

# LENDERS, DEBTORS & GUARANTORS: WHO GETS THEIR WAY IN THE FORECLOSURE FRAY?

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**I**t is no secret that the downturn in the U.S. economy has had a devastating effect on the commercial real estate market, both nationally and in California. As a result, counsel for lenders nationwide are busy prosecuting foreclosure actions involving real estate-secured obligations.

Borrowers' counsel have also been hard at work formulating and testing contentions to either slow or terminate lenders' foreclosure proceedings. For example, attacks upon the integrity of lender-loan documentation have recently obtained significant attention in the media, and, more practically, have derailed numerous foreclosure actions.

California law provides significant potential defenses and protections for borrowers on loans secured by real property. For example, pursuant to California's "anti-deficiency" rules (set forth primarily at California Civil Code sections 580a through 580d), a lender may not pursue a borrower on a real estate-secured loan for any "deficiency," i.e., any amount left due and owing to the lender when foreclosure of the lender's real property security fails to net sufficient funds to repay the balance of the loan. Lenders may not require borrowers to waive those "anti-deficiency" protections. And with real estate values having declined substantially after loans now coming due were made, lenders' real property security interests may be worth much less than the amount of the loan balance. As a result, deficiencies abound.

Seeking to eliminate those deficiencies, lenders are increasingly pursuing actions against the guarantors of real estate-secured transactions in lieu of or in addition to foreclosure actions against the borrowers. Such actions may be advantageous to lenders for

several legal and practical reasons. One primary advantage under California law is that guarantors (unlike borrowers) may waive the protections afforded to borrowers pursuant to the "anti-deficiency" statutes. Thus, the lender may obtain a deficiency judgment against the guarantor where the net funds obtained pursuant to foreclosure on the lender's security interest fall short of the outstanding loan balance.

Counsel for guarantors of real estate-secured loans of course seek to preclude lenders from enforcing their clients' guaranty obligations or at least limit the lenders' recovery. More specifically, guarantors are advancing a theory based on language in a recent opinion of the California Court of Appeal in order to proclaim a right to the protection of California's anti-deficiency statutes. Such efforts should fail pursuant to well-established law regarding the ability of guarantors to waive the protections of California's surety laws, as well as the anti-deficiency protections of California Civil Code sections 580a through 580d.

A long-established and often-cited principal of guaranty law in California is that a guaranty is a separate and independent obligation from the underlying loan. Moreover, a guaranty is generally not secured by the real property pledged as security for the loan.

However, in 1939, the California Legislature abolished the distinction between sureties and guarantors by way of the enactment of California Civil Code section 2787. Just last year, the Third Appellate District of the California Court of Appeal remarked in *Bank of America v. Stonehaven Manor LLC* that the 1939 abolition of the distinction between sureties and guarantors effectively abolished the principle that

the obligation of the principal debtor and that of the guarantor are independent obligations. ((2010) 186 Cal. App.4th 719, 724, n.2.) Guarantors of real estate-secured loans cite this language to attempt to block liability for deficiency judgments, arguing that their guaranty obligations are indistinguishable from the borrowers' obligations on the underlying loans. Therefore, the guarantors contend, the guarantees are secured by real property, affording the guarantors the protections of the anti-deficiency statutes.

What the guarantors and their counsel should be careful not to overlook, and what lenders (and their counsel) should keep in mind, however, is that the Bank of America court also confirmed in no uncertain terms that the "convergence" of guaranties and their underlying obligations affected by Civil Code section 2787 is part of a package of rights that guarantors may legitimately waive. Indeed, such waivers in a guaranty generally permit the lender to pursue the guarantor for a deficiency judgment even where the underlying debt is secured by real estate.

In 1996, the California Legislature enacted Civil Code section 2856, which eliminates any uncertainty over a guarantor's ability to waive the protections of the anti-deficiency and suretyship laws, as well as any other rights that might accrue to a guarantor because the underlying loan is secured by real property. Though no exact language is required to effectuate such a waiver, section 2856 sets forth language sufficient to do so. Many lenders use the verbatim language set forth in section 2856 in their guaranty forms for real estate-secured loans.

In addition, in the same year that section 2856 became effective, the First Appellate District of the California

Court of Appeal in *River Bank America v. Diller* confirmed that waivers of California's surety scheme effectively reinstate the previously long-standing independence of guaranties from principal obligations, which was abolished by Civil Code section 2787. ((1996) 38 Cal.App.4th 1400, 1415-1417.) As the court there held, pursuant to the waivers agreed to by the guarantors, the guaranties were separate and independent from the borrower's obligation; the lender could proceed directly against the guarantors without first proceeding against the security; and, even if the lender did first proceed against the security, the lender's receipt of any foreclosure proceeds would not terminate or reduce the guarantors' obligations under the guaranties.

Though at first blush the language of the Court of Appeal in *Bank of America* appears to offer guarantors a way to avoid liability for deficiency judgments, *River Bank America v. Diller* and Civil Code 2856, among other decisions and statutes, establish that such an argument should not succeed. Proper waivers in a guarantee of a real estate-secured loan should be effective to ensure that the contract of guaranty and the underlying loan remain independent obligations, preserving the lender's right to pursue the guarantor for amounts the lender cannot otherwise obtain from the debtor.

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This article originally appeared in *Western Real Estate Business*, May 2011.  
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