender structured the deal to circumvent the antideficiency statutes, the guarantee would have

44. *See id.*

45. *Id.* at 738.

46. *See id.*

47. *See* *River Bank Am. v. Diller*, 45 Cal. Rptr. 2d 790, 792 (Ct. App. 1995).

48. *Id.*

49. *Id.*

50. *See id.* at 802.

51. *Id.* at 793.

52. *Id.*

53. *Id.*

54. *Id.* at 803.

been deemed a sham and River Bank would not have recovered a deficiency judgment against Diller.⁵⁵

IV. ANALYSIS

The use, and sometimes abuse, of the sham defense is enshrined in California law. However, it is imperative that the courts properly apply the defense, and the split in California precedent hindered achievement of this goal. *Lawlor* resolved the uncertain standard presented by the conflicting precedents in *Valinda* and *River Bank* by holding the party responsible for the structure of the deal liable for their actions.⁵⁶

A. *The Lawlor Decision Cripples Valinda*

Initially the *Lawlor* holding appears unfair to guarantors because facially it substantially decreases the availability of the sham guarantee defense for borrowers.⁵⁷ However, the purpose behind section 580d is to prevent lenders from having two means of recovery from the borrower as part of a nonjudicial foreclosure,⁵⁸ the first being the security interest and the second being a deficiency judgment.⁵⁹ Similarly, a borrower should not be able to sign up for a loan using a limited liability entity, blur the line between themselves and the entity creating a sham, and cleverly limit the lender's recovery to the security interest. Both parties must abide by the antideficiency rules.

Unfortunately, the court's decision in *Valinda* did not create an equal playing field for lenders and borrowers. Although the *Lawlor* decision did not explicitly overturn *Valinda*, it rendered the *Valinda* holding impotent. The two rulings cannot coexist because *Lawlor* forces borrowers to personally accept the consequences of their business entity, whereas *Valinda* allows them to avoid personal liability.⁶⁰ Under the holding in *Lawlor*, individuals cannot escape liability by guaranteeing a loan for their business entity and later

55. *Id.*

56. *See* Cal. Bank & Trust v. Lawlor, 166 Cal. Rptr. 3d 38, 48 (Ct. App. 2013), *as modified* (Dec. 20, 2013).

57. *See id.*

58. Rans & Williams, *supra* note 3, at 485.

59. *See* CAL. CIV. PROC. CODE §§ 580b, 580d (West 2012), *amended by* 2014 Cal. Legis. Serv. Ch. 71 (S.B. 1304) (West); *id.* § 580c.

60. *See id.*

claiming it was merely an instrument of the transaction.⁶¹ The *Lawlor* court unequivocally stated, “[i]ndividuals may structure their business dealings to limit their own personal liability, but they must accept the risks that accompany the benefits of incorporation.”⁶² This approach guts *Valinda* by setting forth the proposition that guarantors are effectively estopped from representing their business entity as a sham.

While this holding seems to paralyze the use of the sham guarantee defense, in reality it has brought its use back within reason. Effectively, the court’s decision correctly prevents individuals from avoiding personal liability on their guarantee by creating a sham guarantee.⁶³ A crafty borrower should not be able to simply form a limited liability entity to become the primary obligor on the loan in order to create a sham guarantee. The *Lawlor* court eliminated the potential for such manipulated shams by holding that individuals were estopped from denying the existence of their corporation.⁶⁴

The *Lawlor* holding will limit future guarantors’ use of the sham guarantee defense. The *River Bank* test for the sham guarantee defense is a very high standard that a guarantor will be unlikely to meet. This new standard is also important because it limits the use of the defense to situations involving an actual sham.

B. *The Future Effects of Lawlor’s Holding on Lenders*

The *Lawlor* holding provides much needed guidance for lenders to properly structure deals to avoid a sham guarantee defense. Lenders, under the *River Bank* and *Lawlor* holdings, must be wary of too much involvement in the structure of the financial transaction. The combination of the *River Bank* decision with the new precedent in *Lawlor* will give lenders clearer guidance on what qualifies as a sham guarantee. The court will become suspicious of the structure of the deal if the lender requires the borrower to set up a borrowing business entity with the individual acting as the guarantor.⁶⁵

61. See *Lawlor*, 166 Cal. Rptr. 3d at 49.

62. *Id.*

63. See *id.*

64. See *id.*

65. See Rans & Williams, *supra* note 3, at 488.

The *Lawlor* court's decision protected creditors' rights and eroded some of the expansive foundation for sham guarantee defenses that the *Valinda* court created. After *River Bank* and *Valinda*, the law became unfavorable toward lenders because it was unclear how the court would view their involvement in a financial transaction. *Lawlor* necessarily clarifies the standard by which lenders should conduct their business.⁶⁶ The court of appeals made clear that had the original lender been involved in the structure of the deal, as was the case in *River Bank*, the outcome of its holding would have been different.⁶⁷ The court provided that, "Defendants offered no evidence . . . that Alliance attempted to separate Defendant's interest in the loans by making Cartwright Properties and Heritage Orcas the borrowers while relegating Defendants to the position of guarantors."⁶⁸ The court's decision in this case importantly affirmed both the holding and the standard for approaching sham guarantees presented in *River Bank*.⁶⁹

Significantly, the court in *Lawlor* strictly interpreted the holding in *River Bank*.⁷⁰ In order to satisfy the standard set forth in *River Bank*, and reaffirmed by *Lawlor*, a party pleading the sham guarantee defense must show 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."⁷¹ In *Lawlor*, the court rejected wholesale the defendants' argument that their guarantee was a sham because the defendants created the corporation, and consequently, the necessary legal separation for a valid guarantee.⁷² The *Lawlor* court's holding demands that the lender have a role in either forming or requiring the formation of the entity that is allegedly a sham obligor.⁷³ Pursuant to the *River Bank* and *Lawlor* holdings, a lender would have to dominate the structure of the deal for a sham guarantee defense to become a possibility.⁷⁴

66. *Lawlor*, 166 Cal. Rptr. 3d at 49.

67. *Id.*

68. *Id.*

69. *Id.* at 48.

70. *See id.*

71. *See id.* at 49.

72. *Id.*

73. *See id.*

74. *Id.*; *River Bank Am. v. Diller*, 45 Cal. Rptr. 2d 790, 803 (Ct. App. 1995).

In both *River Bank* and *Lawlor*, the court stated that the purpose of the transaction, specifically whether it was structured to circumvent section 580d, was the primary basis for reasoning a lender-driven transaction would constitute a sham.⁷⁵ If lenders were permitted to circumvent the antideficiency legislation, guarantors in California would have no protection in lending transactions because lenders would have all the power in pursuing deficiency judgments. The *Lawlor* and *River Bank* courts correctly drew a line, preventing an over expansive grant of power to lenders. Indeed, the *River Bank* court found some evidence that the purpose of the lender-driven transaction was to permit recovery of deficiencies expressly forbidden by section 580d.⁷⁶

Finally, the *Lawlor* decision is so essential that the California Legislature should amend the Civil Code to codify the holding. A legislative amendment to California Civil Code section 2856 would create binding authority for all California courts to follow.⁷⁷ Adding a subsection pertaining to the sham guarantee defense would essentially treat the sham guarantor's actions as a waiver of protection under the antideficiency statutes. Without California Supreme Court authority, it is possible conflicting authority could continue to muddy the water surrounding the sham guarantee defense. A legislative amendment would protect *Lawlor*'s holding and provide a uniform application of the sham guarantee defense.

V. CONCLUSION

Although California's law on sham guarantees remains imperfect, the court's decision in *Lawlor* has taken an important position on the application of California's sham guarantee defense. By strictly interpreting the holding in *River Bank*, the court has provided much needed guidance to lenders in a troubled financial market. A lender controlling the structure of a financial transaction should not be permitted to circumvent the antideficiency statutes, and *Lawlor* and *River Bank* correctly prevented them from doing so.

75. Cal. Bank & Trust v. Lawlor, 166 Cal. Rptr. 3d 38, 48 (Ct. App. 2013), *as modified* (Dec. 20, 2013); *River Bank Am.*, 45 Cal. Rptr. 2d at 803.

76. *River Bank Am.*, 45 Cal. Rptr. 2d at 803.

77. California Civil Code section 2856 contains the statutory provisions pertaining to guarantors and their ability to waive protection under the antideficiency statutes. CAL. CIV. CODE § 2856 (West 2012). Because *Lawlor* is only an appellate court decision, there is still no binding authority statewide. An amendment to the statute would solve this problem.

However, *Lawlor* also recognized that lenders need protection as well, and the court's holding necessarily balances these competing interests.

The sham guarantee defense remains a key part of California's protection for borrowers and their guarantors. The *Lawlor* holding protects guarantors when their financial transaction truly involves a sham guarantee. But, the court's holding, which limits the use of the defense, is necessary to prevent abuse by guarantors attempting to escape personal responsibility on their loan obligations.

