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> *"A guarantor is one who promises to answer for the debt or perform the obligation of another when the person ultimately liable fails to pay or perform."*

GUARANTOR RISKS AFTER FORECLOSURE

THIS ISSUE

The California Court of Appeal recently held that some guarantors may be liable for a loan deficiency judgment after a foreclosure sale on real property, while others may not.[1] The decision follows long California precedent, but may be ripe for legislative review regarding the inherent risks in personal guaranties during a real estate foreclosure.

BACKGROUND

California's antideficiency statutes (Code of Civil Procedure §§ 580a, 580b, 580d, 726), enacted during the Great Depression, limit or prohibit lenders from obtaining personal judgments against borrowers where the lender's sale of real property security produces proceeds insufficient to cover the amount of the debt. The statutes are intended to provide stability in the housing market, by ensuring borrowers that they can buy real property and be at risk in that investment for no more than their down payment and payments made during the life of the loan. The statutory scheme has been generally recognized as beneficial to both borrowers and lenders by encouraging would-be homebuyers to borrow money relatively risk free. And they are becoming ever more relevant as the foreclosure sales throughout the country escalate at a rate not seen since the Great Depression.

But what do the antideficiency statutes do? Section 580a, for example, provides in relevant part: "Whenever a money judgment is sought … following the exercise of the power of sale in [a] deed of trust or mortgage, the plaintiff shall set forth in his or her complaint the entire amount of the indebtedness which was secured by the deed of trust or mortgage at the time of sale, the amount for which the real property or interest therein was sold and the fair market value thereof at the date of sale and the date of that sale.

[1] *Talbott v. Hustwit* (2008) 164 Cal.App.4th 148.

Before rendering any judgment, the court shall find the fair market value of the real property … at the time of sale. The court may render judgment for not more than the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value of the real property … sold ...."

In the appellate decision reviewed here, Mr. and Mrs. Hustwit were the guarantors of a loan made to a trust established by the Hustwits. The trust defaulted on the loan, and the lender initiated a foreclosure sale, acquiring the property by a credit bid of $900,000. The lender then sued the Hustwits under their guaranty agreements for the difference between the $900,000 and the unpaid balance of the loan, $1,288,042. The judge in a court trial entered judgment against the Hustwits for a deficiency judgment.

The Hustwits were the settlors of the debtor trust. They contended at trial that because they were so closely aligned with the trust, they could not be considered “independent” of it, and thus could not legally be held liable as guarantors of the debts of the trust.

On appeal, the court considered whether the Hustwits were truly independent of the trust, and thus correctly held liable for the obligations of the trust. The court’s decision turned on the issue of whether the Hustwits would have had liability for the debts of the trust without signing the personal guaranties. Finding that they would not, because of the manner in which they set up the trust, the court upheld the judgment against them.

SECTION 580a DOES NOT PROTECT GUARANTORS

The Hustwits were held liable as guarantors of the trust's loan obligation. A guarantor is one who promises to answer for the debt or perform the obligation of another when the person ultimately liable fails to pay or perform (Civil Code § 2787).

Many decades ago, the California Supreme Court held that a contract of guaranty gives rise to a separate and independent obligation from that which binds the principal debtor. Since section 580a has to do solely with actions for recovery of deficiency judgments on the principal obligation it has no application to an action against a guarantor. Accordingly, the court of appeal concluded section 580a has no application to guarantors.

WERE THE BORROWERS TRUE GUARANTORS?

Facing over 60 years of Supreme Court precedent, the Hustwits did not challenge the rule that 580a does not apply to guarantors. Instead, they contended that they were not “true” guarantors of the debt, since, as settlors, they were so closely identified with the trust.

And their argument had some basis in precedent. Courts have recognized a distinction between true, independent contracts of guaranty and guaranties executed by the primary obligor. "It is well established that where a principal obligor purports to take on additional liability as a guarantor, nothing is added to the primary obligation. The correct inquiry is whether the purported debtor is anything other than an instrumentality used by the individuals who guaranteed the debtor's obligation, and whether such instrumentality actually removed the individuals from their status and obligations as debtors."

In other words, were the guarantors already liable for the loan repayment at the time they signed the guaranties? If so, they cannot also be liable as guarantors. One exemplar case involved a situation in which partners had individually guaranteed a partnership note. Because the partners were already jointly and severally liable on the note as general partners, the court held the guaranty did not change the partners' status as principal obligors. Thus, they were not “true guarantors” and could not be held liable beyond their liability on the original obligation.

In a contrasting case a wife took out a loan secured by her separately owned real property, and the husband signed a personal guaranty. The court recognized that in many ways a husband and wife are partners, but nonetheless held the husband became a true guarantor because he would not have been personally liable for the loan made to the wife absent the guaranty.

HOW DID THE COURT RULE HERE?

The court noted that the trust arrangement provided the Hustwits a significantly greater degree of separation than that in other California cases. Although the Hustwits were the settlors of the trust, they were secondary, not primary, beneficiaries. More importantly, they were not trustees of the trust; instead, they used a limited liability company as trustee, thus limiting their personal liability for the trust's obligations. The Hustwits were true guarantors because their trust arrangement "actually removed them from their status and obligations as debtors." Accordingly, the trial court did not err in holding the protections of section 580a inapplicable.

DISSENTING OPINION

Justice Sills wrote a concurring opinion, in which he nevertheless questioned the wisdom of their decision, and invited legislative changes to alter the result.

As Justice Sills wrote: “I agree with the reasoning and result of the majority opinion, because both are compelled by Supreme Court authority. However, I write separately to voice concerns about the potential danger for the easy circumvention of the protections offered consumers under California's statutory antideficiency legislation by the use of loan guarantees. [sic] The current ‘subprime mortgage crisis’ at a time of generally declining real estate prices illustrates the public importance of the issue.” Justice Sills focused on Civil Code section 2809, which establishes a limitation on the scope of liability under a guaranty. In particular, he focused on the statute's use of the words “must be neither larger in amount nor in other respects more burdensome than that of the principal.” He reasoned that the guarantor’s merely being on the hook for the amount of the debt is not the end of a court's inquiry. “A logical, natural, and plain reading of the text of section 2809 would thus indicate that if the principal debtor is afforded certain protections against having to pay the entire amount of the debt, not to afford those same protections to a guarantor would indeed be to impose more burdensome obligations on the guarantor. And … that's only common sense anyway: If a homeowner need not fear the prospect of a deficiency judgment, and if a guarantor of the homeowner's loan undertakes no more ‘burdensome’ obligations than that undertaken by the homeowner, the guarantor should not have to fear a deficiency judgment either.”

CONCLUSION

The law of personal guaranties is complex, to say the least. And this decision highlights the irony that a guarantor may incur a greater liability than the borrower whose loan he is guarantying. While a borrower can derive the benefit of the antideficiency statutes, a true guarantor cannot.

Moreover, those guarantors who are closely aligned with the original debtor are treated differently from those who are not. How close is that line? The court reasoned that if the Hustwits had also been trustees of the trust they created (instead of using a limited liability company for that purpose), they would be protected by the statute. Pointing out the irony of this decision, Justice Sills states in his concurrence, the Hustwits “simply outwitted themselves. They have to take the rough with the smooth, and, more specifically, cannot avail themselves of the protections of limited liability corporations [sic] and at the same time claim an obligation is really theirs. Sometimes piercing the veil can actually help you.”

NEXT ISSUE

Another recent appellate decision regarding competing uses of easements.

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