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AN OVERVIEW OF DEFENSES AVAILABLE TO GUARANTORS OF REAL PROPERTY SECURED TRANSACTIONS UNDER CALIFORNIA LAW

Maxwell M. Freeman* & Elizabeth Freeman Gurev**

INTRODUCTION

The climate of California's real estate market from 1987-1996 has caused many developers to default on loans acquired for development of real property. The typical structure of these loans consists of a loan to acquire the real property (land loan), a loan to construct improvements on the property (construction loan), a deed of trust to secure the promissory note evidencing the debt, and a personal guaranty of the note by the developer.

If the developer (or other prime obligor) defaults on the loan, the lender may generally proceed along one of three paths to seek recovery. The lender may foreclose nonjudicially, foreclose judicially, or forego foreclosure and proceed directly against the guarantor on his or her personal guaranty. However, no matter which path is chosen, the lender's ability to recover against the personal guarantor will be limited by relevant antideficiency legislation, suretyship statutes, and case law. This article provides an analysis of many traditional and untraditional defenses available to a personal guarantor after a default by the developer (or other prime obligor/borrower).

Section I, the background section, provides an overview of the general issues relevant to the liability of prime obligors.

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and guarantors of real property secured loans. A more thorough analysis of the traditional commentary on these issues can be found in many sources. Sections II-VI of this article, however, present guarantor liability/defense theories not typically addressed by commentators.

Section II of this article explains typical and atypical applications of the so-called "Gradsky defense." This section also explains why the established due process test articulated in Cathay Bank v. Lee for evaluating the adequacy of waivers, such as the Gradsky waiver, was not abrogated by recently enacted section 2856 of the California Civil Code. Section II also explains that section 2856 of the California Civil Code should not be applied retroactively to guaranties executed prior to January 1, 1997.

Section III explicates the guarantor's argument that if a lender proceeds by judicial foreclosure, a guarantor, like the prime obligor, should be able to invoke the fair value protections of section 726(b) of the California Code of Civil Procedure, and limit his guarantor liability to the difference between the unpaid balance of the note (plus expenses) and the fair value of the property.

Section IV reviews traditional applications of the "sham guaranty doctrine," but more importantly provides an in-depth analysis of why a guaranty of a nonrecourse note securing real property is an unenforceable sham.

Section V discusses some unique applications of section 2809 of the California Civil Code, including why section 2809 prevents a lender from enforcing a guaranty of a nonrecourse note.
Finally, Section VI analyzes a relatively recent decision by the court of appeal for the first district, River Bank America v. Diller, wherein the court improperly declined to evaluate the adequacy of an express waiver of section 2809 of the California Civil Code by the established test articulated in Cathay Bank v. Lee.  

I. BACKGROUND: OVERVIEW OF LIABILITY OF PRIME OBLIGORS AND GUARANTORS OF REAL PROPERTY SECURED LOANS

A. Nonjudicial Foreclosure and the Gradsky Defense

After a default by a developer (or other prime obligor), a lender may seek recovery by nonjudicial foreclosure if the deed of trust contains a power of sale clause. However, the lender generally is precluded from obtaining a deficiency judgment from the prime obligor following a nonjudicial foreclosure pursuant to section 580d of the California Code of Civil Procedure. Moreover, where a lender chooses nonjudicial foreclosure, it is now well established that the lender is thereby estopped from recovering a deficiency from the guarantor pursuant to the so-called Gradsky defense. Under the Gradsky defense, a lender is estopped from collecting a deficiency from the guarantor after a nonjudicial foreclosure because the election of this particular remedy acts to cut off a guarantor’s subrogation rights against the prime obligor. In response, lenders have routinely placed language in the guaranty contract which purports to waive the Gradsky defense.

stated the traditional rule that a lender only may enforce a waiver that is intentional, explicit, and informs of its legal consequences. In addition, section 2856(d) of the California Civil Code codifies “safe harbor” language enabling the lender to impose an effective Gradsky waiver. Many guaranties drafted prior to Cathay Bank fail to articulate enforceable Gradsky waivers, and counsel should be alert to examine such guaranties before opining as to enforceability.

In sum, if a lender proceeds by nonjudicial foreclosure and seeks a deficiency from the guarantor, the guarantor can invoke the Gradsky defense, unless that defense has been waived via an intentional, specific, and informed waiver, or via statutory “safe harbor” language.

B. Judicial Foreclosure and the Right to a Fair Value Hearing

Alternatively, after a valid default by the developer (or other prime obligor), the lender may choose to enforce its lien on the property by judicial foreclosure, rather than by nonjudicial foreclosure. When proceeding by judicial foreclosure, a lender obtains a judgment ordering the sale of the property, a sale is conducted by a levying officer, and the sale proceeds are applied toward reduction of the prime obligor’s debt. A disadvantage to the lender of judicial foreclosure is that it grants the borrower a one-year statutory option to redeem the property for the loan balance and attorney’s fees and costs following the judicial foreclosure sale. Nonetheless, a lender may opt for judicial foreclosure because this method may permit the lender to obtain a deficiency judgment against the borrower where the proceeds of the sale of the property are inadequate to satisfy the debt.

Assuming judicial foreclosure is proper, but the sale proceeds do not satisfy the debt, the lender may seek a deficiency from the prime obligor. However, under the fair

16. See id.
17. CAL. CIV. CODE § 2856(b) (West Supp. 1996).
18. BERNHARDT, supra note 1, § 3.1, at 105.
20. CAL. CIV. PROC. CODE § 726(b) (West 1980 & Supp. 1996); see also CAL. CIV. PROC. CODE § 580b (West Supp. 1996). However, the lender is precluded from obtaining a deficiency in cases involving nonpurchase money secured debt. CAL. CIV. PROC. CODE § 580b.
21. CAL. CIV. PROC. CODE § 726(b).
value protections of section 726(b) of the California Code of
Civil Procedure, a lender's recovery for a deficiency from the
prime obligor is limited to the difference between the unpaid
balance of the secured note (plus expenses) and the adjudicat-
ed fair value of the property. But for the limitation under
section 726(b) of the Code of Civil Procedure, a lender could
bid less than the fair value at the foreclosure sale, and then
obtain a "full deficiency" from the prime obligor.

Because of the fair value limitations contained in section
726(b) of the Code of Civil Procedure, lenders often seek to
obtain the difference between the foreclosure proceeds and
the fair value (the "shortfall") from the personal guarantor.
Stated another way, lenders in California routinely require
developers to personally guaranty development loans to de-
developers' corporations, so that lenders may attempt to avoid
the fair value protections of section 726(b) of the Code of Civil
Procedure. The issue then is, should the protections of sec-
tion 726(b) apply not only to prime obligors, but also to guar-
antors?

C. History and Purpose of Antideficiency Legislation

The antideficiency legislation described above has its
roots in the Great Depression. In the 1930s, California's an-
tideficiency scheme was revised to protect prime obligors who
lost real property through foreclosures. Before 1933, a
lender holding a mortgage on real property was required to
exhaust its security before enforcing the debt. After ex-
hausting the security by foreclosure, however, the lender
could then obtain a deficiency judgment against the prime
obligor for the difference between the amount of indebtedness
and the amount realized on the sale. Thus, during the
Great Depression, a lender was frequently able to purchase
the secured property at a foreclosure sale for a depressed
price, and then hold the prime obligor for a full deficiency.

22. Full deficiency is understood as the difference between the unpaid bal-
ance of the secured note plus expenses and the amount produced at the sale.
See infra note 43.
23. See discussion infra Section II.C.
24. See discussion infra Section III.
27. Id.
28. Id.
The cumulative effect often amounted to a double recovery because the lender got both the land (with value greater than the bid price) and the deficiency proceeds.

To alleviate this unfair result and to prevent spiraling downturns of real estate in bad markets, the California Legislature enacted the fair value protections of section 726(b) (applicable to judicial foreclosure sales) and section 580a (applicable to nonjudicial foreclosure sales) of the California Code of Civil Procedure in 1933 in order to correct the depressed economic conditions. The Legislature additionally enacted section 580b of the Code of Civil Procedure, which bars deficiency judgments on purchase money mortgages whether foreclosure is nonjudicial or judicial. Moreover, section 580d of the Code of Civil Procedure was enacted to prevent deficiency judgments after nonjudicial foreclosures.

D. The Sham Guaranty Doctrine

The legislative policies of the antideficiency legislation should be upheld regardless of any creative or unique structuring of loan transactions by lenders or other parties. Where guaranty contracts are effectively used to avoid the antideficiency legislation protections, the same spiraling decline in property values that the legislature intended to prevent occurs. Thus, California courts will closely scrutinize any guaranty contract to determine whether it is a "sham."

A guaranty of one's own credit is a nullity and will not circumvent antideficiency rules. A transaction schemed by the lender to appear to be a third party guaranty transaction

31. CAL. CIV. PROC. CODE § 580b (West 1976 & Supp. 1996). A purchase money note under section 580b of the California Code of Civil Procedure does not include third party financing of dwellings for more than four families that are not owner occupied. Id.
32. Id.
33. BERNHARDT, supra note 1, § 4.1, at 185.
34. See discussion supra Section I.C.
35. See Charles A. Hansen, Recent Developments Concerning Antideficiency Protection, the Full Credit Bid Rule, and Guaranties of Real Property-Secured Transactions, in EMERGING ISSUES IN FORECLOSURES, GUARANTIES AND OTHER REMEDIES 137, 177-85 (Continuing Education of the Bar ed., 1996) [hereinafter Hansen, Recent Developments 1996].
will not generate guarantor liability.\textsuperscript{36} For example, if the lender structures a transaction by requiring the borrower to create a corporation to act as the prime obligor with the borrower individually issuing a loan guaranty, the court may regard that structure as a sham and refuse enforcement of the guaranty on the theory that \textit{de facto} there is only one borrower and that borrower is entitled to antideficiency protection.\textsuperscript{37}

E. \textit{Suretyship Defenses: Sections 2845, 2848, 2849, and 2809 of the California Civil Code}

In addition to antideficiency legislation, the suretyship sections of the California Civil Code directly provide important rights and defenses to guarantors. A lender who chooses to proceed directly against a guarantor after default without first foreclosing on the security will, in the absence of full recovery, be precluded from additional recovery by sections 2845, 2848 and 2849 of the Civil Code.\textsuperscript{38} Section 2845 of the Civil Code grants a guarantor the right to require a lender to first proceed against the prime obligor or the security. Sections 2848 and 2849 of the Civil Code grant a guarantor the right to be subrogated to the lender’s position, and thus acquire the secured property where the guarantor is sued by the lender and the debt is satisfied without a foreclosure.\textsuperscript{39}

Further, section 2809 of the Civil Code precludes collection to the extent that the guarantor’s obligation is either “larger in amount” or “more burdensome” than that of a prime obligor.\textsuperscript{40} Unique applications of this defense are discussed in detail below in Sections V and VI.

**DISCUSSION**

II. \textit{Gradsky Estoppel Defense}

If a prime obligor defaults on a note secured by a deed of trust, the secured lender may choose to proceed by nonjudi-
cial foreclosure. In that case, section 580d of the California Code of Civil Procedure prevents the lender from collecting a deficiency judgment from the prime obligor.\(^{41}\) Moreover, the \textit{Gradsky} defense precludes the lender from obtaining a deficiency from the guarantor (unless the guarantor has waived this defense).\(^{42}\)

The rationale of \textit{Gradsky} is that a lender is estopped from recovering a deficiency judgment\(^{43}\) from a guarantor when the lender elects nonjudicial foreclosure, because the nonjudicial foreclosure exculpates the prime obligor from all future actions on his debt, thereby cutting off a guarantor's subrogation rights.\(^{44}\) The \textit{Gradsky} estoppel defense properly shifts the risk of loss to the party with control of the situation—the lender.\(^{45}\)

\begin{itemize}
    \item \textbf{42.} \textit{See} Union Bank v. Gradsky, 71 Cal. Rptr. 64 (Ct. App. 1968).
    \item \textbf{43.} BERNHARDT, \textit{supra} note 1, § 4.13, at 196 (defining deficiency judgment as "the difference between the unpaid balance of the secured debt (plus expenses) and the amount produced by the sale [i.e., 'full deficiency']"). \textit{But see} discussion \textit{infra} Section III regarding a guarantor's right to limit a deficiency to the difference between the unpaid balance of the secured debt and the fair value of the secured property pursuant to a fair value hearing under section 580a of the California Code of Civil Procedure or section 726(b) of the California Code of Civil Procedure.
    \item \textbf{44.} Cathay Bank v. Lee, 18 Cal. Rptr. 2d 420 (Ct. App. 1993). The court opined that:
        \begin{quote}
        [A] lender is estopped to recover a deficiency judgment against a guarantor when it elects a particular remedy (such as nonjudicial foreclosure) which cuts off the guarantor's subrogation rights against the debtor. Thus, even though California's antideficiency statute (section 580d of the California Code of Civil Procedure) does not protect guarantors directly, as a practical matter the "Gradsky defense" precludes deficiency judgments against them unless the lender elects the relatively cumbersome remedy of judicial foreclosure.
        \end{quote}
        \textit{Id.} (citing Union Bank v. Gradsky, 71 Cal. Rptr. 64 (Ct. App. 1968)).
    \item \textbf{45.} Kathleen Abdallah, \textit{Guarantors and the California Antideficiency Legislation: Is There Room Under the Umbrella of Protection?}, 20 PAC. L.J. 127, 141 (1988). Abdallah explains why the \textit{Gradsky} court recognized that the lender, not the guarantor, was ultimately liable for deficiency resulting from lender's election to proceed by nonjudicial foreclosure:
        \begin{quote}
        First, both the creditor and the guarantor were barred from recovering a personal judgment from the principal debtor after a nonjudicial foreclosure. Second, if the creditor elected to foreclose judicially... both the creditor and guarantor would have the right to obtain a deficiency judgment against the principal debtor. Third, the creditor alone had the option of choosing whether to preserve the right to a deficiency judgment against the principal debtor by electing to judicially foreclose. Finally, the creditor had a statutory duty not to impair a guarantor's remedy against the principal.
        \end{quote}
\end{itemize}
Although the Gradsky defense has typically been applied in the context of nonjudicial foreclosures, the logic of Gradsky also applies to estop a lender from obtaining a deficiency judgment from a guarantor where a lender proceeds by judicial foreclosure, but elects not to apply for a fair value hearing under section 726(b) of the Civil Code within three months of the foreclosure sale.

A. Cathay Bank Articulates the Standard for Testing the Validity of a Gradsky Defense Waiver

If a guaranty effectively waives the Gradsky defense (i.e., waives his subrogation rights), the guarantor may be personally liable for a deficiency judgment following a nonjudicial foreclosure by the lender. Thus, the due process adequacy of the waiver language is key to analyzing the liability of the guarantor. The court in Cathay Bank v. Lee articulated the

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46. CAL. CIV. PROC. CODE § 726(b) (West 1980 & Supp. 1996). This section states:

[U]pon application of the plaintiff filed at any time within three months of the date of the [judicial] foreclosure sale and after a hearing thereon at which the court shall take evidence at which hearing either party may present evidence as to the fair value of the real property . . . therein sold as of the date of sale, the court shall render a money judgment against the defendant[s] . . . for the amount by which the amount of the indebtedness with interest and costs of levy and sale and of action exceeds the fair value of the real property . . . therein sold as of the date of the sale.

47. BERNHARDT, supra note 1, § 8.14, at 409. This section states:

There is no reason to believe . . . that . . . a scheme [by a lender to obtain a deficiency from a guarantor without applying for a fair value hearing] would work, because the logic of Gradsky would apply. Following the [judicial] foreclosure sale, a deficiency judgment cannot be entered against the trustor except after a timely fair-value hearing. If the beneficiary could underbid and recover the entire difference from the guarantor, the guarantor would be left with an unrecoverable loss due solely to the beneficiary's action. Furthermore, failure to hold a fair-value hearing within three months after the sale would bar any recovery against the trustor, imposing the entire loss (not just the loss of the difference between the amount bid and the fair value) on the guarantor. This situation arises only because the beneficiary has credit-bid both less than it is owed and (possibly) less than the property is worth; thus, the consequences must fall on the beneficiary, who can credit-bid a larger amount, rather than on the guarantor, who must make a cash bid.

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requirements for an effective waiver.\textsuperscript{48}

\textit{Cathay Bank} restated the traditional rule that an enforceable waiver must be intentional, explicit, and inform of its legal consequences.\textsuperscript{49} Thus, a valid waiver must explain the precise nature of the guarantor's defense and the fact that it is being waived.\textsuperscript{50} Moreover, the \textit{Cathay Bank} court stated: (1) that the lender has the burden to prove by clear and convincing evidence that any waiver is informed,\textsuperscript{51} and (2) that ambiguities are constructed against the drafter, who is usually the lender.\textsuperscript{52}

B. Section 2856 of the California Civil Code.

Section 2856(d) of the California Civil Code\textsuperscript{3} creates "safe harbor" language that a lender may adopt to ensure an enforceable \textit{Gradsky} waiver. However, \textit{Cathay Bank} is still dispositive regarding the adequacy of waivers if the language in the guaranty does not mirror this statutory language.

The relatively recent appellate court case, \textit{River Bank America v. Diller},\textsuperscript{54} suggests that \textit{Cathay Bank} was amelio-

\begin{itemize}
  \item \textsuperscript{48} Cathay Bank v. Lee, 18 Cal. Rptr. 2d 420 (Ct. App. 1993).
  \item \textsuperscript{49} See infra Section II.B, discussing how section 2856 of the California Civil Code does not abrogate \textit{Cathay Bank}.
  \item \textsuperscript{49} Cathay Bank v. Lee, 18 Cal. Rptr. 2d 420 (Ct. App. 1993) at 423 (emphasis in original).
  \item \textsuperscript{50} Cathay Bank, 18 Cal. Rptr. 2d at 423 ("To find a waiver of the \textit{Gradsky} defense... one must go beyond the actual words and imply into them two more ideas, namely: (1) that the destruction of subrogation rights creates a defense to a deficiency judgment, and (2) the guarantor is now waiving that specific defense.").
  \item \textsuperscript{51} Id. ("[T]he burden is on the party claiming the waiver to prove it by clear and convincing evidence... ").
  \item \textsuperscript{52} Id. at 423 ("[A]mbiguities would be construed against the party who selected the language, who normally is the lender, [and]... if the matter is arguable, the doubt should be resolved against [enforcing] waiver.").
  \item \textsuperscript{53} CAL. CIV. PROC. CODE § 580d (West 1976 & Supp. 1996).
  \item \textsuperscript{54} 45 Cal. Rptr. 2d 790 (Ct. App. 1995).
\end{itemize}
rated by section 2856 of the Civil Code. The legislative history of section 2856 of the Civil Code, however, indicates that Cathay Bank is still controlling law.

Section 2856 of the Civil Code was enacted pursuant to California Assembly Bill 3101 ("AB 3101"). The original version of section 2 of AB 3101 contained language designed to abrogate Cathay Bank, which drew sharp criticism, including several letters to California representatives. An August 4, 1994 letter from Earl Lui, Staff Attorney, Consumers Union, to the bill's author (Assemblymember Louis Caldera) stated: "[O]ur more general concern is with the bill's apparent weakening of basic principles of waiver law. A waiver is an intentional relinquishment of a known right. We believe the Cathay Bank court correctly invalidated the waiver at issue in that case."

An August 11, 1994 letter from Doug DeVries, President, Legislative Department, California Trial Lawyers Association, to Assemblymember Caldera stated: "AB 3101 flies in the face of settled anti-deficiency and waiver law. It creates an exception to the rule that a waiver must be an intentional relinquishment of a known right.

Further, an August 4, 1994 letter from Thomas K. Bannon, Executive Vice-President for the California Apartment Association, to Senator Bill Lockyer stated:

55. River Bank America v. Diller, 45 Cal. Rptr. 2d 790 (Ct. App. 1995) ("[A]lthough [Cathay Bank] purports to be 'declarative of existing law' it is clear the Legislature enacted section 2856 to ameliorate the strict rule laid down in Cathay Bank... Cathay Bank... has arguably been eroded by the recently enacted legislation [CAL. CIV. CODE § 2856].").
57. 1994 Cal. Stat. 1204 (A.B. 3101) § 1. The version of section 2856 of the California Civil Code enacted in 1994 was repealed by 1996 chapter 1013 § 1 and another section 2856 was enacted in 1996 in its place. 1996 Cal. Stats. 1013 (A.B. 2585) § 1. The safe harbor language of section 2856(d) in the 1996 version is the same as section 2856(b) in the 1994 version.
58. Section 2 of AB 3101, as amended in the Senate on June 21, 1994 stated:
   It is the intent of the late legislature in enacting Section 2856 of the Civil Code to abrogate the decision of the California Court of Appeal in Cathay Bank... which appears to establish requirements for waivers of the rights of sureties that go beyond those required under state law...
59. See letters at Appendices A-C (original letters on file with author).
60. See letter at Appendix A.
61. See letter at Appendix B.
The standard set out by the Cathay decision . . . is consistent with the principle that a party can only waive a right or defense if he or she knows and understands that the right or defense is available in the first place. . . . It is our position that the Cathay ruling should be allowed to stand, and that any statutory standard for Gradsky waivers crafted through legislation should be prospective in application.62

Following receipt of the above letters, the Legislature deleted the “abrogation” language from the final version of AB 3101. The Legislature’s rejection of language in the original version of section 2 of AB 3101 (designed to abrogate Cathay Bank) is persuasive to the conclusion that Civil Code section 2856 does not abrogate Cathay Bank.63 Additionally, the Legislature expressly stated that section 2856 of the Civil Code “do[es] not represent a change in, but [is] merely declarative of, existing law [Cathay Bank].”64 Thus, the Legislature revealed its intent that Cathay Bank remain in effect, despite the “safe harbor” provision provided in the new legislation.

C. Section 2856 of the California Civil Code Should Not Be Applied Retroactively to Guaranties Executed Prior to January 1, 1997

Further, section 2856 of the California Civil Code on its face does not apply retroactively to guaranties executed prior to January 1, 1997.65 Accordingly, the adequacy of all Gradsky waivers in guaranties executed prior to January 1, 1997 should be tested by the controlling case law (i.e., Cathay Bank and related authority), not the safe harbor language of section 2856(d) of the Civil Code.

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62. See letter at Appendix C.
63. “[T]he rejection by the Legislature of a specific provision contained in an act as originally introduced is most persuasive to the conclusion that the act should not be construed to include the omitted provision.” Madrid v. Justice Court, 125 Cal. Rptr. 348, 351 (Ct. App. 1975) (quoting Rich v. State Bd. of Optometry, 45 Cal. Rptr. 512, 522 (Ct. App. 1965)).
64. CAL. CIV. CODE § 2856 (historical and statutory notes) (West Supp. 1996).
III. THE FAIR VALUE PROTECTIONS OF THE ANTIDEFICIENCY LEGISLATION AFFORDED PRIME OBLIGORS SHOULD BE AVAILABLE TO GUARANTORS FOLLOWING A JUDICIAL FORECLOSURE

A. Direct Right to a Fair Value Hearing Under Section 726(b) of the California Code of Civil Procedure

If a prime obligor validly defaults on a note secured by a deed of trust, a lender may choose to proceed by judicial foreclosure, rather than by nonjudicial foreclosure. If judicial foreclosure is chosen, section 726(b) of the California Code of Civil Procedure gives a prime obligor the right to a fair value hearing following the judicial foreclosure. Under section 726(b) of the Code of Civil Procedure, a lender's recovery for a deficiency from a prime obligor is limited to the difference between the unpaid balance of the secured note [plus expenses] and the fair value of the property. Without these protections, a lender could bid less than the fair value at the foreclosure sale, and then obtain a "full deficiency" from the prime obligor (for the difference between the unpaid balance of the secured note [plus expenses] and the amount produced at the sale).

California courts have generally held that only a prime obligor, not a guarantor, is entitled to antideficiency legislation protections such as the right to a fair value hearing. However, the fair value protections of section 726(b) of the Code of Civil Procedure should be extended to guarantors.

Many prominent real property commentators note that there are several reasons why a guarantor should be entitled to a section 726(b) fair value hearing following a judicial foreclosure: (1) a lender should be prevented from collecting a

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67. Id.
68. See discussion supra Section II.C.
69. SHENEMAN, supra note 1, § 8.17, at 8-68. However, in 1995, the fourth district California court of appeal, held that the fair market value provisions of section 580a of the California Code of Civil Procedure applied to guarantors in an action to collect an unpaid debt balance following a nonjudicial foreclosure. See Bank of So. California v. Dombrow, 46 Cal. Rptr. 2d 656 (Ct. App. 1995). Although this case was decertified by the California Supreme Court (March 18, 1996) 96 Daily Journal D.A.R. 3023, “a logical and well-reasoned decision despite vacatur is always persuasive authority.” In re Finley, 160 B.R. 882, 896 (Bankr. S.D.N.Y. 1993).
double recovery (by underbidding the property at the foreclosure sale and then holding a guarantor liable for a full deficiency);\(^70\) (2) the broad language of section 726(b) of the Code of Civil Procedure (stating that if “any defendant” is personally liable for the debt, the fair value limitations apply to the debt) indicates that section 726(b) of the Code of Civil Procedure is available to both prime obligor and guarantor defendants;\(^71\) (3) earlier judicial decisions suggesting that section 726(b) of the Code of Civil Procedure was inapplicable to guarantors, may be dismissed as they were based on antiquated law;\(^72\) and (4) granting guarantors the fair value rights of section 726(b) of the Code of Civil Procedure furthers the policies driving the antideficiency legislation and suretyship law, such as minimizing overvaluation and shifting the risk of a depressed market to the lender.\(^73\)

\(^70\) MILLER & STARR, supra note 1, § 9:200, at 637-39; see also MILLER & STARR, supra note 1, § 9:200, at 199 n.82 (Supp. 1998).

\(^71\) MILLER & STARR, supra note 1, § 9:200, at 199 n.82 (Supp. 1998) (“CCP § 726 states that if ‘any defendant’ is personally liable for the debt, the fair value limitations apply to the debt. Thus, the limitation should apply to a money judgment against a guarantor.”).

\(^72\) MILLER & STARR, supra note 1, § 9:200, at 637-38. To wit:
The cases decided before the abolition of the surety-guarantor distinction held that the creditor was not limited to the excess of the obligation owed over the (fair value) of the security when pursuing the guarantor’s liability. However, subsequent cases have reaffirmed the earlier decisions without reference to the abolition of the surety-guarantor distinction. The courts consider the guaranty contract as any other additional security received by the creditor, and the (fair-value) limitations do not hinder the creditor in pursuing other types of additional security. However, because of subsequent expansion of the (fair-value) limitations, the policy of these limitations may be extended to protect the guarantor.

\(^73\) Abdallah, supra note 45, at 161. This section states:
The policy of the antideficiency scheme and suretyship law favor granting a guarantor a fair value hearing on the real property security after foreclosure. Accordingly, a debtor will never be liable for a deficiency judgment over and above the fair value of the real property security, and the liability of a guarantor will be no more burdensome than that of the principal debtor . . . [A] fair value hearing will keep overvaluation to a minimum and the risk of a depressed market on the creditor and not the guarantor.

\(^\text{Id. See also Abdallah, supra note 45, at 161-62 (“While the California antideficiency legislation was enacted to protect principal debtors from personal liabilities on debts secured by real property, the courts must recognize similar protections to guarantors under suretyship law.”); and, BERNHARDT, supra note 1, § 8.14 at 409:}\

\(^\text{It is probably . . . true that a creditor who underbids at its foreclosure}\

In addition to the well-reasoned positions of the California real property law commentators, the Nevada Supreme Court, in the face of antideficiency legislation, held that the fair value protections of antideficiency legislation are directly available to guarantors. The Nevada Supreme Court, in First Interstate Bank of Nevada v. Shields, stated that the court is "now convinced that it is unsound to deny guarantors the benefits of such legislation." In Nevada, Shields grants guarantors the right to a fair value hearing under Nevada's antideficiency scheme (which is comparable to California) to prevent lenders from: seeking a double recovery; circumventing legislative purposes; manipulating sources of recovery in order to obtain amounts from guarantors which are greater than the balance of the debts due; unfairly enriching themselves at the expense of guarantors; and thwarting general principles of guaranty law.

sale becomes subject to a fair-value defense by the guarantor as well as by the trustor. The trustor clearly has fair-value protection, [and although] it is unsettled whether the beneficiary can avoid complying with the fair-value rules by seeking a deficiency judgment only against the guarantor[, ] [there is no reason to believe ... that such a scheme would work ... .

Id.

75. Id. at 431.
76. Id. ("Nevada's deficiency legislation is designed to achieve fairness to all parties to a transaction secured in whole or in part by realty ... . [O]bligors are assured that creditors in Nevada may not reap a windfall at an obligor's expense by acquiring the secured realty at a bid price unrelated to the fair market value of the property and thereafter proceeding against available obligors for the difference between such a deflated price and the balance of the debt.").
77. Id. ("It is irrefutably clear that the salutary purposes of the legislative scheme for recovering legitimate deficiencies would be attenuated, if not entirely circumvented in specific instances, by denying guarantors, or any other form of obligor, the protection provided by the deficiency statutes. A lender in Nevada is not privileged to manipulate sources of recovery in order to realize debt satisfaction in amounts substantially greater than the balance of the debt due.").
78. Id.
79. First Interstate Bank of Nevada v. Shields, 730 P.2d 429, 431 (Nev. 1986) ("The way would ... be paved for an unscrupulous lender to bid an insignificant price for real property of a true and sufficient value to satisfy the debt it secured, and then pursue a second essentially full satisfaction from a financially responsible guarantor. Any less extreme variant from the preceding hypothetical would still unfairly enrich the lender at the expense of the guarantor. We are convinced that the Legislature never intended to facilitate such scenarios.").
80. Id. ("[T]he holding [of this court] is consistent with general principles of guaranty law. As a general rule, the payment or other satisfaction or extin-
In sum, if the commentators are right and the Nevada Supreme Court is followed, both California prime obligors and guarantors should be entitled to the section 726(b) fair value protections.

IV. THE SHAM GUARANTY DOCTRINE PROTECTS DE FACTO PRIME OBLIGORS

The legislative policies of the antideficiency legislation will be honored regardless of any creative or unique loan transaction structure. Accordingly, if a guaranty has been used to obtain a disguised waiver of antideficiency legislation protections, the guaranty will be characterized as a "sham." 81 For example, if a loan transaction is structured so that the prime obligor/borrower is a general partnership and the guarantor is an individual partner, then the guaranty will be treated as a mere sham since the guarantor, as an individual partner, is primarily obligated for the debts of the partnership. 82

Once a guaranty is found to be a "sham," then the guarantor will be treated as a "de facto prime obligor." The distinction between mere guarantor and de facto prime obligor is significant for two main reasons. First, a de facto prime obligor is entitled to the direct protections of the antideficiency legislation (i.e., the section 580d of the California Code of Civil Procedure defense to liability for the deficiency after a nonjudicial foreclosure). 83 Second, a de facto prime obligor's waivers of antideficiency statute protections are generally unenforceable. 84

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81. Hansen, Recent Developments 1996, supra note 35, at 177-78.
83. Everts v. Matteson, 132 P.2d 476, 482 (Cal. 1942) ("[I]f... the appellants... are liable as principal obligors and not as guarantors of the indebtedness, they clearly come within the [fair value] provisions of section 580a of the Code of Civil Procedure and are entitled to its benefits."). Note that the sham guaranty analysis is particularly important to a guarantor who has waived the Gradsky defense, because if that guarantor achieves characterization as a de facto prime obligor, he may directly invoke the nonwaivable defense under section 580d of the California Code of Civil Procedure defense to liability for the deficiency. CAL. CIV. PROC. CODE § 580d (West 1976 & Supp. 1996).
84. CAL. CIV. CODE § 2953 (West 1993). This section states:

[1]ny express agreement made or entered into by a borrower at the time of or in connection with the making of or renewing of any loan secured by a deed of trust, . . . whereby the borrower agrees to waive the
A. If Guarantor Is Actually a De Facto Prime Obligor, Then Guaranty Is a Sham

Traditional analysis of the sham guaranty doctrine focuses on the partner guarantor, shareholder guarantor or trustee guarantor, each of which are briefly discussed below, but as this section explains, a guaranty of a nonrecourse note also is a sham.

1. Partner Guarantor

If the transaction is structured so that the guarantor is a general partner and the borrower is a general partnership or a limited partnership, then the guarantor is actually a de facto prime obligor because he is primarily obligated for the debt. However, "[i]t remains uncertain how the sham guaranty doctrine will be applied to [guarantors who are] limited partners ...".

2. Shareholder Guarantor

If the transaction is structured so that a guarantor is the alter ego of a corporate borrower, then the guarantor may be treated as a de facto prime obligor. A court may examine the traditional factors considered by a court to determine whether the guarantor is a corporation's alter ego, but the salient factor probably is whether the lender tacitly engineered the structure of the transaction to circumvent antideficiency protections.

3. Trustee Guarantor

Moreover, a court may treat a trustee who guaranties

rights, . . . conferred upon him . . . by Sections 580a or 726 of the Code of Civil Procedure, shall be void and of no effect.

Id.

85. See discussion infra Part IV.A.1-3.
86. See discussion infra Part IV.A.4.
87. Union Bank, 61 Cal. Rptr. at 894; Riddle v. Lushing, 21 Cal. Rptr. 902, 904-05 (Ct. App. 1962).
91. Hansen, Recent Developments 1996, supra note 35, at 178 (citing Valinda Builders, 40 Cal. Rptr. 735 (Ct. App. 1964)).
the trust’s debt as a *de facto* prime obligor.

4. Guarantor of Nonrecourse Note

Finally, if the transaction is structured so that the loan is nonrecourse as to the prime obligor, the guarantor of the nonrecourse note should also be treated as a *de facto* prime obligor, entitled to the direct protections of the antideficiency legislation. A nonrecourse note, by its terms, generally releases a debtor/signator to a note from any personal obligation to pay any amount to a lender. Since a debtor/signator to the note has no legal obligation to pay the note (because the note is nonrecourse), the ostensible guarantor (as the only person with liability on the loan) becomes a *de facto* prime obligor.

The court in *Roberts v. Reynolds* stated that “the words “guaranty” or “guarantee” do not always import a contract of guaranty.” Rather, such words may be used with reference to an obligation which is primary in nature as distinguished from one which is secondary. Thus, even if a document is entitled “Guaranty,” that contract may “import[ ] an original obligation on the part of the person executing such contract.” Where an ostensible contract of guaranty creates a “primary liability,” and not a “collateral undertaking,” then the ostensible guarantor is in fact a primary obligor.

A lender cannot evade antideficiency protections by using novel combinations of debtor/guarantor/security arrangements in ways which violate or skate very close to the edge of the policies underpinning these rules and their non-waivability. "Such sophisticated structuring is arguably in

94. *Id.* at 266 (citations omitted).
96. Kilbride v. Moss, 45 P. 812, 812-13 (Cal. 1896). In *Kilbride*, a purchase of the capital stock of a corporation was made at the request of a large stockholder who, in order to induce the purchase, verbally promised to return the purchaser’s money for the stock should the stock become worthless. *Id.* The court held that the promise was an original one and not a guaranty, drawing a distinction between a promise which is original and one which is only collateral to the undertaking of a third party: “[a] contract of guaranty is a collateral undertaking. It cannot exist without the presence of a main or substantive liability to which it is collateral.” *Id.*; see also City Nat. Bank v. Lemco Mfg. Co., 207 P. 509, 509 (Cal. Ct. App. 1922).
violation of the ringing pronouncements against circumvention found in such recent cases as Simon, . . . O'Neil, . . . and Westinghouse . . . .\textsuperscript{98} Moreover, "[c]ourts consistently strike down schemes aimed at avoiding the deficiency legislation by illusory changes in form. A flimsy avoidance device based upon an intermediate surety would have no chance of success."\textsuperscript{99}

Accordingly, since the guarantor of a nonrecourse note has primary liability, such guarantor is really a \textit{de facto} prime obligor entitled to all the benefits connected with that status.

\textbf{B. Significance of a Court Finding that Guaranty Is a Sham and that Guarantor Is a Prime Obligor}

As previously stated, when a court finds that a guaranty is a sham, the guarantor/\textit{de facto} prime obligor is entitled to the direct protections of the antideficiency legislation.\textsuperscript{100} This right is particularly important to a guarantor who has effectively waived his Gradsky defense\textsuperscript{101} or surety defenses under sections 2809, 2845, 2848, and 2849 of the California Civil Code.\textsuperscript{102} Another advantage of prime obligor status is that a prime obligor's waiver of antideficiency protections almost

\textsuperscript{98} Charles Hansen, \textit{Recent Developments and Trends Concerning Antidefiency Issues; Judicial Foreclosure; The Full Credit Bid Rule; and Guaranties of Real Property Secured Transactions}, in \textit{EMERGING ISSUES IN PRIVATE AND JUDICIAL FORECLOSURES, DEEDS IN LIEU, AND ACTIONS OR GUARANTIES}, 186-87 (Continuing Education of the Bar ed., 1995) [hereinafter Hansen, \textit{Recent Developments 1995}] (citing Simon v. Superior Court, 5 Cal. Rptr. 2d 428 (Ct. App. 1992); O'Neil v. General Sec. Corp., 5 Cal. Rptr. 2d 712, 720 (Ct. App. 1992); Westinghouse Credit Corp. v. Barton, 789 F. Supp. 1043, 1045-56 (C.D. Cal. 1992)). In \textit{Westinghouse Credit}, the general partner who guarantied the partnership note was found to be a \textit{de facto} prime obligor entitled to antideficiency protections, even though the loan guarantied was nonrecourse. \textit{Westinghouse Credit Corp.}, 789 F. Supp. at 1046. The lender unsuccessfully argued that because the loan was nonrecourse, the general partner was relieved of principal liability on the debt, and therefore, was not a prime obligor entitled to antideficiency protection. \textit{Id}. The court held, however, this device/circumvention did not avoid section 580d of the California Code of Civil Procedure: "the result of allowing a non-recourse provision to qualify a general partner separately a guarantor would be to circumvent the legislative intent of the anti-deficiency statutes." \textit{Id}.

\textsuperscript{99} Heckes v. Sapp, 40 Cal. Rptr. 485, 489 (Ct. App. 1964) (citations omitted).

\textsuperscript{100} Everts v. Matteson, 132 P.2d 476, 482 (Cal. 1942).

\textsuperscript{101} See discussion \textit{supra} Section II regarding Gradsky defense.

\textsuperscript{102} \textit{CAL. CIV. CODE} §§ 2809, 2845, 2848, 2849 (West 1993); see discussion \textit{supra} Section I.E. regarding these defenses.
always is void as against public policy;\textsuperscript{103} whereas a mere guarantor’s waiver of suretyship statute defenses is probably enforceable,\textsuperscript{104} unless the waiver language is inadequate.

C. De Facto Prime Obligor’s Waiver of Antideficiency Legislation Defenses

If a lender seeks to hold a guarantor liable for a deficiency after valid default of the debtor, but the guarantor successfully counters that the guaranty is a “sham” and that the guarantor is a \textit{de facto} prime obligor, certain waivers in the guaranty may be unenforceable.

At the time of making or renewing a loan, a “prime obligor’s” contemporaneous waivers of sections 580a, 580d, and 726 of the California Code of Civil Procedure are invalid.\textsuperscript{105} The rationale posited for this rule is the lender’s superior bargaining power at the time the loan is made.\textsuperscript{106}

Although the law regarding waiver at the time of making or renewing the loan is well-settled, “[t]he law is less clear regarding whether the trust deed beneficiary [or \textit{de facto} prime obligor] can obtain a subsequent waiver of the antideficiency protections after the initial loan is made.”\textsuperscript{107} One commentator notes that the enforceability of a waiver under section 2953 of the Civil Code depends on whether a subsequent waiver is characterized as an “extension of time” (waiver possibly enforceable) or a “renewal” (waiver void).\textsuperscript{108}

\begin{footnotes}
\item[103] See discussion \textit{infra} Section IV.C.
\item[104] \textsc{Cal. CIV. CODE § 3268} (West 1993).
\item[105] \textsc{Cal. CIV. CODE § 2953} (West 1993) (“Any express agreement made or entered into by a borrower at the time of or in connection with the making of or renewing of any loan secured by a deed of trust, \ldots whereby the borrower agrees to waive the rights, \ldots conferred upon him \ldots by Sections 580a or 726 of the Code of Civil Procedure, shall be void and of no effect \ldots”). \textsc{Sheneman, supra} note 1, § 6.15, at 6-68 (“[Section 580d of the Civil Code] also may not be waived at the outset of the transaction, although §580d is not mentioned by the antiwaiver statute.”).
\item[106] \textsc{Bernhardt, supra} note 1, § 4.48, at 230 (“California courts have consistently refused to permit waivers of antideficiency protections that are made contemporaneously with the making of the loan. The courts take the view that, to obtain a loan, a necessitous borrower will always waive all of his or her rights at the creditor’s insistence.”).
\item[107] \textsc{Sheneman, supra} note 1, § 6.15, at 6-68.
\item[108] \textit{Id.} § 6.15, at 6-69 (“The enforceability of a waiver under Civil Code § 2953 depends in part on the distinction between an \textit{extension of time} on an existing loan (in which case the waiver may be enforceable) and the \textit{renewal} of a loan (in which case a waiver is void). A \textit{renewal} is a separate and distinct contract, the substitution of a new right or obligation for another of the same na-
Yet, even the distinction between extension of time and a renewal is ambiguous. 109

Salter v. Ulrich suggests that subsequent waivers are valid because the rights between the lender and prime obligor are already established. 110 However, Palm v. Schilling questioned the authority of Salter and notes that the rule espoused in Salter is pure dictum. 111 Moreover, the logic underlying the Salter dictum is easily discredited because a debtor in dire straits regarding a pre-existing loan is often more desperate to make concessions to a lender than one merely seeking a loan. 112 Accordingly, it is likely that both contemporaneous and subsequent waivers of antideficiency protections are invalid.

Nonetheless, even if a court finds that a (de facto) prime obligor's subsequent waiver of any antideficiency defense is valid, the guarantor still may challenge the enforceability of the waiver if it is not knowing and voluntary. 113

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109. Hansen, Recent Developments 1995, supra note 98, at 155 n.13 (“One of the most pregnant and poorly-explored issues in this area is the meaning of loan ‘renewal’ under Civil Code section 2953. If ‘renewal’ is defined broadly to include such events as loan extension, forbearance and modification, waiver by contract may almost never be possible.”).

110. Salter v. Ulrich, 138 P.2d 7, 9 (Cal. 1943). The court stated:

Since necessity often drives debtors to make ruinous concessions when a loan is needed, section 726 should be applied to protect them and to prevent a waiver in advance. This reasoning, however, does not apply after the loan is made, when all rights have been established and there remains only the enforcement of those rights . . . . The rule against waivers in advance has been codified by section 2953 of the Civil Code . . . . [S]ection 2953 . . . is entirely consistent with the right of a mortgagor or trustor to make a subsequent waiver, since by its terms it purports to apply only to a waiver agreement which is exacted in advance as a condition to the making or renewing of any loan secured by a mortgage or deed of trust.

Id.

111. Palm v. Schilling, 244 Cal. Rptr. 600, 608 (Ct. App. 1988) (“With the passage of time Salter's dictum has become the sole authority approving a subsequent contractual waiver of section 726 of the Civil Code. Based on the facts in Salter and the purposes of deficiency legislation, we have severe reservations as to the rule's heritage.”).

112. Bernhardt, supra note 1, § 4.49, at 231 (“Presumably, the dures that might compel the waiver vanishes once the loan has been made, although a debtor in distress with regard to the existing loan may be in even more desperate straits than one who has not yet borrowed at all.” (analyzing Palm v. Schilling, 244 Cal. Rptr. 600 (Ct. App. 1988))).

113. See discussion supra Section II.A.; see also discussion infra Section VI.
V. SECTION 2809 OF THE CIVIL CODE PREVENTS LENDER FROM ENFORCING THE GUARANTY OF NONRECOUPCE LOAN

An important and frequently litigated suretyship defense is section 2809 of the California Civil Code, which provides a defense to a guarantor where a guarantor's obligation is either "larger in amount" or "more burdensome" than that of the prime obligor. A complete discussion of this defense is beyond the scope of this article. However, the article does address the specific issue raised, but not resolved, in the recent case, River Bank America v. Diller, as to "whether section 2809 provides a defense to a guarantor who has personally guaranteed a contractual nonrecourse obligation." We conclude that section 2809 of the Civil Code should exonerate the guarantor of a nonrecourse note because where the prime obligor has no personal liability at the time the guaranty is executed, the guarantor's obligation exceeds the prime obligor's obligation.

The facts in the River Bank America case are similar to many construction financing deals. In River Bank America, the developer/prime obligor assumed no personal liability because the obligation was nonrecourse; therefore, its loss was limited to the secured property. The guarantors, however, subjected their personal assets to risk by assuming personal liability.

The court stated that pursuant to section 2809 of the Civil Code, the guarantors' obligation was "not larger in amount" than the prime obligor's because the guarantor's exposure was limited to 20% of the face amount of the note.

114. Note that this position is in the alternative to the discussion in Section IV that a guarantor of a nonrecourse note is a prime obligor and the guaranty is a sham.
115. CAL. CIV. CODE § 2809 (West 1993) ("The obligation of a surety must be neither larger in amount nor in another respects more burdensome than that of the principal; and if in its terms it exceeds it, it is reducible in proportion to the principal obligation.").
116. 45 Cal. Rptr. 2d 790 (Ct. App. 1995).
117. Id. at 794-95.
118. Id. at 795 ("[The prime obligors] had absolutely no personal liability for the... loan. From the outset, the lender could only proceed against "the premises." If the proceeds from the sale of "the premises" were insufficient to satisfy the outstanding debt...,[the lender] had no recourse against other assets not connected to the [secured property].").
119. Id. In this case, the guarantors guaranteed 20% of the face amount of the notes. Id.
120. River Bank Am., 45 Cal. Rptr. 2d at 795 (citing CAL. CIV. CODE § 2809
However, the court found "it . . . difficult - if not impossible - to say which of these obligations is 'more burdensome'" under section 2809 of the Civil Code—the guarantor's personal liability of $3.6 million (20% of the loan); or the prime obligor's 0% personal liability for its $38 million note, but the loss of its property. Yet, the court suggested that where a guarantor guaranties 100% of a loan, the guarantor's personal liability for the deficiency "may be viewed as 'more burdensome'" than the prime obligor's loss of the secured assets of the specific project.

The River Bank America court seemingly failed to understand that the obligations of guarantors of a nonrecourse obligation are always both "larger in amount" and "more burdensome" than that of the nonrecourse prime obligor. At the time a nonrecourse loan is made to a developer, the loan proceeds almost always go to purchase the security (for example, the land). As to the nonrecourse debtor, the transaction can only be positive—the debtor receives land, yet cannot be held personally liable to repay the loan. A guarantor of a nonrecourse loan, on the other hand, receives neither the loan proceeds, nor the land. Rather, the guarantor acquires only the obligation to repay the loan should the nonrecourse debtor default. Thus, the guarantor's obligation is greater than the debtor (the debtor received land) and more burdensome (the debtor is not personally liable on the loan, whereas the guarantor is liable), and accordingly, section 2809 of the Civil Code precludes guarantor liability.

In a dispositive ruling on this issue, the California Supreme Court, in U.S. Leasing Corp. v. Du Pont, stated "The obligation of a surety must be neither larger in amount
nor in other respects more burdensome than that of the principal . . . ." Therefore, since the liability of a surety is commensurate with that of the principal, where the principal is not liable on the obligation, neither is the guarantor.\textsuperscript{124} The common law underpinnings to the above rule were explained in Anderson v. Shaffer\textsuperscript{125} which states that it is unjust and incongruous to hold a guarantor liable, unless the prime obligor has some obligation.\textsuperscript{126} "Consequently, no liability can be imposed upon [the] guarantors unless [the prime obligor] is liable under the [loan documents]."\textsuperscript{127} Although these absolute

\textsuperscript{124} Id. at 74-75 (emphasis added).
\textsuperscript{125} 277 P. 185 (Cal. Ct. App. 1929).
\textsuperscript{126} Id. at 189-90. The Anderson court defined the surety's obligation:

The obligation of a surety is an obligation accessory to that of a principal debtor, and it is of the essence of this obligation that there should be a valid obligation of some principal . . . . If the principal is not holden, neither is the surety; for there can be no accessory if there is no principal . . . . "It is correctly laid down in Chitty on Contracts that the contract of a surety is a collateral engagement for another, as distinguished from an original and direct agreement for the party's own act; and, as is stated in Theobold on Principal and Surety, . . . . it is a corollary from the very definition of a contract of suretyship that, the obligation of the surety being accessory to the obligation of the principal debtor or obligor, it is of its essence that there should be a valid obligation of such a principal, and that the nullity of the principal obligation necessarily induces the nullity of the accessory . . . . It would be most unjust and incongruous to hold the surety liable where the principal is not bound.

\textsuperscript{127} U.S. Leasing Corp., 444 P.2d at 75.
rules appear to contradict case law holding that a guarantor may agree to increase his obligation beyond that of his principal.\textsuperscript{128} The conflicting rules are harmonized when one realizes that: (1) \textit{after} contracting, a guarantor's obligation may be increased beyond the prime obligor; but (2) \textit{at the time of} contracting, the guarantor's obligation may not exceed that of the prime obligor.\textsuperscript{129}

As stated in \textit{Mortgage Finance Corp. v. Howard},\textsuperscript{130} "[t]he requirements of section 2809 are fully met if the surety's ob-

\begin{itemize}
\item \textsuperscript{128} Id. For example, \textit{Bloom v. Bender} held that where the statute of limitations runs against the prime obligor, but not against the guarantor, section 2809 of the California Civil Code does not prevent the creditor from seeking a full recovery from the guarantor. \textit{Bloom}, 313 P.2d at 574. Moreover, \textit{Loeb v. Christie}, held that where a guarantor's liability on a note may be enforced without first resorting to the security, section 2809 of the Civil Code does not bar a creditor from seeking a full recovery from the guarantor. \textit{Loeb v. Christie}, 57 P.2d 1303, 1303-04 (Cal. 1936). But, note that the result in \textit{Loeb}, a 1936 case, would have a different result today because a pre-1939 guarantor had no right to require a lender to proceed first against the encumbered property. \textit{Id}. Also, \textit{Heckes v. Sapp} held that where antideficiency legislation prevents a lender from seeking a deficiency judgment against the prime obligor, section 2809 of the Civil Code does not preclude the creditor from collecting a deficiency from the guarantor. \textit{Heckes v. Sapp}, 40 Cal. Rptr. 485, 488 (Ct. App. 1964).

\item \textsuperscript{129} In \textit{Bloom} (313 P.2d 568 (Cal. 1957)), \textit{Loeb} (57 P.2d 1303 (Cal. 1936)), and \textit{Heckes} (40 Cal. Rptr. 485 (Ct. App. 1964)), the guarantors' obligations did not exceed the obligation of the prime obligors at the time of contracting:

\begin{enumerate}
\item In \textit{Bloom}, the prime obligor was obligated to the creditor for the full amount of the note at the inception of the guaranty. \textit{Bloom}, 313 P.2d at 573-74. The prime obligor merely asserted a statute of limitations defense to liability for the deficiency. \textit{Id}.

\item In \textit{Loeb}, the prime obligor also was obligated for the full amount of the note at the inception of the guaranty: The liability of the principal or maker of a note secured by mortgage or trust deed is for the face amount of the note and is not simply for any deficiency remaining after foreclosure or sale. . . . A mortgage, trust deed, or any other security is merely a fund which the principal . . . makes available for the performance of his obligation to pay. Though the . . . trust deed security becomes the primary fund for the discharge of the indebtedness, by virtue, respectively of the provisions of [Civil Procedure] section 726 . . . it merely remains a source from which the obligation of the principal . . . is to be repaid. The principal debtor remains liable at all times for the full amount of the obligation and may be compelled to pay it, first out of the security, and thereafter out of the general assets. \textit{Loeb}, 57 P.2d at 1304 (emphasis added).

\item Similarly, in \textit{Heckes}, the prime obligor was obligated for the full amount of the note at the inception of the guaranty, but merely chose to invoke the antideficiency defense of section 580b of the California Code of Civil Procedure to limit its liability. \textit{Heckes}, 40 Cal. Rptr. at 488.
\end{enumerate}

\item \textsuperscript{130} 26 Cal. Rptr. 917 (Ct. App. 1962).
ligation, *when undertaken*, does not exceed the obligation of the principal . . . " However, if at the time the guaranty is executed, "there is no primary liability on the part of [the prime obligor], . . . there is nothing to guarantee, and hence there can be no contract of guaranty." 2

It then follows that a guarantor's liability for the guaranty of a nonrecourse note is exonerated under section 2809 of the Civil Code, because at the time such guaranty is executed, the guarantor's obligations are greater and more burdensome than that of the debtor.

VI. WAIVERS OF SURETYSHIP DEFENSES, SUCH AS SECTION 2809, SUBJECT TO CATHAY BANK TEST

Waivers of suretyship defenses, including section 2809 of the California Civil Code, should be evaluated under the test articulated in *Cathay Bank v. Lee*.

*Cathay Bank* restates the traditional view that an adequate waiver must state the precise nature of the defense and the fact that it is being waived. However, the appellate court in *River Bank America* inexplicably declined to evaluate the guarantor's waiver of section 2809 of the Civil Code by the test described in *Cathay Bank* for the following three purported reasons:

First, *Cathay Bank* did not purport to set out a waiver [sic] standard applicable to all surety defenses. To the contrary, *Cathay Bank* focused on the narrow issue of whether there was a sufficient waiver of the *Gradsky* de-

131. *Id.* at 919.
132. Somers v. United States F. & G. Co., 217 P. 746, 749 (Cal. 1923); accord *Bloom*, 313 P.2d at 573-74. The *Bloom* court stated:

[The] rule of the civil law [codified in § 2809] appears to relate to conditions at the time of the execution of a guarantee agreement, and to provide that at the time of the contracting of the surety's obligations he cannot agree to perform higher and greater obligations than those imposed on the principal debtor . . . . [Thus,] a surety is not liable where the principal does not incur any obligation under the basic contract.

*Id.* Conversely, once the original obligations of the principal and guarantor are fixed, the guarantor may then agree to modify his obligation to make it greater than that of the principal.

134. 18 Cal. Rptr. 2d 420 (Ct. App. 1993).
136. *Id.* at 800 ("We decline to apply *Cathay Bank*'s strict waiver requirements in this case.").
fense.\textsuperscript{137}

Second, unlike \textit{Bloom [v. Bender]}, \textit{Cathay Bank} did not address... the waiver of a defense based on Civil Code section 2809.\textsuperscript{138}

Third, although it purports to be "declarative of existing law" it is clear that the Legislature enacted [Civil Code] section 2856 to ameliorate the strict rule laid down in \textit{Cathay Bank}.\textsuperscript{139}

These arguments fail because the \textit{Cathay Bank} court did not limit its analysis to \textit{Gradsky} defense waivers.\textsuperscript{140} Rather, \textit{Cathay Bank} merely articulated preexisting general principles of waiver, citing waiver cases completely unrelated to guaranty waivers.\textsuperscript{141} Further, there is nothing unique about the \textit{Gradsky} defense that requires a more "strict" waiver than a waiver under section 2809 of the Civil Code\textsuperscript{142} waiver (or of any waiver). Moreover, a waiver of a statutory right, arguably should be held to a higher standard than a waiver

\textsuperscript{137} Id.

\textsuperscript{138} Id.

\textsuperscript{139} Id. \textit{See supra} Section II.B (discussing that section 2856 of the California Civil Code did not abrogate \textit{Cathay Bank}).

\textsuperscript{140} Cathay Bank v. Lee, 18 Cal. Rptr. 2d 420 (Ct. App. 1993). \textit{Union Bank v. Gradsky} held that where a lender elects to proceed by nonjudicial foreclosure, rather than by judicial foreclosure, the lender destroys the guarantor's right of subrogation, and thus the lender is estopped from seeking a deficiency from the guarantor. \textit{Union Bank v. Gradsky}, 71 Cal. Rptr. 64 (Ct. App. 1968). This defense has been dubbed the "Gradsky defense."

\textsuperscript{141} Cathay Bank, 18 Cal. Rptr. 2d at 423-24. The court stated:


These principles emphasize actual knowledge and awareness of what is being waived, and require resolution of doubts against waiver.\textsuperscript{142} \textit{Id.} Note that none of the cases cited by \textit{Cathay Bank} above involved the adequacy of a \textit{Gradsky} waiver.

\textsuperscript{142} \textsc{Cal. \textit{Civ. Code} § 2809} (West 1993).
of a judicially created right.

As stated by the River Bank America appellate court, Cathay Bank requires that a written waiver “must state the precise nature of the guarantor’s defense and the fact that it is being waived.”143 This is not a new waiver standard. Cathay Bank merely restates the law for effective waivers of all types, not just Gradsky waivers.

For example, in Bauman v. Islay Investments,144 the court held that a provision in a rental agreement for a cleaning fee was not an adequate waiver of tenants’ rights under section 1951 of the Civil Code because:

... it is settled law in California that a purported “waiver” of a statutory right is not legally effective unless it appears that the party executing it had been fully informed of the existence of that right, its meaning, the effect of the “waiver” presented to him, and his full understanding of the explanation.145

In B. W. v. Board of Medical Quality Assurance,146 the court held that a waiver of section 1000.5 of the California Penal Code147 is not effective unless the party has been fully informed of the existence and meaning of the right being waived and effect of a waiver of that right.148

In In re Marriage of Moore, the court found that a wife’s waiver in a separation agreement of a right to her husband’s retirement benefits was unenforceable unless she

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144. 106 Cal. Rptr. 889 (Ct. App. 1973).
145. Id. at 893. Section 1951(c) of the California Civil Code limits a landlord’s right to claim only the amount of the deposit for cleaning fees necessary to clean the premises on termination of the tenancy. CAL. CIV. CODE § 1951(c) (West 1985).
146. 215 Cal. Rptr. 130 (Ct. App. 1985).
147. Section 1000.5 of the California Penal Code provides that, upon successful completion of a drug abuse diversion program, the record pertaining to the arrest “shall not, without the divertee’s consent, be used in any way which could result in the denial of any employment, benefit, license, or certificate.” CAL. PEN. CODE § 1000.5 (West Supp. 1996).
   It is settled in California that a purported “waiver” of a statutory right is not legally effective unless it appears that the party charged with the waiver has been fully informed of the existence of that right, its meaning, the effect of the “waiver” presented to him, and his full understanding of the explanation.

Id.
"intentionally relinquished 'a known right after knowledge of the facts.'"\textsuperscript{149}

In \textit{Roberts v. Superior Court},\textsuperscript{150} the court held that the waiver of a physician-patient privilege must be done with awareness of the consequences of that waiver. "The waiver of an important right must be a voluntary and knowing act done with sufficient awareness of the relevant circumstances and likely consequences."\textsuperscript{151}

In \textit{Hittle v. Santa Barbara County Employees' Retirement Association},\textsuperscript{152} the appellate court determined that the trial court erred in finding that an employee knowingly waived his right to apply for disability retirement, stating: "The valid waiver of a right presupposes an actual and demonstrable knowledge of the very right being waived'..."\textsuperscript{153}

The above is a nonexhaustive, but illustrative, list of waiver cases, all unrelated to \textit{Gradsky} waivers. These waiver cases all apply the basic principle articulated in \textit{Cathay Bank} that a waiver "must state the precise nature of the guarantor's defense [or more generally the right being waived] and the fact that it is being waived."\textsuperscript{154} Accordingly, the test articulated in \textit{Cathay Bank} applies to waivers of all statutory suretyship defenses, including waivers of section 2809 of the California Civil Code.\textsuperscript{155}

\textbf{CONCLUSION}

There are several defenses available to a guarantor of a real property secured transaction. If a lender proceeds by nonjudicial foreclosure, then seeks a deficiency from a guarantor, a guarantor may invoke the \textit{Gradsky} defense\textsuperscript{156} (unless that defense is adequately waived). A guarantor may also invoke a "Gradsky-type" defense if a lender proceeds by judicial foreclosure, but fails to apply for a fair value hearing under section 726(b) of the California Code of Civil Procedure.\textsuperscript{157}

\begin{itemize}
\item \textsuperscript{149} \textit{In re Marriage of Moore}, 169 Cal. Rptr. 619, 624 (Ct. App. 1980).
\item \textsuperscript{150} 508 P.2d 309 (Cal. 1973).
\item \textsuperscript{151} \textit{Id.} at 317.
\item \textsuperscript{152} 703 P.2d 73 (Ct. App. 1985).
\item \textsuperscript{153} \textit{Id.} at 82 (citing \textit{Jones v. Brown}, 89 Cal. Rptr. 651 (Ct. App. 1970)).
\item \textsuperscript{155} \textit{CAL. CIV. CODE} § 2809 (West 1993).
\item \textsuperscript{156} \textit{See discussion supra} Section II regarding \textit{Gradsky} defense.
\item \textsuperscript{157} \textit{CAL. CIV. PROC. CODE} § 726(b) (West 1980 & Supp. 1996).
\end{itemize}
within three months of the foreclosure sale. Where a lender asserts that the Gradsky defense was waived in a guaranty, a guarantor may counter this assertion by claiming that the guaranty language is inadequate if the guaranty language fails to meet the established test for adequate waivers, as articulated in Cathay Bank v. Lee.\footnote{158} As previously discussed, Cathay Bank v. Lee was not abrogated by recently enacted section 2856 of the California Civil Code.\footnote{159}

Alternatively, if a lender proceeds by judicial foreclosure and then seeks a deficiency from a guarantor, a guarantor might argue that sound application of antideficiency legislation policies dictates that a guarantor should be able to invoke the fair value protections of section 726(b) of the California Code of Civil Procedure,\footnote{160} and thus limit his liability to the difference between the unpaid balance of the note (plus expenses) and the fair value of the property. Any waiver of the fair value limitations of section 726(b) of the Code of Civil Procedure must be knowing and voluntary.\footnote{161}

On the other hand, if a lender chooses to proceed directly against a guarantor without first foreclosing on the property, a guarantor may invoke the section 2845 defense.\footnote{162} Again, any waiver of this defense must be both knowing and voluntary.\footnote{163}

Additionally, if a guarantor establishes that he is a "de facto prime obligor" and that a guaranty is a mere "sham," then the guarantor may successfully assert all of the antideficiency protections afforded a prime obligor.\footnote{164} Notably, a guaranty of a nonrecourse note is a sham.\footnote{165}

Finally, section 2809 of the California Civil Code\footnote{166} provides a defense to a guarantor where his obligation is larger in amount or more burdensome than that of the prime obligor.\footnote{167} Thus, section 2809 prevents a lender from enforcing a

\footnote{158. Cathay Bank v. Lee, 18 Cal. Rptr. 2d 420 (Ct. App. 1993).}
\footnote{159. CAL. CIV. CODE § 2856 (West Supp. 1996); see discussion supra Section II.B.}
\footnote{160. CAL. CIV. PROC. CODE § 726(b) (West 1980 & Supp. 1996).}
\footnote{161. See Cathay Bank v. Lee, 18 Cal. Rptr. 2d 420 (Ct. App. 1993).}
\footnote{162. CAL. CIV. CODE § 2845 (West 1993).}
\footnote{163. See Cathay Bank v. Lee, 18 Cal. Rptr. 2d 420 (Ct. App. 1993).}
\footnote{164. See discussion supra Section IV.}
\footnote{165. See discussion supra Section IV.}
\footnote{166. CAL. CIV. CODE § 2809 (West 1993).}
\footnote{167. See discussion supra Section V.}
guaranty of a nonrecourse note. Moreover, any waivers of the suretyship defenses, including section 2809 waivers, must be knowing and voluntary, and we argue that it is appropriate to test them by the existing law on waivers, as restated by the court in *Cathay Bank v. Lee*. In effect, whether a lender proceeds by nonjudicial foreclosure, judicial foreclosure, or directly against the guarantor without foreclosure, a guarantor has many defenses at his disposal to eliminate or limit his liability.

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168. See discussion *supra* Section V.
169. See discussion *supra* Section VI.
The Honorable Louis Caldera  
California State Assembly  
P.O. Box 942849  
Sacramento, CA 94249-0001  

Re: Opposition to AB 3101, as amended June 21, 1994

Dear Assembly Member Caldera:

Consumers Union, the nonprofit publisher of Consumer Reports magazine, regrets to inform you of our opposition to AB 3101. Our opposition is based on two grounds.

First, we believe the bill should not apply to consumer residential real estate secured loans, but only to commercial transactions. Consumers who obtain a home loan, or individuals who may be required by lenders to guarantee such loans (relatives or other individuals) need the protection under current law. Thus, the bill should contain an exemption for obligations secured by a deed of trust on a residence for 1-4 families, similar to the language in your AB 3071 (re letters of credit). In addition, the reference on p. 2, line 21 to Section 580b of the Code of Civil Procedure appears to be unnecessary and overbroad. The Cathay Bank decision concerned only Section 580d - nonjudicial foreclosures on non-purchase money mortgages. Section 580b, on the other hand, applies only to purchase money mortgages for residential dwellings. Including "580b" in the bill's current form would give lenders a loophole around the antideficiency law for purchase money mortgages on residences.

Second, our more general concern is with the bill's apparent weakening of basic principles of waiver law. A waiver is an intentional relinquishment of a known right. We believe the Cathay Bank court correctly invalidated the waiver at issue in that case. We agree with the Court that the waiver there was "insufficiently specific about the precise rights that are being waived" (original emphasis) (14 Cal.App.4th 1533, 1539 (1993)). To be effective, waivers must specifically state in plain language the entirety of rights that are being waived, which was not done in Cathay Bank.

Paragraph 4 of the purported "waiver" in Cathay Bank completely failed to state that the guarantor was in fact waiving any specified rights or defenses: "Guarantor shall be liable to Bank for any deficiency . . . even though any rights of which Guarantor may have against others by be . . . destroyed" (id. at 1536 & n.4) (emphasis added). The language failed to reveal that "any rights" included
the guarantor’s complete defense against a deficiency judgment and that executing the agreement would in fact waive that defense. The Court also found paragraph 5 of the “waiver” to be “hopelessly” confusing and even more vague than paragraph 4 (id. at 1541).

In our view, any “uncertainty” in this area has not been caused by the courts—who have merely applied hornbook waiver law—but instead by careless drafting of waivers by banks. We don’t believe the Legislature ought to overturn court decisions in order to bail out poor drafting by bank lawyers.

Very truly yours,

Earl Lui
Staff Attorney
August 11, 1994

Assemblymember Louis Caldera
State Capitol, Room 2176
Sacramento, Ca. 94249-0001

RE: AB 3101 (Caldera) OPPOSE

Dear Assemblymember Caldera:

The California Trial Lawyers Association opposes AB 3101, which is scheduled to be heard before the Senate Judiciary Committee on August 6, 1994.


1. Current law makes sense because if a lender elects to foreclose non-judicially, it should bear the consequences of that choice absent an explicit and clear waiver by the guarantor.

California law contains an anti-deficiency statute (Code of Civil Procedure Section 580d); although the statute does not protect guarantors directly, as a practical matter, case law and the “Gradsky defense” preclude deficiency judgments against guarantors unless the lender elects judicial foreclosure instead of non-judicial foreclosure. (Cathay Bank, supra, 1535).

It works like this: after default, the lender has the choice to foreclose judicially or non-judicially. If judicial foreclosure is chosen and there is a remaining deficiency, the lender can try to collect on the deficiency and the debtor has a right of redemption. If the lender chooses to foreclose non-judicially, the remedy is usually quicker and it is easier for the lender to manipulate the sale. However, the anti-deficiency statutes kick in, and the lender can not collect on a deficiency. This extends to guarantors and to lines of credit. However, the guarantor can waive this right to be protected by the anti-deficiency statutes. This is known as a “Gradsky defense” or waiver.

In Gradsky, the court found that the lender was estopped from collecting a deficiency judgment against the guarantor when the lender had opted to foreclose non-judicially. The court reasoned that by electing to foreclose non-judicially, the lender had effectively cut off the guarantor’s rights to subrogation: the guarantor could not then collect from the borrower, since the borrower was protected by the anti-deficiency statutes.
In *Cathay Bank*, the court held that a continuing guaranty had failed to explicitly waive the *Gradsky* defense. The guaranty language neither explained what the defense was, nor the legal consequences of waiving it. The waiver was therefore defective because it was not intentional and knowing.

AB 3101 flies in the face of settled and anti-deficiency and waiver law. It creates an exception to the rule that a waiver must be an intentional relinquishment of a known right.

2. AB 3101 has broad implications; by legislating that waivers need not be an intentional relinquishment of a known right, the Legislature would start the chipping away of long-standing waiver law.

A waiver is an intentional relinquishment of a known right. Valid waivers must specifically state in plain English what rights are being waived so that the consumer who signs a waiver will understand the implications.

It is becoming increasingly common for large institutions to seek to limit their responsibilities under the law by having consumers sign waivers. If the Legislature condones waivers that do not meet the well-accepted standards, the implications are serious.

3. Lenders claim that their current contracts may not contain sufficient language and hence be invalid under *Cathay Bank*: however, if they had written the waivers properly in the first place, they would not be in that situation. The Legislature should not ratify invalid waivers.

Lenders claim that they are concerned about the validity of waiver language in current contracts. They claim that many of the current waivers may not meet the *Cathay Bank* qualifications. Strangely, the argument is that their contracts do not present intentional relinquishments of known rights. If this is true, these contracts should be invalid.

Further, as detailed in the attached Continuing Education of the Bar materials, sample language has been available to lenders. If lenders chose to write their own language in a vague fashion, we should not now ratify its effectiveness.

If you or a member of your staff would like to discuss this issue further, please fee free to contact me or one our legislative representatives in Sacramento.

Sincerely,

Doug de Vries
President

cc: Senate Judiciary Committee
August 4, 1994

The Honorable Bill Lockyer
California State Senate
State Capitol, Room 205
Sacramento, California 95814

RE: OPPOSE - AB 3101 (Caldera)
Senate Judiciary Committee - August 9, 1994

Dear Senator Lockyer:

The California Apartment Association (CAA), representing over 20,000 developers, owners and managers of residential rental property throughout the state, must oppose AB 3101. This measure would abrogate the holding of the Cathay Bank vs. Lee decision regarding "Gradsky waivers" in guaranties utilized in secured real property financing.

CAA is aware that the Cathay decision causes concern in the lender community regarding the specificity of Gradsky waivers; however, these waivers, which were originally authorized by an appellate court decision (Union Bank vs. Gradsky), have always been subject to a case by case, transaction by transaction, review. Thus, caselaw has been very important in the development and use of these waivers.

The Cathay case is not an aberration - the court simply defines and delineates what must be contained in a Gradsky waiver in order to be effective. Prior to this case, there was no standard other than the very general requirement that the waiver be "an express contract" or "sufficiently explicit" (See Gradsky at page 48). The standard set out by the Cathay decision is not a difficult one to meet, and is consistent with the principle that a party can only waive a right or defense if he or she knows and understands that the right or defense is available in the first place.

We believe that the present economic circumstances relating to real property values have contributed to the assertion that this decision has created havoc in real property financing. Our concern is from the consumer side: where once property was worth more than the paper, and now is not, a lender may take the property back by non-judicial foreclosure, discount and/or mismanage the asset without concern as the guarantor will be forced to pay the deficiency based upon a waiver that may not have been made clear to the guarantor. As presently drafted, AB 3101 would allow a lender to get around
the one action rule based upon a Gradsky waiver that was not specific in explaining the guarantor's underlying rights of subrogation and reimbursement which are destroyed by the lender's choice of remedies, a choice over which the guarantor has no control. Additionally, the waiver may not be clear that the guarantor has a defense to the deficiency action under the one action rule when the lender selects nonjudicial foreclosure, and that it is this defense that the guarantor is giving up by signing the waiver document.

Further, AB 3101, by stating that it is declarative of existing law without Cathay leaves in place and statutorily enacts a very general and ambiguous standard for Gradsky waivers, both for those in existence and future waiver documents. The only guidance the bill gives as to what “express” means is in the negative - the waiver language need not contain any references to statutes or judicial decisions. If AB 3101 becomes law, Gradsky waivers will again be subject to case by case scrutiny without any certainty as to what language is sufficient to truly educate the guarantor on the defenses and rights that he or she is giving up by signing the waiver document.

It is our position that the Cathay ruling should be allowed to stand, and that any statutory standard for Gradsky waivers crafted through legislation should be prospective in application. Thank you for considering our views. We are available to meet either you or your staff at the earliest possible convenience should you so desire.

Respectfully,

CALIFORNIA APARTMENT ASSOCIATION

By:

Thomas K. Bannon
Executive Vice President

TKB:dmc

cc: Assemblymember Caldera
    Senate Judiciary Staff
    Maurine Padden, CBA
    Rex Hime, BPOA
    Stan Wieg, CAR