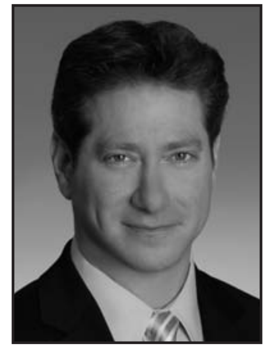
Law of Intended Consequences?

By Seth Weissman



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I. INTRODUCTION

During better economic times, capital was flowing freely to support the growth of new, emerging, and established businesses. With good business plans and realistic profit expectations, owners of closely held companies availed themselves of readily-available equipment financing, receivables financing, real estate and construction financing, and simple revolving lines of credit. Recipients of such financing rarely saw themselves as "borrowers" or "debtors" in the classic sense. Rather, they were "customers" of financial institutions that wanted and needed their business, and the depository relationships that generally accompanied the financing. For many of these customers, receiving and executing a customary package of loan documents governing these simple, win-win financing arrangements, did not deserve significant review. Often, one of those "standard" documents was a basic, unlimited, personal guaranty executed by the principal or principals of the borrower, and often, the principals' spouses.

As businesses grew, so too, often, did lines of credit, frequently taking the form of simple amendments to existing loan documents, increasing the credit limits, and acknowledged by the guarantors without a systematic review of the impact of the change in terms. At the same time, the facts in place at the time the original guarantee was made also changed — parties pass away, couples get divorced, children mature — while old guarantees remain unchanged and unconsidered, until the guarantor represents the last, best, hope to save a struggling business or repay an old loan.

After several years of economic stress and economic setbacks, credit facilities that previously had been routinely increased are now being frozen or contracted, and "customers" are discovering that those seemingly simple loan documents actually have covenants and conditions, and that credit lines have stated maturity dates and the potential for acceleration. Ultimately, the relationship has transformed — the "customer" is, in fact, a "borrower," the "borrower" is in default, and the bank calls the loan.

In some cases, lenders are taking rapid steps to realize on any collateral they can. In others, since the borrower's collateral (real estate, receivables, equipment) may not be particularly valuable, lenders are invoking a so-called "amend, extend, and pretend" approach, but with conditions. Moreover, as a condition to forbearance, some lenders are trying to firm up their positions by tacking on real estate security from the guarantors to supplement the open-ended, unlimited but generally unsecured personal guarantees entered into during better economic times.

This article addresses some of the issues that face guarantors of financial obligations during deteriorating economic conditions, with special attention to how real estate security impacts the rights of lenders, borrowers and guarantors on those obligations.

II. CALIFORNIA ONE-ACTION AND ANTI-DEFICIENCY LAWS

Whether separate real estate security is provided concurrently with the execution of a guaranty, or offered as collateral to secure a guaranty as part of a workout, it may surprise borrowers, guarantors, and practitioners alike, many of whom have a passing familiarity with California's "one-action" rule and anti-deficiency laws, that those laws may not protect all of the guarantors from a general attachment of their assets.

Without recreating a treatise on limitations of recovery against borrowers and guarantors with respect to loans secured by real property, here are a few general concepts to think about:

1. When a loan is secured by real property, the lender is required to exhaust such real property security by judicial foreclosure before it may pursue a deficiency judgment against the borrower (this is the "security-first" component of the one-action rule) (and failing to do so will result in a loss of the real property collateral[1]);
2. In lieu of judicial foreclosure, the lender may conduct a private, non-judicial trustee's sale, and have

no further right to pursue the borrower for any deficiency (but preserve the right to pursue a guarantor for the deficiency);

3. Waivers by borrowers of the foregoing protections are generally not enforceable; and
4. A pledge of real property by a third party (not the borrower) to directly secure the borrower's debt (referred to as an "accommodation pledge"), is a suretyship relationship under Civil Code section 2787,[2] for which the surety would have the right to assert suretyship defenses codified in Civil Code sections 2787 through 2855, including compelling the creditor to first proceed against the primary obligor or any security provided by the primary obligor (rather than the surety), which defenses, however, are waivable.

III. SURETY VS. GUARANTY

Consider this example: Borrower Bob gets a loan — a simple line of credit for Borrower Bob's business. The lender wants some real property security. Surety Steve (Borrower's Bob's brother-in-law) grants a deed of trust to the lender to secure Borrower Bob's loan. The deed of trust does not include any suretyship waivers. Borrower Bob defaults on the loan. The lender sues Borrower Bob for recovery, but Borrower Bob rightfully objects arguing that the lender is required to pursue the security first. The lender files an action against Surety Steve to foreclose on Surety Steve's property. Surety Steve objects, claiming that the lender must first pursue Borrower Bob pursuant to Civil Code section 2845. This is a circular problem that does not bode well for the lender, all because the lender did not get a waiver from Surety Steve of the defense under Civil Code section 2845 that the lender must pursue the primary obligor first.

As a general matter of practice, sophisticated lenders are aware of this problem, and do not generally accept accommodation pledges to secure the primary debt. Rather, where the only real property security for the loan is to come from a third party, it is generally structured as a non-recourse guaranty, which guaranty is secured by the guarantor's real property. Since most form guarantees contain broad suretyship waivers, there is less risk that the waivers will be overlooked (as they may not generally be contained in a lender's form deed of trust), and the lender will be able to pursue the real property security without claim that it must first go after the borrower.

Conversely, in the present land of hard money bridge lending, opportunistic (but perhaps less sophisticated) lenders may think that a deed of trust from a third party is as good as from the borrower, and not think about or understand suretyship implications.

Let's change our hypothetical and assume that the loan to Borrower Bob is secured by Borrower Bob's real estate, as well as a full recourse guaranty (unsecured), with full waivers of all suretyship defenses, executed by Guarantors Greg and Gretchen (Borrower Bob's parents). Borrower Bob defaults on the loan, and the lender pursues an action directly against Guarantors Greg and Gretchen, without ever first going after Borrower Bob's real estate security. This is generally permitted, as a guarantor's obligations are generally regarded as separate and distinct from those of the Borrower, and the security-first protections afforded by Code of Civil Procedure section 726 are intended only to protect the borrower, and do not apply to guarantors who have waived all such protections.

IV. ADDITIONAL SECURITY AND THE ONE-ACTION AND ANTI-DEFICIENCY RULES

Expanding this hypothetical further, assume that as the economy declined further, Borrower Bob and the lender agreed to a forbearance and restructuring of Borrower Bob's loan, but as a condition to the restructuring, the lender required Guarantors Greg and Gretchen to secure their guaranty with a separate deed of trust against an office building they owned. Assume further, however, that before this restructuring, Greg and Gretchen got divorced. They had been married for 50 years, and all of their assets were community property. In the divorce, Guarantor Gretchen got a lot of cash and other assets, and Guarantor Greg got the very valuable office building. They are still guarantors under the guaranty, with joint and several liability, but only Guarantor Greg puts up collateral (the office building) to secure the guaranty.

Do the security-first and anti-deficiency rules apply to the enforcement of Guarantor Greg and Guarantor Gretchen's guaranty secured by Guarantor Greg's real estate? Can the lender obtain a general attachment of Guarantor Greg's and/or Guarantor Gretchen's assets without first pursuing the office building securing the Guaranty?

A common reading of the general anti-deficiency rules,[3] is that they do not apply to guarantors. However, the answers to the inquiry are not strictly found in the classic anti-deficiency statutes. Rather, California law generally provides that an attachment may not be issued on a claim which is secured by any interest in real property arising from agreement, statute, or other rule of law (including any mortgage or deed of trust of realty and any statutory, common law, or equitable lien on real property), except to the extent that, through no fault of the secured party, the security has become valueless or has decreased in value to less than the amount then owing on the claim (in which event the amount so secured by the attachment shall not exceed the lesser of the amount of the decrease or the difference between the value of the security and the amount then owing on the claim).[4]

So, in the case of Guarantor Greg and Gretchen's guaranty, which has been secured with real estate, it would appear that the lender's right to attachment would be limited to the amount of the deficiency. Or is it? Recall that Greg and Gretchen are now divorced. When they originally executed the guaranty, they were married and they held, as community property, all of the cash, personal property, and real property that was eventually divided in the divorce. The office building is very valuable — and exceeds the amount of Borrower Bob's loan. Can the lender attach Gretchen's assets despite the presence of such valuable security?

This issue was recently addressed in the California appelate court decision in *Bank of America, N.A. v. Stonehaven Manor, LLC*.[5] In this case, three persons jointly and severally guaranteed a loan — which loan itself was secured by real property, and one of the guarantors also secured the guaranty with its real property. The other two guarantors did not separately secure the guaranty. Upon default by the borrower, Bank of America pursued the real property security of the borrower and the guarantor that granted the security interest in its real estate, and sought general attachment of the property of the other guarantors. The other guarantors objected to the attachment of their assets on the grounds that the guarantee-based claim against them was secured by real property (of the other guarantor), and that attachment was therefore precluded by Code of Civil Procedure section 483.010(b). The court concluded that the lender had the right to seek attachment of those guarantors' assets. The court reasoned that the "joint and several" language in the guaranty meant that it should be read as three separate guarantees (for which they had not given separate security), and further, while not expressly stated in these terms, that even if the guaranty was read as one guaranty, and even though that guaranty contained the full complement of suretyship waivers with respect to the fact that the underlying loan was secured by the borrower's real property, and notwithstanding the fact that there was no express waiver of Code of Civil Procedure section 483.010, that language in the guaranty specified that nothing in it "shall be deemed to limit the right of [Bank] … to obtain … prejudgment attachment."[6]

Is this the right result? Would the court make the same conclusion had the lender pursued attachment of the assets of the guarantor that had executed the deed of trust securing the guaranty? The language authorizing the right to seek attachment is just as present as it relates to that guarantor. Should a waiver of Code of Civil Procedure section 483.010 be implied from such language, or should an express waiver referencing such provisions be required? Should such a waiver be enforceable at all?

At first blush, given the broad view that guarantors can, and routinely do, waive every possible defense, it should be no surprise that the court would be so dismissive with respect to those guarantors that did not put up real estate collateral. In fact, the question may be more to the point of why the guarantor that did pledge real estate is protected by Code of Civil Procedure section 483.010. However, by analogy, consider the situation where two persons execute a promissory note, as joint and several obligors for a debt, but only one of them pledges real estate collateral. Is the obligor that did not put up real estate collateral protected by the one-action rule? In the 1987 decision in *Pacific Valley Bank v. Schwenke*,[7] the court held just that. How is that any different than in the guarantor example described above? Is the co-signer on a loan not effectively a guarantor — and, as such, should they be permitted to waive the protections of the anti-deficiency laws suretyship defenses?

At the end of the day, it would seem that we would need to go back and explore the public policy for the general one-action and anti-deficiency protections afforded borrowers, and consider under what circumstances the guarantor securing his guaranty should have similar benefits in exchange for the additional security afforded the lender. We also need to consider whether a guarantor that pledges real estate security for its guaranty (either at inception or as part of a workout) anticipates that he or she is protected by the one-action rule, or whether a waiver of Code of Civil Procedure section 483.010 is enforceable. In the 1992 case of *First Interstate Bank of California v. Anderson*,[8] the court, holding against a guarantor on procedural grounds (for failing to appeal an attachment order) noted, in dicta, that the protections of Code of Civil Procedure 483.010 cannot be waived (in that case applying to a guarantor that pledged real property, but where there were no other guarantors).[9] Would they apply the same holding to additional guarantors that did not pledge real estate collateral?

V. CONCLUSION

As economic conditions have worsened and remain challenging, the impact of loan documents designed in a more sanguine climate are now coming under stress. All parties to the transaction — lenders, borrowers, and guarantors — are being tested. For now, it is essential for borrowers, guarantors, lenders, and their respective counsel, to understand the subtle differences between how parties are treated depending on the obligor hat they are wearing at the time, which hat, quite likely, may be shielding their eyes at a time of substantial financial hardship. ■

ENDNOTES

1 Often referred to as the "sanction aspect" of California Code of Civil Procedure section 726.

2 Unless otherwise indicated, all statutory citations are to California Codes.

3 *See* Cal. Civ. Proc. Code § 726; Cal. Civ. Proc. Code § 580(a), (b), (d).

4 Cal. Civ. Proc. Code § 483.010(b).

5 *Bank of Am., N.A. v. Stonehaven Manor, LLC*, 186 Cal. App. 4th 719 (2010).

6 *Id.* at 722.

7 *Pac. Valley Bank v. Schwenke*, 189 Cal. App. 3d 134 (1987).

8 *First Interstate Bank of Cal. v. Anderson*, 3 Cal. Rptr. 2d 337 (1992) (order not previously published).

9 *Id.* at 340.