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The limitations of the sham guaranty defense

By Benjamin Taylor

Many commercial loan transactions involve a personal guaranty of repayment, given by either a principal of the borrower or a related entity. Lenders will often require a personal guaranty, sometimes from multiple guarantors, even when the underlying loan is secured by real estate or personal property. In the context of a collections action to enforce the guaranty, a popular but often improperly claimed defense is that of the "sham guaranty." With the increasing number of breach of guaranty lawsuits that has accompanied the economic downtown of the last several years, the sham guaranty defense has been asserted with more regularity, but rarely is it truly applicable.

The sham guaranty defense is well-established in California law. Distilled to its essence, the defense applies where a guaranty is nothing more than, well, a sham. Under California Civil Code Section 2787, a guarantee is defined as "the promise to answer for the debt...of another person." By definition, then, one cannot guarantee his own debt. If "A" borrows $1 million from the bank and signs a promissory note evidencing that debt and promising to repay, "A" cannot then also sign a personal guaranty of repayment. Since he is already contractually obligated to repay the $1 million, his "guaranty" of repayment adds nothing - it's a sham. This illustration is the most simplistic example of sham guaranty. As in many areas of the law, however, the applicability of the sham guaranty defense is rarely so straightforward.

One of the thornier questions of the applicability of the sham guaranty defense arises when the borrower is an individual and the guarantor is the borrower's trust (or vice versa). The leading case in this area, and the one perhaps most often cited by counsel for guarantor defendants in such a circumstance, is *Torrey Pines Bank v. Hoffman* (1991) 213 Cal.App.3d 308. In *Torrey Pines*, husband and wife Jerome and Naomi Hoffman personally guaranteed a construction loan to their own revocable living trust, of which they were the trustors, trustees and beneficiaries. After completing a non-judicial foreclosure of the deed of trust on the property that secured the loan, the bank sued the Hoffmans to recover the resulting deficiency balance.

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The Hoffmans argued successfully to the trial court that, because they were in fact already the principal obligors under the promissory note, their guarantee was a sham and therefore, under the antideficiency protections of Civil Code Section 580d, they were entitled to summary judgment. In its analysis of the trial court's ruling on the sham guaranty defense, the appellate court summarized the proper inquiry into whether a guaranty is a sham, as follows:

"The correct inquiry set out by the authority is whether the purported debtor is anything other than an instrumentality used by the individuals who guaranteed the debtor's obligation, and whether such instrumentality actually removed the individuals from their status and obligations as debtors.... Put another way, are the supposed guarantors nothing more than the principal obligors under another name?"

In concluding that the guarantee given by the individual trustors, trustees and beneficiaries of the debt of their own revocable trust was a sham, the appellate court looked to the applicable law governing trusts to determine whether the guarantees by the trustees in fact created any separate obligation that did not already exist. Under the rules in effect at the time the loan was made in 1986, a trustee was personally liable on a contract unless the contract stipulated that the trustee was not liable. Thus, the individual trustees (guarantors) were already personally liable under the promissory note evidencing the loan to the trust, and their purported guarantees added nothing.

However, in 1991, an important change in the trust law took effect. Probate Code Section 18000(a) was modified to excuse a trustee from personal liability on a contract where either his representative capacity or the identity of the trust is revealed in the contract. This rule marked an important change in the substantive law in this area, and in fact is the reverse of the prior long standing case-law rule in California. Although certain subsequent appellate court opinions have declined to apply Section 18000(a) to trust guaranty cases (most notably, *The Cadle Company II v. Harvey* (2002) 83 Cal.App.4th 927), these cases appear to have misapplied the law, and courts should probably now decline to find that a guaranty is a sham in such situations.

Another leading case in the sham guaranty area is *River Bank America v. Diller* (1995) 38 Cal.App.4th 1400. In *River Bank*, Sanford and Helen Diller, individually and as trustees of the DNS Trust, signed guarantees of River Bank's loan to Hacienda Gardens Venture, a limited partnership, for the purpose of financing construction of an apartment complex. The bank sued to enforce the guaranty after rental income from the completed apartment project proved to be inadequate to service the debt. In ruling on the bank's motion for summary judgment, the trial court found that there was a triable issue of fact on the Dillers' sham guaranty defense. The bank appealed.

The appellate court concluded that there was a triable issue of fact on whether the guaranty was in fact a sham. Although *River Bank* is often cited by counsel for guarantors for the principle that the subject guarantee is a sham, it is usually distinguishable because the evidence before the court suggested that the bank's conduct in that case was particularly egregious: There was evidence that, in originating the loan,

the bank looked to the guarantors as the principal obligors, and in an attempt to avoid the antideficiency statutes, insisted that the guarantors set up a new entity "borrower."

While the appellate court did not find that the guaranty was a sham as a matter of law, as it is properly a question of fact, it noted that the evidence suggested that the "purpose and effect" of the guarantees was to recover deficiencies in violation of Code of Civil Procedure Section 580d. In the wake of *River Bank*, rarely if ever is a lender so careless in structuring a loan transaction.

With the collapse of the real estate market in 2008, the ensuing flood of litigation involving failed construction projects and the unpaid loans that financed them has been accompanied by a renewed attempt by guarantors to assert the sham guaranty defense. Most frequently, it is asserted (without success) in cases involving a personal guaranty of repayment of a loan to an LLC given by a member of that LLC. While the applicability of the sham guaranty defense depends on the facts of the case, courts will generally continue to enforce the guarantees in such situations. Although judges are reluctant to disregard the separate legal identities of a corporation or LLC and its individual shareholders or members, if a guarantor can present evidence that the guaranty was obtained for the purpose of subverting California's antidefiency statutes, the sham guaranty defense might still have a chance of success.

While the sham guaranty defense still has its place, its applicability is more limited in the wake of the change to Section 18000. The bottom line for lenders is to sidestep this potential quandary by either requiring that the borrower provide some other grant of security or obtain a guarantee from a truly separate guarantor. Lenders that attempt to enforce guarantees given by the borrower's trust or that structure a transaction looking primarily to the guarantor as the source of repayment do so at their own peril.

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