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A GUARANTY BY A “TRUE GUARANTOR” MAY BE ENFORCED FOLLOWING FORECLOSURE

(The Relationship Between Borrower and Guarantor May Be Determinative)

In Talbott v. Hustwit, 2008 DJDAR 9342 (June 20, 2008), two individual guarantors attempted to avoid their obligation for the deficiency (difference between amount owed and amount bid at sale) following a power of sale foreclosure by arguing that they were not “true guarantors” and, thus, were entitled to the anti-deficiency protections of California Civil Code Section 580a. In rejecting this contention and holding the guarantors liable, the court focused on the following facts: (i) the individual guarantors were not the trustees of the trust (a limited liability company owned by the individual guarantors was utilized to be the trustee); (ii) the individual guarantors were only secondary, rather than primary, beneficiaries of the trust; and (iii) the individual guarantors were not otherwise personally liable for the obligations of the trust because of use of the limited liability company as trustee. The court specifically found that on these facts there was sufficient separation between the borrower trust and the individual guarantors as to make the guaranty enforceable against the individual guarantors as true guarantors.

The court specifically distinguished the situation before it from the facts in Riddle v. Lushing (1962) 203 Cal.App.2d 831 (partners held not liable for guaranty of partnership note obligations) and in Torrey Pines Bank v. Hoffman (1991) 231 Cal.App.3d 308 (individual guarantors held not liable for guaranty of trust note obligations where individual guarantors were settlors, trustees, and primary beneficiaries of the trust). The reasoning in these cases – the so called “Alter Ego Rule” – is that where there is a sufficient identity of interest between the borrower and the guarantor, under Section 580a of the California Civil Code, the guaranty will not be enforced as the guarantor is in essence the borrower.

Although the holding in this case can reasonably be viewed as being consistent with the “Alter Ego Rule,” it begs the question as to how much separation between the borrower and the guarantor is necessary to ensure that the individual guarantors will be considered “true guarantors” and how much engineering will be permitted. We can only speculate whether the outcome in Talbott would have been the same if:

- The individual guarantors had been the primary beneficiaries?
- The individual guarantors had been co-trustees?
- The entity structure in Talbott had been required by the lender as a condition to the making of the loan rather than existing for the borrowers/individuals separate business or estate planning purposes?

These open questions provide both opportunities and challenges in structuring, negotiating, and drafting loan documents and trust instruments.

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