Going After a Guarantor Of a Real Property Loan

By Alan S. Petlak

With commercial real estate loan default rates continuing to rise and estimates that commercial property values in certain areas have declined as much as 40 percent since their 2007 peak, many commercial properties are underwater (i.e., the properties are worth less than their underlying loans). As a result, lenders, when they can, are increasingly looking to guarantors to recover the difference between the unpaid amount of the loan and the value of the property. While a breach of guaranty action is a relatively straightforward action grounded in contract, there are many minefields that a lender should be careful to avoid. Failure to recognize these minefields before filing a breach of guaranty action may ultimately lead to the lender being barred from recovering anything from the guarantor.

Before pursuing a guaranty, it is important to look before you leap.

The California Civil Code provides the guarantor certain rights that, unless waived, may prevent the lender from recovering from the guarantor. Such rights include, among others, the right of the guarantor to require the lender to proceed first against the principal debtor, or otherwise require a lender to pursue collateral provided by the principal debtor before seeking to enforce a guaranty. Under Civil Code Section 2848, after guarantor's payment to a creditor, a guarantor may enforce creditor's rights against the primary debtor as a subrogee of the creditor.

While California's antideficiency laws do not directly bar an action against a guarantor, they may do so indirectly. California Code of Civil Procedure Section 580d provides that no deficiency judgment may be rendered on any note secured by a trust deed or mortgage after the encumbered property has been sold by private sale. The impact of Section 580d is to limit recovery from a borrower in a nonjudicial foreclosure proceeding to the value of the security. In the seminal case of *Union Bank v. Gradsky*, 265 Cal. App. 2d 40, 45-48 (1968), the California Court of Appeals held that by foreclosing through a nonjudicial sale, the creditor forgoes the right to proceed further against the debtor, and therefore the guarantor is denied a claim against the debtor. The *Gradsky* court concluded that as a result of a lender choosing nonjudicial foreclosure as its remedy (as opposed to judicial foreclosure), the lender is estopped from pursuing the guarantor because the guarantor in such circumstance is barred from pursuing the debtor as a result of Section 580d. The *Gradsky* court noted that had the lender pursued the judicial foreclosure remedy, the lender could have obtained a deficiency judgment against the debtor, which, in turn, would have left intact the guarantor's subrogation claim against the debtor.

For lenders, there is a bright side to this story. In California, a guarantor may waive most defenses, including antideficiency defenses. Civil Code Section 2856(c) sets forth a broad array of guarantor defenses that may be waived, including rights of subrogation, reimbursement, indemnification, and contribution, and any other rights and defenses available under the Civil Code. When drafting a guaranty, the safest course of action is to recite the waiver language set forth in California Civil Code Section 2856, although language in a guaranty showing an intent to waive defenses has been found to be sufficient even without specific reference to Section 2856.

One note of caution. Even assuming a guaranty properly contains all the applicable waivers, a lender may still not be out of the woods when pursuing a guarantor. To be a "true guaranty" and not a "sham guaranty" the guarantor must be distinct from the borrower. As the California Supreme Court succinctly stated in *Everts v. Matteson*, 21 Cal. 2d 437, 444-46 (1942), a person cannot guaranty his or her own debt. Following the California Supreme Court's lead in *Everts*, in *Union Bank v. Dorn*, 254 Cal. App. 2d 157, 159 (1967), the appellate court found that a general partner of a partnership is considered a principal obligor entitled to the antideficiency defense. Similarly, in *Torrey Pines Bank v. Hoffman*, 231 Cal. App. 3d 308, 321 (1991), the appellate court found that guaranties of a trust obligation were unenforceable because the trustees (husband and wife) were the alter ego of the family trust, the obligor. Therefore, in order to be a valid guaranty, the guarantor and the obligor must be legally separate and distinct from each other.

While a breach of guaranty action may be simple and straightforward, it is important to review and analyze the guaranty before deciding on the proper course of action prior to seeking recovery from the guarantor. Should the guaranty be missing any waivers of defenses, a lender may find itself out of luck if it attempts to pursue a guarantor for a deficiency after foreclosing nonjudicially. Even if the appropriate waivers are present, it is important to make sure that a true guaranty was obtained — not merely the obligor guaranteeing its own debt. As with many other things, before pursuing a guaranty, it is important to look before you leap.

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