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THE SHAM GUARANTY DEFENSE AND LITIGATION STRATEGY

Our last email reviewed court decisions which held that various individual guarantors – partners, trustors/trustees, corporate executives and shareholders – were not guaranteeing the debt "of another" but were, in fact, equivalent to the debtor. As such, they were entitled to the protection afforded by the sham guaranty defense and the anti-deficiency statutes. However, there are other implications of sham guaranty use in contexts where a corporate entity itself is involved.

Corporate Alter Ego. Although the *River Bank* and *Union Bank* cases that we discussed in the previous email relied on certain evidence ordinarily used to prove "alter ego" liability, the courts in those cases did not make a finding of alter ego. Thus, a guarantor's direct liability, "intended" direct liability, or even alter ego liability is not required to prove a sham guaranty in the corporate context. To this degree, *River Bank* expands sham guaranty theory beyond *Valinda*, *Younker* and *Union Bank*.

Conversely, the question remains, may a shareholder avoid a guaranty merely by piercing his own corporate veil and proving he is the alter ego of the corporate principal? Given that direct liability supports a sham guaranty finding (as in the cases where a partner and a trustor were the guarantor, as well as in the *Valinda* case where two individuals entered a loan obligation as a separate corporate entity), and given that alter ego theory shifts liability to shareholders, the answer to the question may be "yes" but the courts have yet to give adequate direction on that issue.[1]

Notably, in both the *River Bank* and *Union Bank* cases, the courts were influenced by evidence of the lenders' "intent to subvert" anti-deficiency protection. No "intent to subvert" was considered in the partner and trustor cases, or even in *Valinda,* because those guarantors remained liable as principals as a matter of law. Thus, evidence of a lender's "intent to subvert" may become significant where officer or shareholder guarantors are not directly liable in the corporate context.

"***Dummy" Corporations.*** If the actual purchaser of property uses a third-party to take title and enter into the loan obligation, a guaranty executed by the actual purchaser may be a sham guaranty. In *Wilton-Maxfield Management Co. v. Coast Federal Savings & Loan Ass'n,*[2] a corporation purchased real property in California. Instead of taking title in its own name, the corporation directed the seller to convey the property to a third-party. At the corporation's request, the third-party then executed a promissory note in favor of the seller. The seller was aware that the corporation was the real purchaser, that the third-party had no real interest in the property, but merely took title as a "dummy." The corporation guarantied the promissory note.

Upon default, the seller foreclosed on the property and sought a deficiency judgment against the guarantor. The court concluded that Section 580b was designed not simply to protect those signing the note but all "purchasers" of real property. Because the corporation was the "actual purchaser" of the property, the seller's claim for a deficiency judgment was precluded by Section 580b.

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***Litigation Strategy and the Sham Guaranty Defense*.** The question of whether a person is a true guarantor or really the principal obligor is a factual issue.[3] In *Younker,*[4] the appeals court reversed a summary judgment in favor of the lender and against the guarantors, holding that "there is an issue to be tried, which depends in part on a factual determination, namely, whether [the guarantor] really was a guarantor."[5]

In *River Bank*, the lender's motion for summary adjudication to enforce the guaranties was denied. The disputed factual issues included whether (1) the transaction was structured to avoid section 580d, (2) the lender intended from the outset to look to the real property security for collection of the debt or the purported guarantors exclusively for collection of any deficiency after foreclosure, and (3) the principal obligor was an undercapitalized corporation, entirely owned by the guarantors, whose financial wherewithal the lender never investigated.[6]

A sham guaranty defense may also be asserted in opposition to an application for writ of attachment to counter the lender's required showing of the probable validity of its underlying claim, and the lender's assertion that the attachment is not sought for a purpose other than the recovery on the claim upon which the attachment is based.[7]

From the guarantor's perspective, investigation into and development of facts supporting a sham guaranty defense may be one of only a few strategic theories available to preclude a lender's successful pursuit against a guarantor, including attachment and summary judgment. **The key to the successful application of this defense is to do that analysis as early as possible, preferably before there is a lawsuit pending.** Moreover, a valid sham guaranty argument may persuade a lender to reassess the risks associated with proceeding to a trial before jurors who may be more sympathetic to individuals than lenders.

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[1] One court entertained that alter ego alone could establish a sham guaranty, but that guarantor was unable to factually prove alter ego existed. Roberts v. Graves, 269 Cal.App.2d 410, 418 (1969). However, a recent unpublished opinion viewed a similar attempt skeptically. Pacific Western Bank v. Stull (Cal. Ct. App., Feb. 24, 2011, E050551) 2011 WL 664017 ("piercing the corporate veil is a sword wielded on behalf of a plaintiff, not a shield brandished by the defense").

[2] 117 F.2d 913 (9th Cir., 1941)

[3] River Bank, 38 Cal.App.4th at 1422; Younker v. Reseda Manor, 255 Cal.App.2d 431, 438 (1967).

[4] 255 Cal.App.2d 431 (1967).

[5] Younker, 255 Cal.App.2d at 438.

[6] River Bank, 38 Cal.App.4th at 1427.

[7] Code of Civil Procedure section 484.090(a).