Runaway Guarantors: Reevaluating the Scope of the Sham Guaranty Defense

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RUNAWAY GUARANTORS:
REEVALUATING THE SCOPE OF
THE SHAM GUARANTY DEFENSE

Ndidi Onyebuchukwu*

Guarantors are responsible to lenders for the debts that they guarantee. Unfortunately, some guarantors try to avoid this responsibility by asserting the sham guaranty defense, a defense with poorly defined criteria and an inconstant application. The current lack of clarity surrounding the sham guaranty defense has rendered it susceptible to abuse by runaway guarantors and left lenders uncertain about how to best structure their commercial real estate loan transactions. Against this backdrop, this Note surveys the current state of the sham guarantee defense in California, focusing both on the historical development of the defense and the common factual scenarios in which it is asserted. Next, this Note explores how the California courts’ uneven treatment of the defense has resulted in confusion, unfair results, and an expansion of the defense that favors guarantors. Finally, this Note argues that the California Legislature should intervene and provide guidance to the courts about the proper scope of the sham guaranty defense. To assist in this effort, this Note offers proposed statute that legislators and other interested parties may consider in their attempts to provide some much-needed stability to this area of commercial lending law.

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I. INTRODUCTION

Until recently, lenders had little to worry about when they approved a loan that was partly based on the assurance of a guarantor. Guaranties used to be a routine part of these loan transactions. However, “[i]n the current economic climate, guarantors and lenders are taking a closer look at their guaranty agreements.” Nowhere is this more prevalent than in the area of commercial real estate loans secured by real property.

A surety or guarantor can be defined as one who “promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security.” Conceptually, a guaranty is simply “a promise to pay the debt of another.” But courts have not historically favored guaranties, and guarantors have successfully asserted several defenses to avoid accountability for the loans they freely guaranteed.

Further, courts have historically shown a great deal of concern for guarantors, “exonerating them from their obligations whenever . . . [borrowers and lenders] change[d] the contract without the guarantor’s consent.” The courts’ concern likely stemmed from their effort to understand what, exactly, the guarantors agreed to

4. CAL. CIV. CODE §§ 2787–2788 (West 2008). However, the California legislature abolished the distinction between surety and guarantor in 1939. See CAL. CIV. CODE § 2787.
6. Id.
answer for when they signed guaranty agreements. Nonetheless, despite guaranties’ unpopularity with courts, they serve a useful purpose in commercial loan transactions. By allowing the guarantor’s financial strength to enhance the creditworthiness of the borrower, guaranties enable borrowers to gain access to credit that might otherwise remain out of reach.

Unfortunately, guaranty enforcement is not as easy as guaranty creation. In fact, enforcement has become more difficult in the current U.S. economic environment. It is more difficult still in California, where the real estate crisis, which began in 2007, remains severe. “[F]ew people foresaw the historically significant economic storms of the recent past or the negative effect they would have on the [borrower’s] financial strength.” Needless to say, much has changed over the past few years due to these negative effects. Today, as the number of foreclosures continues to increase, property values have declined below the levels lenders anticipated when they initiated the loan transactions.

These changes in the real estate landscape have increased lenders’ desire to foreclose quickly, before property values depreciate further. However, in California, unlike other states, the choice of foreclosure substantially affects the rights of all parties involved in the transaction. A lender has two options for foreclosing on a property. The first option gives the lender the right

8. Id.
9. Ruhr, supra note 5, at 1.
11. Although this problem is prevalent in all parts of the country, this Note focuses on the issue in California.
13. Id.
15. Id.
16. In many states, the law does not prohibit a lender from getting a deficiency judgment from a borrower following a nonjudicial foreclosure. See State Limits on Deficiency Judgments, FORECLOSUREFISH (Feb. 25, 2010), http://www.foreclosurefish.com/blog/index.php?id=994. These states include Alabama, Arkansas, Colorado, Georgia, Idaho, and Maryland. All of these states allow some form of deficiency judgment after a nonjudicial foreclosure. Id. This is a sharp contrast to California, where, by conducting a nonjudicial foreclosure, the lender is prohibited from obtaining any deficiency amounts from the borrower. See CAL. CIV. PROC. CODE § 580d (West 2008). For a definition of a “deficiency judgment,” see infra note 20.
to proceed through a judicial foreclosure, which is “often a lengthy process carried out through the court after . . . [the creditor has] obtain[ed] a judgment against the debtor.”

The second option is for the lender to proceed through a nonjudicial foreclosure sale of the collateral real property. This is usually a “shorter, less formal, generally less expensive and simpler process.” Regardless of the type of foreclosure the lender conducts, “what if, after foreclosing on the borrower’s real property, a deficiency [sum] is still left owed to the lender[?]” For example, if a lender loans $8 million to a borrower, but the sale of the property recoups only $5 million, the lender is left $3 million short.

The legal consequences of the above situation depend on the form of foreclosure that the lender decides to take. If a lender pursues judicial foreclosure, it will be able to recoup the $3 million owed after the sale from the borrower. But if it proceeds through a nonjudicial foreclosure, there are laws that restrict the lender’s actions against the borrower. Statutes—called “antideficiency statutes”—protect the borrower by preventing the lender from obtaining a judgment for any deficiency still owed after the nonjudicial foreclosure. Borrowers cannot waive these protections, which are inapplicable to guarantors.

A guarantor is not completely without rights. In California, a guarantor enjoys two rights against a primary borrower, one direct and the other derivative. First, guarantors have a direct right of reimbursement against the borrower for any amounts it paid to the lender on behalf of the borrower. Second, guarantors enjoy a

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17. Rans & Williams, supra note 14, at 484.
18. Id.
19. Id.
21. Rans & Williams, supra note 14, at 484.
22. Id.
23. Rans & Williams, supra note 14, at 484; see CAL. CIV. PROC. CODE. §§ 580a, 580b, 580d, 726 (West 2008).
25. Id.
27. Id.
derivative right known as subrogation in which they stand in the position of the lender and assert the lender’s right against the borrower. Unlike the borrower’s unwaivable statutory protections, a guarantor’s rights may be voluntarily waived.

These factors—the rise in foreclosures, antideficiency protections for borrowers, declining property values, and guarantors’ waivable rights—have all increased lenders’ incentives to pursue guarantors after judicial or nonjudicial foreclosure sales, in order to recoup remaining amounts. Unfortunately for lenders, when they call guarantors to answer for loans that the guarantors freely guaranteed, the guarantors often artfully claim defenses to avoid accountability. The most prominent is the “sham guaranty” defense, which stems from the principle that a borrower cannot guarantee his or her own debt.

As an illustration of this concept, assume the following facts. Owen is a developer who seeks a loan from the Los Angeles People’s Bank to finance the development of an apartment complex in Los Angeles. The bank reviews Owen’s financial standing and is satisfied. However, the bank informs Owen that to qualify for the loan, he must create a new company that will be used as the primary borrower. In addition, Owen would also guarantee the obligation of the new company he created. At the bank’s urging, Owen creates the new company, which becomes the primary borrower, and guarantees the loan. Under these facts, many, if not all, courts will find Owen’s guaranty a sham guaranty, which renders it unenforceable. The legal basis behind this argument is that the guarantor is the de facto borrower and cannot guarantee his own debt. If a court finds that a guaranty is a “sham,” the guarantor will be treated as the real borrower. Consequently, the guarantor will be protected by the antideficiency statutes, and he or she will be unable to waive the

28. Id.
29. Rans & Williams, supra note 14, at 483. For a discussion of how guarantors waive their rights, see infra Part II.A.
30. See Rans & Williams, supra note 14, at 486.
31. Id.
32. Id.
33. Id.
protections. Thus, a guarantor who succeeds on a sham guaranty defense is exonerated from further liability to the lender.

Even though the finding of a sham guaranty has far-reaching consequences for the lender, California has not defined what constitutes a sham guaranty through either statutory or case law. As a result, courts often consider a broad variety of factors, including but not limited to (1) whether the principal obligor, if it is a corporation, was created for the sole purpose of entering into the underlying loan; (2) whether the lender inquired about the borrower’s financial status or merely relied on the guarantor’s financial statements; and (3) whether the purpose of the loan agreements was to avoid the antideficiency statutes. While courts generally balance these factors, they have done so inconsistently. Not surprisingly, such inconsistencies have resulted in conflicting holdings in factually similar cases, and confusion for lenders.

The lack of clarity and the inconsistency in this area of law have left lenders unsure of whether a guarantor may escape its obligation under a commercial real estate loan transaction by invoking the sham guaranty defense. Part II.A of this Note includes a brief overview of guarantors’ statutory rights in California. It also examines the history of enforceable waivers through which guarantors voluntarily waive their statutory rights, thus paving the way for lenders to recoup their losses following a nonjudicial foreclosure. Part II.B discusses the...
history of the sham guaranty defense, which is a last refuge for a guarantor who has waived his or her rights, and it examines common scenarios where guarantors have successfully or unsuccessfully asserted the defense.

Part III illustrates the inconsistent application of the sham guaranty defense, which has resulted in confusion, unfair results, and an expansion of the defense that favors guarantors. Complicating this landscape is the California appellate court’s recent decision in *Talbott v. Hustwit*. Part IV proposes a legislative solution to the problem. Given the uncertainty surrounding the factual predicate for this defense, the legislature should expressly define its scope by outlining factors for courts to consider, designating the appropriate weight to accord to each factor, and delineating certain parameters that the courts should adhere to in applying the defense.

II. STATEMENT OF EXISTING LAW

A. Historical Perspective on Guarantors’ Statutory Rights and Waivers in California

In California commercial real estate transactions where real property is used as security for debt, the borrower executes a deed of trust in favor of the lender, and the lender receives a promissory note from the borrower as evidence of the debt owed. If the borrower defaults on the promissory note, the lender has the option to foreclose on the secured property to recoup its loss. These transactions usually involve a personal guaranty of the obligation.

Although the basic purpose of the guaranty is clear, “there can be no absolute assurance that every guaranty will be fully enforceable in [all] situation[s].” Thus, to protect their rights, lenders try to understand the guarantor’s and borrower’s rights under the applicable laws. Specifically, in California guarantors have statutory rights that make it difficult to enforce a guaranty. Among other things, statutes provide that the obligation of a guarantor “must

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39. 78 Cal. Rptr. 3d 703 (Ct. App. 2008).
40. Rans & Williams, supra note 14, at 484.
41. *Id.*
42. Ruhr, *supra* note 5, at 8.
43. *Id.*
be neither larger in amount nor in other respects more burdensome than that of the principal”;44 that the guarantor is exonerated if the creditor alters the principal’s original obligation without the guarantor’s consent or if the creditor’s remedies or rights against the principal are impaired,45 and that the guarantor may require the creditor “to proceed against the principal, or to pursue any other remedy in the creditor’s power which the [guarantor] cannot pursue.”46

While a guarantor may voluntarily waive all of the above rights,47 it was not always clear to lenders what language would render their waivers valid and effective. This problem was apparent in the landmark case of Union Bank v. Gradsky.48 In Gradsky, a bank approved a construction loan that was secured by the real property of the primary borrower.49 The contractor for the project, Max Gradsky, personally guaranteed the loan, which included a general waiver.50 Subsequently, the primary borrower defaulted on the construction loan; the lender sold the real property through a nonjudicial foreclosure sale and sought to collect the remaining loan balance from Gradsky.51

The court decided that because the bank pursued a remedy that “destroy[ed] both the security and the possibility of [Gradsky’s] reimbursement from the principal debtor,” it could not pursue Gradsky for a deficiency following the nonjudicial foreclosure sale.52

By conducting a nonjudicial sale of the property, the bank

44. CAL. CIV. CODE § 2809 (West 2008).
45. Id. § 2819.
46. Id. § 2845. California law provides guarantors with a number of additional statutory protections. See, e.g., id. § 2847 (stating that a guarantor who satisfies the principal obligation is entitled to reimbursement from the principal); id. § 2848 (“[A guarantor], upon satisfying the obligation of the principal, is entitled to enforce every remedy which the creditor then has against the principal to the extent of reimbursing what he has expended . . . .”); Union Bank v. Gradsky, 71 Cal. Rptr. 64 (Ct. App. 1968) (holding that if a lender nonjudicially forecloses upon real property securing the debt—and thereby loses the right to a deficiency judgment under the California antideficiency laws—the lender is estopped from proceeding against the guarantor because the lender has destroyed the guarantor’s rights of subrogation and reimbursement).
47. Rans & Williams, supra note 14, at 485.
48. 71 Cal. Rptr. 64 (Ct. App. 1968).
49. Id. at 65–66.
50. Id. at 66.
51. Id. Recall from Part I that a lender cannot collect any deficiency amount from the primary borrower after conducting a nonjudicial foreclosure, so the lender instead pursues the guarantor.
52. Id. at 69.
irreparably damaged Gradsky’s postsubrogation rights under Sections 2848 and 2849 of the California Civil Code.53 Furthermore, Section 580d of the California Code of Civil Procedure prohibits a creditor and his assigns from further debt collection after a nonjudicial sale.54 Although Section 580d only protects the primary borrower, through its operation, the bank’s nonjudicial sale of the real-property security “fully destroy[ed] the future rights of any creditor, including the subrogated Gradsky. In light of these considerations, the court ruled in Gradsky’s favor.”55 After Gradsky, lenders began to draft documents that not only contained general waivers but also specific waivers of subrogation rights.56

Lenders soon began using Gradsky waivers in an attempt to ensure that nonjudicial sales would not impair their ability to collect any remaining debt from a guarantor.57 Subsequently, the court in Cathay Bank v. Lee58 placed strict requirements on the validity of Gradsky waivers.59 Cathay Bank was later superseded by Section 2856 of the California Civil Code, which relaxed these requirements and permitted guarantors to waive their Gradsky defenses.60 Through the statute, the California legislature finally clarified the validity and effectiveness of waivers. Following the legislature’s intervention, it appeared that lenders could finally be assured that, if they conducted

54. Id.
55. Id. at 1104.
56. Id. These waivers are called “Gradsky Waivers” after this landmark case.
57. Id.
58. 18 Cal. Rptr. 2d 420 (Ct. App. 1993). In Cathay Bank, a bank loaned money to a corporate debtor, securing the principal obligation with both real property and a personal guaranty—with Gradsky waivers—from one of the corporation’s directors. Id. at 420–21. The corporation defaulted on its obligation, and the lender conducted a nonjudicial foreclosure and obtained summary judgment against the guarantor for the balance of the loan. Id. at 420. The court exonerated the guarantor, stating that the waiver “does nothing to tell the guarantor that the very fact of the loss of those subrogation rights itself has legal significance—namely that it confers an immunity from a deficiency judgment.” Id. at 423.
59. WRI Opportunity Loans II LLC v. Cooper, 65 Cal. Rptr. 3d 205, 221 (Ct. App. 2007) (noting that the Cathay court “imposed stringent requirements on a guarantor's waiver of a defense arising from the principal's rights under the antideficiency statutes”).
60. CAL. CIV. CODE § 2856 (West 2008); see also Cooper, 65 Cal. Rptr. 3d at 221 (“Civil Code section 2856 was the Legislature's response to Cathay Bank . . . .”). Under this section, guarantors are “expressly permitted to waive the Gradsky defense and all common law rights and defenses.” Hackett, supra note 53, at 1107. California lawmakers enacted this legislation in response to lenders’ concerns that “it would be impossible to draft reliable [guaranty] documents with no clear guidance on future judicial review and intervention.” Id. at 1106–07.
a nonjudicial foreclosure, they could still recoup any remaining amounts from guarantors who waived their rights.61 Unfortunately, the expansive but inconsistent use of the sham guaranty continues to confuse lenders when structuring a transaction.

B. Historical Perspective of the Sham Guaranty Defense

A guarantor, it has been said, is a “fool with a pen.”62 As such, courts indulge guarantors by creating several equitable defenses.63 Guarantors routinely and voluntarily waive these defenses.64 As a result, waivers clear the way for lenders to recoup their losses from guarantors regardless of the form of foreclosure that the lenders pursue.65 When the waivers are deemed to be valid and effective, guarantors next turn to another avenue to avoid their obligations: the sham guaranty defense.66

It is indeed a convenient avenue because this area of law is sorely lacking in legislative and judicial guidance.67 Each case that has found a sham guaranty has been fact-sensitive.68 With no clear law to guide them in adjudicating this issue, courts rely on weighing several factors including: (1) whether the lender was directing the structure of the transaction,69 (2) whether the lender engineered a change in the borrowing entity and then required the initially proposed borrower, usually the sole shareholder, to execute a

61. See Hackett, supra note 53, at 1106–08.
63. Id.
65. With valid waivers in place, the effect is that creditors can pursue guarantors for any remaining amounts after the foreclosure sale of the security, even if they have destroyed the guarantors’ subrogation rights. See Hackett, supra note 53, at 1097.
66. See Rans & Williams, supra note 14, at 485–86.
67. See supra notes 35–39 and accompanying text.
69. See Valinda Builders, 40 Cal. Rptr. at 738.
guaranty;\(^{70}\) (3) whether the guarantor is the alter ego of the borrower;\(^{71}\) (4) whether the lender reviewed the guarantor’s financial information in approving the loan rather than relying on the borrower’s;\(^{72}\) (5) whether the lender demanded that the guarantor add additional collateral to the transaction;\(^{73}\) and (6) whether the lender first sought to secure liens on the guarantor’s personal property.\(^{74}\) These factual inquiries have grown rather broad, giving lenders little guidance when structuring loan transactions involving personal guaranties.

Most of the earlier sham guaranty cases focused mainly on the fact that the guarantor was merely an alter ego of the primary borrower—that the primary borrower, if an entity, was a shell entity, created solely for the transaction.\(^{75}\) One such case was Valinda Builders, Inc. v. Bissner.\(^{76}\) There, two men agreed to purchase acreage that would then be subdivided into building lots.\(^{77}\) In the agreement, the purchasers guaranteed payment of the purchase price and other obligations related to the ultimate development.\(^{78}\) When escrow was ready to close, the purchasers had title vest in a newly organized corporation that executed the promissory note.\(^{79}\)

When the project failed, the lender sued the guarantors on their personal guaranty of the loan.\(^{80}\) The court found that the corporation was a shell corporation that was created at the request of the lender solely for conducting the transaction.\(^{81}\) The court reasoned that the

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71. See Riddle v. Lashing, 21 Cal. Rptr. 902, 903 (Ct. App. 1962); infra note 75 and accompanying text.

72. See Diller, 45 Cal. Rptr. 2d 790, 802–03.

73. Heller, supra note 36, at 17.

74. Id.


76. 40 Cal. Rptr. 735 (Ct. App. 1964).

77. Id. at 735–36.

78. Id. at 736–37.

79. Id. at 736.

80. Id. at 736–37.

81. Id. at 737 (“There was no evidence that [the company] was anything other than an instrumentality used by the individuals or that defendants were ever removed from their status and obligations of purchasers.”).
purported guarantors were already liable for the debt as primary obligors and that the lenders could not recoup any additional amounts from them.\footnote{See \textit{id.} at 739.} The court thus exonerated the guarantors.

A subsequent case addressed a scenario in which the guarantor was purportedly the alter ego of the primary borrower. In \textit{Torrey Pines Bank v. Hoffman},\footnote{282 Cal. Rptr. 354 (Ct. App. 1991).} the plaintiff made a construction loan to an inter vivos trust that the trustees (and settlors) personally guaranteed, and appropriate waivers were inserted in the guaranty agreement.\footnote{\textit{Id.} at 356–57.} After the primary borrower (the inter vivos trust) defaulted, the lender conducted a nonjudicial foreclosure but recouped less than the debt.\footnote{\textit{Id.} at 358.} The lender subsequently sued the guarantors for the remaining amount.\footnote{\textit{Id.}} The court denied any recovery to the lender on the basis that the borrower and the guarantor were in fact the same.\footnote{\textit{Id.} at 359.}

A similar case was \textit{Cadle Co. II v. Harvey}.\footnote{100 Cal. Rptr. 2d 150 (Ct. App. 2000).} The Harvey Family Trust purchased real property from a bank and gave it a note secured by a deed of trust on the property.\footnote{\textit{Id.} at 153.} Mr. Harvey, the settlor and trustee of the trust, signed a personal guaranty.\footnote{\textit{Id.}} The trust defaulted on the loan, and the bank conducted a nonjudicial foreclosure.\footnote{\textit{Id.}} Since the bank recouped less than the amount borrowed, it sued the guarantor to collect the balance.\footnote{\textit{Id.} at 153–54.} Under these facts, the court found that the guaranty was a sham since Mr. Harvey, as trustee, was the primary obligor on the note.\footnote{\textit{See} Paradise Land & Cattle Co. v. McWilliams Enters., 959 F.2d 1463 (9th Cir. 1992); River Bank Am. v. Diller, 45 Cal. Rptr. 2d 790 (Ct. App. 1995).}

Courts deal with a different and more complex scenario when an individual unilaterally creates an entity prior to a transaction, uses that entity as the primary borrower or guarantor of a loan, and subsequently guarantees the debt.\footnote{\textit{Id.}} Since the guarantor was not induced to create this new entity, the question then becomes whether
it is proper to allow him or her to later assert a sham guaranty defense. The holdings in cases involving this factual scenario have been inconsistent at best. An older case that addressed a similar fact pattern was *Paradise Land & Cattle Co. v. McWilliams Enterprises, Inc.* The McWilliamses were ranchers who owned and operated their business through Enterprises, a corporation that father and son had formed together prior to their attempts to secure a loan. The McWilliamses controlled Enterprises and were its only shareholders. In order to purchase another ranch, the McWilliamses approached a bank seeking the loan necessary to finance the purchase.

To secure the loan, the McWilliamses served as the primary borrowers and Enterprises purported to guarantee the debt on the note. Subsequently, the McWilliamses defaulted on the loan and the bank foreclosed on the security. The holder of the note then sued Enterprises to recoup the remaining amounts, since Enterprises had guaranteed the debt. Although Enterprises tried to assert the sham guaranty defense, the court found that it was a true guarantor, even though the McWilliamses were its sole shareholders. The court reasoned that Enterprises was a viable entity that was not created at the inducement of the lender. The court further rejected the guarantor’s suggestion that the court adopt a “transactional instrumentality” rule.

However, two years after *Paradise Land & Cattle Co.*, a court addressed a similar fact pattern but came to a different conclusion.
In *River Bank America v. Diller*,\textsuperscript{107} Sanford Diller, a real estate developer, and his wife, Helen, were the trustees of a revocable family trust that owned all of the stock in Prometheus Development ("Prometheus").\textsuperscript{108} Prometheus sought construction loans from River Bank to complete an apartment complex.\textsuperscript{109}

To protect its right to recover from a guarantor if the primary borrower were to default, River Bank required that the primary borrower could not be Prometheus since the Dillers—the prospective guarantors if Prometheus was the primary borrower—were its only shareholders and, as such, were not distinct from it.\textsuperscript{110} Coincidentally, the Dillers already owned a separate entity called Prom XX, which they routinely used as a place marker in other transactions.\textsuperscript{111} Further, Prom XX was not without any capital or assets.\textsuperscript{112} The Dillers suggested using Prom XX as the primary obligor in the transaction, with the Dillers guaranteeing the loan personally.\textsuperscript{113}

Prom XX defaulted on the loan and River Bank conducted a nonjudicial foreclosure.\textsuperscript{114} Following the nonjudicial foreclosure, River Bank sued the Dillers on their personal guaranty to recoup the remaining amount.\textsuperscript{115} Based on these facts, the court held that "the Dillers ha[d] raised a triable issue of fact concerning their ‘sham guaranty’ defense."\textsuperscript{116} The court made this decision although Prom

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\textsuperscript{107} In *River Bank America v. Diller*, 45 Cal. Rptr. 2d 790 (Ct. App. 1995).

\textsuperscript{108} Id. at 792. Although the guarantors made several other allegations against River Bank, such as accusations of modification and duress, this Note focuses only on the sham guaranty defense.

\textsuperscript{109} Id.

\textsuperscript{110} See id. at 802.

\textsuperscript{111} Id. at 801.

\textsuperscript{112} See id. The court mentioned that Prom XX did not have "substantial" assets or capital. Id. This, however, does not foreclose the possibility that the entity held some assets and capital. Courts have never delineated the amount of capital or assets that a company must have in these situations. See Rans & Williams, supra note 14, at 488.

\textsuperscript{113} *River Bank Am.*, 45 Cal. Rptr. 2d at 802.

\textsuperscript{114} Id. at 793.

\textsuperscript{115} Id.

\textsuperscript{116} Id. at 803. In finding for the Dillers, the court essentially adopted the transactional instrumentality rule that the court in *Paradise Land & Cattle Co.* had rejected. See *Paradise Land & Cattle Co. v. McWilliams Enters.*, 959 F.2d 1463, 1468 (9th Cir. 1992). The *River Bank America* court emphasized that the bank used Prom XX—a company previously created and used as a place marker in other transactions by the Dillers—as the primary borrower. *River Bank Am.*, 45 Cal. Rptr. 2d at 803.
XX was already in existence at the time of the transaction, and the lenders had not induced the Dillers to create the entity.117

Furthermore, in finding that there was a triable issue as to the sham guaranty, the court also considered the Dillers’ assertion that River Bank did not inquire into the financial standing of Prom XX, the primary borrower, during the loan application process.118 Rather, River Bank relied heavily upon the Dillers’ own financial statements.119 Thus, the court concluded that since River Bank looked at the financial standing of the guarantors rather than that of the primary borrower, the guaranty was possibly a sham.120

Following the different outcomes in River Bank America and Paradise Land & Cattle Co., the governing law of this factual scenario became even more confusing for lenders. On the one hand, lenders could be wary of situations in which individuals create an entity prior to a transaction without the inducement of the lender, the entity is used as the primary borrower in the transaction, the individual subsequently signs a personal guaranty, or the entity is used as a guarantor for the individual debt.

On the other hand, such facts were clearly present in Paradise Land & Cattle Co., yet the court upheld the guaranty as a true guaranty. Consequently, the present state of this area of law creates several questions. What does the law require to find a sham guaranty defense? How broad is the scope of this defense, and how can lenders anticipate the defense when structuring their transactions without clear law? Thus far, the answer to these questions remains inconclusive.

III. CRITIQUE OF EXISTING LAW

An investigation of the legal standards, factors, and other variables that are considered in the analysis of a sham guaranty defense could confuse any lawyer not familiar with California real property law.121 The problems that have plagued this area of law, and continue to do so, “stem from the secondary results of what appears,
at first blush, to be [the] application of sound legal principle[s].”

However, upon closer examination, the California courts’ application and interpretation of the many factors considered in finding a sham guaranty—both those that can be contemplated at the time of transaction and those that cannot—has resulted in “a spin-off of confusion and inequity” in this area of the law.

Lenders are often left perplexed. How can they structure a transactions in ways that would not run afoul of the sham guaranty defense? Without any statutory or case law that clearly states the rule, courts deciding the issue have been free to consider any number of factors that they and guarantors’ attorneys choose. As such, it becomes more difficult for lenders to prepare for foreclosure proceedings against borrowers who default on loans. A recent case, Talbott v. Hustwit, has done little to clarify this unsettled area of law.

A. The Talbott v. Hustwit Decision: A Return to Paradise Land & Cattle Co. or a Temporary Departure from River Bank America?

Confusion regarding the laws that govern real estate loans secured by real property is not entirely new. Analyzing whether the guaranty is a “true” one is particularly important prior to the lender taking any enforcement actions. However, due to the confusion in this area, lenders are unable to effectively perform this analysis before structuring transactions. Thus, the implications can be disastrous for a lender who seeks to enforce a guaranty that is later determined to be a sham.

The decision in Talbott v. Hustwit has made this issue even more confusing for lenders. It is a case of a lawyer who outsmarted himself. Hustwit and his wife were the settlors of a revocable trust

122. Id. at 286.
123. Id.
124. Id. at 266.
125. Id.
126. 78 Cal. Rptr. 3d 703 (Ct. App. 2008).
127. See Hackett, supra note 53 (discussing the confusion over the validity of waivers).
129. Bassak, supra note 121, at 265.
that owned real property.\textsuperscript{130} The trust borrowed money and the Hustwits personally guaranteed the debt.\textsuperscript{131} Unlike the guarantors in \textit{Cadle Co. II v. Harvey}\textsuperscript{132} and \textit{Torrey Pines Bank v. Hoffman},\textsuperscript{133} who were also the trustees of the borrower trust, the Hustwits unilaterally formed a limited liability company to act as the trustee.\textsuperscript{134}

The trust defaulted on the loan, and the bank foreclosed via a nonjudicial foreclosure.\textsuperscript{135} Not surprisingly, the bank sued the Hustwits to collect the loan balance, and the Hustwits asserted the sham guaranty defense to avoid any obligation.\textsuperscript{136} The court held that the Hustwits, by creating a separate entity that stood as the primary borrower in their stead, became secondary obligors—i.e., guarantors.\textsuperscript{137}

Thus, the appellate court held that the Hustwits were indeed real guarantors.\textsuperscript{138} They were not trustees of the trust; instead, they had unilaterally created a limited liability company as trustee, thereby limiting their personal liability for the trust’s obligations.\textsuperscript{139} In fact, “the Hustwits simply outwitted themselves.”\textsuperscript{140} By going through the charade of creating an entity to stand in as the primary borrower, they effectively separated themselves from the trust, and made themselves true guarantors.\textsuperscript{141}

The similarities between \textit{Paradise Land & Cattle Co.}, \textit{River Bank America}, and \textit{Talbott} are clear. In all three cases, the following facts were present: (1) the individual borrower formed a separate entity prior to the creation of the underlying loan transaction; (2) the owner unilaterally created an entity without the lender’s inducement; (3) the individual borrower used the entity as the primary borrower

\begin{footnotes}
\item[130] \textit{Talbott}, 78 Cal. Rptr. 3d at 704, 707.
\item[131] \textit{Id.} at 704–05.
\item[132] \textit{See supra} notes 88–93 and accompanying text.
\item[133] \textit{See supra} notes 83–87 and accompanying text.
\item[134] \textit{Talbott}, 78 Cal. Rptr. 3d at 706–07.
\item[135] \textit{Id.} at 705.
\item[136] \textit{Id.}
\item[137] \textit{Id.} at 707.
\item[138] \textit{Id.}
\item[139] \textit{Id.}
\item[140] \textit{Id.} at 710 (Sills, J., concurring) (“[The Hustwits] cannot avail themselves of the protections of limited liability corporations and at the same time claim an obligation is really theirs.”).
\item[141] \textit{See} Dan Schechter, “\textit{Fair Value” Rule Does Not Apply to Guarantors, and Settlor of Family Trust Can Serve as “True Guarantor” if Settlor Is Separate from Trust} [\textit{Talbot v. Hustwit} (\textit{Cal. App.})], \textit{COM. FIN. NEWS.}, June 30, 2008, at 56 (“[T]he settlor of a family trust can serve as a “true guarantor” of the trust’s debt, if the settlor is properly separated from the trust itself.”).
\end{footnotes}
or guarantor in the transaction; and (4) the creator of the entity or the entity itself later guaranteed the debt. Given these basic similarities, it is a wonder that when faced with similar facts, courts have managed to rule differently on the sham guaranty issue. The likely reason for this disparity is a simple lack of clear law for the courts to follow when confronted with this defense.

**B. The Implications of the Talbott v. Hustwit Ruling**

On its face, the *Talbott* ruling is welcome relief to lenders in California. After all, the decision can be construed to stand for the proposition that a borrower who creates a separate entity prior to entering a transaction should not be allowed to claim later that he and the entity are one and the same.\(^1\) However, the implication of the *Talbott* decision is not that rosy for lenders. A lender who accepts “the clumsy structure in *Talbott*, in which the settlor interpose[d] an intermediary special-purpose entity . . . as trustee, in order to create the appearance of separation between the trust (the primary debtor) and the settlor (as guarantor),” could still be exposed to a sham guaranty defense.\(^2\)

If the guarantor can demonstrate that the lender controlled the structure of the transaction or that the lender looked to the guarantor’s financial standing, as in *River Bank America*, a court might still stretch to find a sham guaranty—notwithstanding the apparent separation between the guarantor and the primary borrower.\(^3\) Furthermore, the decision in *Talbott* does not constrain the courts. Just as the court in *River Bank America* virtually ignored the factual similarities with *Paradise Land & Cattle Co.*, a different case that happens to be factually similar to *Talbott* might still be decided in a different way.

Of course, not all cases involving a sham guaranty defense are indefensible or confusing for lenders. Cases involving a lender who, in an effort to avoid the reach of debtor protections, forces an individual borrower to form a corporation to serve as the primary

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1. See *Talbott*, 78 Cal. Rptr. 3d at 706–07 (finding that the Hustwits’ creation of a trust removed them from their status as debtors and made them true guarantors).
3. *Id.*
borrower for the loan transaction are clear enough.\textsuperscript{145} Unfortunately, the basic transaction structures of these cases are indistinguishable from the conventional loans in other cases in which the facts are distinct.\textsuperscript{146} Thus, following \textit{Paradise Land & Cattle Co., River Bank America}, and \textit{Talbott}, “it is not entirely clear whether a guaranty by an entity that wholly owns a borrowing subsidiary, even where they have both been organized many years earlier for different purposes, is fully enforceable following a nonjudicial foreclosure.”\textsuperscript{147}

\textbf{C. Courts’ Favoritism Towards Guarantors Has Led to the Inconsistent Application of the Sham Guaranty Defense}

The guarantor has always been a favorite of the law.\textsuperscript{148} “Perhaps as a result of a judicial preference for debtors or lawmakers’ fear of creditor overreaching, or a combination of the two, the enactment of statutory law . . . ha[s] betrayed a discernible deference to any party that becomes obligated to answer for the debt of another.”\textsuperscript{149} This is so despite the party’s initial willingness to be a secondary obligor. Not surprisingly, the guarantors’ initial willingness tends to dissipate when they are actually confronted with the liability they agreed to, and they begin to assert several grand defenses—like the sham guaranty defense.

Cases that found a sham guaranty where the lender inspected the financial standing of the guarantor, or where the borrower initially created an entity prior to the transaction,\textsuperscript{150} may be explained only by concluding that “when confronted with a guarantor who elicits

\begin{footnotesize}
\begin{enumerate}
\item This scenario occurs in situations where the guarantor is merely an “alter ego” of the borrower, and therefore is entitled to the protections of the “one action rule” and the “antideficiency rule.” David R. Krause-Leemor, \textit{Guarantors Beware}, McKENNA LONG & ALDRIDGE LLP (Mar. 23, 2009), http://www.mckennalong.com/publications-advisories-2868.html. “For example, if a lender requires a general partner to guaranty the loan of a limited partnership, [the] guaranty could be construed as an invalid sham guaranty since, by law, the general partner [is] already obligated for the debts of the partnership/borrower, and [is entitled to] receive[] the protections of a borrower.” \textit{Id.}
\item \textit{Id.}
\item Brian Specter, \textit{Is that Personal Guaranty Enforceable?}, JENNINGS STRAUSS (Feb. 24, 2012), http://jsslaw.blogspot.com/2012/02/is-that-personal-guaranty-enforceable.html.
\item See River Bank Am. v. Diller, 45 Cal. Rptr. 2d 790 (Ct. App. 1995).
\end{enumerate}
\end{footnotesize}
sympathy, the courts are willing to find numerous reasons to abrogate the guaranty contract.”\(^\text{151}\) Unfortunately, “[t]his sentimental deference to the plight of the guarantor has seldom been the source of venerable legal principles.”\(^\text{152}\) As the cases have shown, the courts are not always careful in applying these factors consistently.

Consequently, “the creditors’ only practical response ‘necessarily resembles something of a shotgun approach.’”\(^\text{153}\) As lenders attempt to draft guaranty forms that can avoid various defenses by guarantors,\(^\text{154}\) knowledge and understanding of applicable laws are necessary to create an effective guaranty agreement. Such knowledge and understanding is presently nonexistent with regards to the scope of the sham guaranty defense. Confronted with a substantial bias favoring guarantors, the “perhaps unfortunate” creditor who relies in good faith on a loan guaranty frequently becomes the victim of proguarantor decisions.”\(^\text{155}\)

Although sound reasons exist for many of the guarantor’s defenses, “the courts’ inconsistencies have hampered the integrity of credit documentation” and weakened lenders’ ability to effectively look out for their interests\(^\text{156}\)—recouping remaining amounts after a foreclosure sale recovers less than the amount loaned.

Thus, based on current law, the cases suggest that a lender’s arguments to avoid a sham guaranty defense by a guarantor, “no matter how reasonable, might not prevail when directed at a guarantor favored by the court.”\(^\text{157}\)

\begin{flushright}
\textit{D. Lenders’ Inquiries into the Guarantor’s Financial Status Should Not Expose Them to a Sham Guaranty Defense}
\end{flushright}

“One central and often ignored principle concerning guaranties has remained true from the time of Solomon through the era of structured finance—a guaranty is only as good as the guarantor.”\(^\text{158}\)

In other words, a guaranty is of little use if the guarantor is not

\begin{flushright}
151. Alces, supra note 149, at 660.
152. Id.
153. Id. at 661.
154. Id.
155. Id. at 683.
156. Id.
157. Id. at 665.
158. Peterson et al., supra note 2, at 12, 18.
\end{flushright}
financially capable of assuming the debt of the primary obligor if they default. While some unsophisticated guarantors may garner sympathy from the courts, guanators involved in large commercial real estate transactions are presumed to be more sophisticated. They ought to understand that they are legally bound to pay back the loan if the borrower cannot or will not pay.

“The general rule of law is that a guaranty is a separate independent contract, and the guarantor has secondary liability after the default of the debtor is proven.” Because the guaranty is a separate contract, a lender will have to look into the financial strength of the guarantor. The lender does this not only to ensure that the guarantor will be able to step in and pay the debt if the primary borrower is unable to but also to ensure that the guarantor can enhance the credit of the primary borrower. But with the court’s decision in River Bank America based in part on the fact that the bank looked primarily at the financial standing of the guarantors, lenders are in a difficult situation.

The reality in current real estate lending is that lenders “look principally to the financial condition of the guarantors and other principals of the borrower, rather than the [financial condition of the] borrower . . . .” Lenders may also dictate the entity structure of the borrower; for example, when a transaction involves nonsecuritized loans, lenders often insist on a guaranty.

In light of these considerations, it is not strange that some commercial loan approval decisions are based on the financial strength of the guarantor. Typically, the lending institution

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159. Han Nguyen, Gauging the Personal Guaranty for Your Borrower’s Loan, LAW360 (Nov. 10, 2011), http://www.schnader.com/files/Publication/11e6bb31-3e3e-4001-89db-0269d8a82fc961/Presentation/PublicationAttachment/dbde5595-8359-4523-8f44-c038883488be Nguyen_Han,Guaranty_Nov%202011.pdf.


162. See Geiger & Allen, supra note 7, at 35.


164. Id.

requires information sufficient to assess the guarantor’s financial ability to satisfy the obligation.\textsuperscript{166} It is therefore difficult to defend the proposition that a lender who looks too closely at the financial strength of the guarantor in our current economy should fall prey to the sham guaranty defense. Unfortunately, the present state of this area of law allows and even encourages this position.

\textbf{E. The Expansive Use of the Sham Guaranty Defense Discourages Individual Responsibility}

A lender usually requires a guaranty prior to approving a loan because it is unsure whether a borrower is capable of paying it back.\textsuperscript{167} Under such circumstances, “the lender will not advance the loan without the comfort of a guarantor.”\textsuperscript{168} With that being said, most lenders advise the prospective guarantor to seek independent legal advice regarding the transaction.\textsuperscript{169} A guarantor’s legal adviser, assuming they are proficient in this area of law, could lay out the different options available to the guarantor in order for them to make an informed decision regarding the type of guaranty agreement they are willing to sign.

There are basically three different types of guaranties available, and they each expose the guarantor to varying degrees of liability in the event the primary borrower defaults. The first type is called a payment guaranty.\textsuperscript{170} Under a payment guaranty, “[t]he guarantor typically waives notice, . . . demand for payment and any requirement that the lender proceed against the principal obligor or the collateral before making a claim against the guarantor.”\textsuperscript{171}

\textsuperscript{166} Id. Some of the factors include “liquidity, income, debt and debt service requirements, other cash uses, contingent liabilities, and other relevant factors including credit ratings.” Id.


\textsuperscript{168} Id.


\textsuperscript{171} Id.
A second common guaranty is a limited guaranty,172 which may be limited in several ways.173 One common way is to limit the amount for which the guarantor is liable.174 The guarantor will then only take on the responsibility that he or she bargained for should the need arise.175 Finally, a third guaranty available is a nonrecourse guaranty.176 This type of guaranty limits the liability for default to recovery against the property, subject to a few exceptions.177

After the proper disclosures are made to the guarantors, it would be safe to assume that they have a good sense of their obligations under each type of guaranty. It follows, then, that for them to later assert that they were victimized, or were unaware of the full extent of their obligations, or were deceived, would be a mockery to individual responsibility. Nonetheless, with the current state of the law, even a fully informed guarantor can still assert the defense in an attempt to avoid his or her obligation.178

Such unrestrained use of an equitable defense by savvy guarantors must be restricted. If guarantors are free to use the sham guaranty defense even when they are sophisticated, lenders’ abilities to rely on guaranties will consequently be derailed. Moreover, guarantors’ attorneys will continue to come up with more novel factors for the courts to consider. Without any guidance or restrictions, courts will be hard pressed not to follow their lead, which will result in even more confusion in this area of law. Lest this be characterized as the “parade of the horribles,” a brief look at the history of this equitable defense shows a gradual expansion that has led to this present chaotic state.

IV. PROPOSAL

In the current economic climate, fulfilling loan obligations and generating new loans are of significant importance to lenders,
borrowers, and guarantors alike.\textsuperscript{179} With borrowers defaulting on loans, guarantors invoking the sham guaranty defense to avoid liability, and lenders scrambling to mitigate their losses, some clarity is necessary. Thus, it is an appropriate time for the California Legislature to step in and clarify the scope of the sham guaranty defense like they did with the enforceability and validity of guaranty waivers.\textsuperscript{180}

In considering the most effective way to clarify this area of the law, it is imperative to accept that questions of whether a guaranty is a true guaranty or a sham will inevitably involve a factual analysis. Nonetheless, a factual analysis does not necessarily have to be unrestrained. Therefore, the legislature should give the courts some guidance and restrictions when considering the issue. Such guidance will aim to provide the courts with a list of factors to consider as well as indicate the importance of each. Finally, the legislature should set down certain parameters as a guide for courts to adhere to when applying these factors.

With that in mind, the legislature or other interested parties can consider this proposal as a sample for future legislation on the sham guaranty defense:

\begin{quote}
\textbf{SECTION 2011(A): PRESUMPTION OF A SHAM GUARANTY}

Absent a substantial showing of some or all of the following factors, there is a strong presumption in favor of a true guaranty:

1. Evidence that a lender induced a prospective borrower to create a new entity as a prerequisite to approving a loan, and the entity is later used as the primary borrower in place of the original borrower who subsequently becomes the guarantor.

   a) This section applies to lenders who maintain an established policy that requires the creation of a “special purpose entity” as a prerequisite to approving a loan, regardless of whether the prospective borrower already had such entity established. A “special purpose entity” is one that is created solely for the purpose of the underlying transaction,
\end{quote}

\textsuperscript{179} See Rans & Williams, supra note 14, at 483.

\textsuperscript{180} See Hackett, supra note 53, at 1117–20; discussion supra Part II.A.
b) This section applies to a lender’s continuous and persistent suggestions directed towards a prospective borrower to compel them to create a special purpose entity.

c) This section does not apply to a transaction where: (1) the primary obligor, if a form of business entity, was in existence prior to the transaction; (2) the lender was not instrumental in its creation; and (3) the lender does not violate Section 2011(A)(1).

2. Evidence that the primary obligor, if a corporation, is without any assets, thus making it a shell corporation. Nonetheless, a corporation’s lack of substantial assets, without additional evidence that it is a shell corporation, does not automatically render it a shell corporation.

3. Evidence that a lender was aware of a guarantor’s naivety regarding the implications of the guaranty, and that the lender failed to advise the guarantor to seek independent legal representation to conduct the transaction on their behalf.

   a) A guarantor who signs a guaranty agreement is presumed to have had knowledge and a full understanding of the terms and consequences of the guaranty.

   b) A guarantor who has previously guaranteed a loan in a similar transaction is deemed to be knowledgeable as to such matter and is thus estopped from invoking this subsection.

   c) The expressed opinion of the guarantor’s counsel regarding the validity of the transaction will be considered in evaluating the validity of said transaction.

4. Evidence of fraud on the part of the lender.

SECTION 2011(B): ADDITIONAL DISCRETIONARY FACTORS

If a guarantor fails to overcome the presumption in favor of a true guaranty, a court may consider the following additional factors:

1. Whether the lender directed the structure of the transaction and the guarantor did not have independent representation.

2. Whether the guarantor is the alter ego of the borrower.
3. Whether the lender demanded that additional collateral owned by the guarantors be added to the transaction.
4. Whether the lender first sought to secure liens on the guarantor’s personal property after the primary obligor defaulted.
5. Whether the documents were ambiguous. For example, because of carelessness, does one document indicate a person is a borrower and another document state the person is a guarantor? When ambiguity in the documents exists, the lender can provide additional evidence to explain the discrepancy.
6. Whether and to what degree a guarantor is sophisticated at the time they sign the agreement.
7. Whether the guarantor independently formed the corporation for the purpose of procuring the loan from the lender. If so, the guarantor is estopped from invoking this subsection. Evidence of said purpose includes, but is not limited to:
   a) Failure of the incorporator(s) to observe corporate formalities in terms of behavior and documentation.
   b) Intermingling of assets of the corporation and of the shareholder.
   c) Treatment by the incorporator(s) of the assets of corporation as personal property.
8. Other factors that are specifically tailored to a case.

SECTION 2011(C): BALANCING CONSTRAINTS
Without limiting the force of sections 2011(A) and (B), the courts, in applying these factors, shall abide by the following constraints:
1. The factors in sections 2011 (A) and (B) will not, on their own, be determinative of a sham guaranty.
2. Where the challenger of a guaranty agreement fails to sufficiently overcome the presumption in section 2011(A), a higher showing of factors present in section 2011(B) will be required to overcome the presumption of a true guaranty.
3. If a guarantor fails to carry his or her burden under this rule, but if the court determines that to find a true guaranty would be an injustice under the totality of the circumstances, the court, in its discretion, may invalidate the guaranty agreement in the
interest of justice. Such balancing must be tailored specifically to the case. A showing of injustice will not be found in the following situations:

a) A guarantor who is already liable for other defaulted loans;
b) A guarantor who had the opportunity to mitigate his liability from the outset of the transaction;
c) A deep sense of sympathy for the plight of the guarantor as a secondary obligor; or
d) A general feeling that lenders need to be punished based on a prevailing public animosity towards them.

V. JUSTIFICATION FOR THE PROPOSAL

This proposed legislation will serve as soothing relief in a chaotic area of law and is justified on a number of grounds. First, this proposal provides the courts with clear law to apply whenever they are confronted with a sham guaranty defense. Instead of considering a variety of novel factors that guarantors and their attorneys create, courts need only look to the law to know which factors to consider and how to balance them in order to reach a decision that is fair to all parties under the factual situation.

Moreover, this proposal fosters a culture of responsibility by encouraging guarantors to be more cautious before signing guaranties. Instead of relying on a court’s sympathy to avoid liability on loans they voluntarily guaranteed, guarantors will be more likely to look for ways to reduce their liability in anticipation of the primary obligor defaulting. Even borrowers, who might ordinarily contemplate creating a fictitious entity to get approval for a loan that they later guaranty, will reevaluate the wisdom of their strategy in light of this legislation.

Furthermore, this legislation will finally alleviate lenders’ confusion in this area of law. When structuring their transactions, the proposal alerts lenders to a set of factors that might expose them to a sham guaranty defense. This places them in a better position to avoid falling prey to a guarantor’s sham guaranty defense, since they can better anticipate problematic behaviors and strategies.

Additionally, the proposal addresses the potential that if given the chance, lenders may seek to take advantage of both the borrower and the guarantor. To mitigate this concern, the proposed legislation
includes provisions that give courts some controlled discretion in situations in which a creditor has clearly gone against the rule but the guarantor is unable to prove the specific factors to establish a sham guaranty defense. Thus, the proposal is fair to all parties involved. Finally, this proposed legislative solution is consistent with the policy reasons behind the California antideficiency statutes that were designed to limit the liability of real property owners following foreclosure. The proposal does not remove any protection from a real property owner, but works to hold guarantors accountable.

The proposed legislation will be a conversation starter for the California Legislature in its attempts to clarify this area of law. As the economic situation continues to unfold, the effects on the commercial real estate market may require the legislature to continue to amend certain sections of any statute they eventually choose to adopt. Nonetheless, this proposed solution serves as a step in the right direction in the quest for clarity of the sham guaranty defense.

VI. CONCLUSION

Creditors serve a crucial role in our economy. “Every nation needs a mechanism to expand its money supply, consistent with the growth rate potential of the economy.” Creditors serve that function by making loans available for economic development. They provide much needed funds to the small business owner who seeks to expand, the real estate developer who seeks to develop a new mall, the multinational corporation that seeks to conduct a merger, and many other entities. Guaranty contracts are a fundamentally important tool to all parties in such transactions.

Such an important part of the economy should have clear laws governing its adjudication. The law should work for all parties, instead of treating some as villains and others as favorites. Moreover, this is hardly the first time the courts have faced challenges in enforcing guaranties without any law to guide them. They faced the challenge of guaranty enforceability in the mid-1990s, and the legislature sensibly worked to safeguard their viability by enacting a

law that specifically clarified the issue.\textsuperscript{183} The same should be done here. In the current economic climate, the sham guaranty defense issue is important, and failure to act will preserve a status quo that is inherently unfair and seeks to punish an important sector of the economy.

\textsuperscript{183} See discussion supra Part II.A (discussing how the California Legislature finally clarified the enforceability and validity of guaranty waivers).