

News & Types: Corporate, Finance & Acquisitions Update

California Court Allows Equitable Defense to Enforcement of Guaranty in Spite of General Waiver

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Practices: Corporate, Finance & Acquisitions, Litigation

Shortly before the new year, California's Fourth District Court of Appeal, sitting in Riverside, delivered some clarity to California's law on waivers of defenses in guaranties. California's Civil Code provides guarantors with numerous defenses to their liability on guaranties. Historically, the California courts have strictly construed any waivers of defenses by guarantors. By the 1990's, one California court required that waivers actually recite in detail the rights or defenses being waived in order to be valid. But in 1996, the California Legislature amended the Civil Code to allow creditors to obtain waivers of all statutory defenses from guarantors, without any specific form requirements. Since that time, California's appellate courts have not had much opportunity to explain the effect of this change to the Code.

The Fourth District Court of Appeal's decision in *California Bank & Trust v. Del Ponti*, No. E053187 (Cal. App. Dec. 9, 2014), arises out of an August 2008 trustee sale and the lender's attempt to collect the resulting deficiency from the individual guarantors of the loan. The case essentially represents the aftermath of a foreclosure in the Inland Empire region of California, one of the epicenters of the U.S. housing crisis, which occurred a month before the Lehman Brothers bankruptcy in September 2008. As cases arising out of creditors' actions taken later on during the Great Recession reach their appellate phases, we have good reason to expect further clarifications from the California courts on California's law of guaranties in the coming several years.

In *Del Ponti*, a local bank lent \$22.5 million for construction of a 70-unit townhome development in Rialto, California. The project went well for the first 18 months, until the end of 2007 when the bank stopped making payments for the construction. The bank made one further payment, which encouraged the developer and contractor to continue construction of the townhomes so that they could be completed and sold. However, work could not be completed due to the lack of payments from the bank. The bank no indication that it had disapproved any payments or that there was anything wrong with the loan. It sent the developer a cryptic email stating that housing prices were declining, which meant that the Bank had no room for additional advances and might require a capital call. Since the bank had not funded the completion of Phase I of construction, the townhomes could not be sold before the end of 2007, meaning that the developer was not able to pay off the loan at its maturity in February 2008.

The bank still did not serve or record a notice of default (although it had prepared and signed one). Instead, the bank initiated discussions with the developer and contractor, which resulted in a "global strategy." The bank indicated that if all parties complied with the "global strategy," the bank would not pursue the borrower or guarantors for deficiencies. Although the developer and contractor complied with the "global strategy," at some personal expense, the bank did not. The bank ultimately disposed of the property at a trustee's sale, even though it had assured the developer it would allow an auction to go forward. The bank then pursued the guarantors for the deficiency remaining on the loan after the trustee's sale.

The trial court found against the bank. The Court of Appeal upheld the trial court's findings that the bank had breached the loan agreement by failing to pay out on pay applications that had been approved, and that the bank had led the parties to believe that the guarantors would not be pursued if they complied with the agreed "global strategy."

The *Del Ponti* court held that California's Civil Code does permit creditors to obtain a general waiver of all statutory defenses guarantors may have. However, that general waiver does not waive all defenses. Thus, equitable defenses, or defenses based upon public policy, were not waived by a general waiver of defenses. In *Del Ponti*, this meant that the bank could be barred from pursuing the guarantors because of its own misconduct. Essentially, the *Del Ponti* court ruled that the bank's "unclean hands," prevented it from being able to enforce the guaranty and the guarantors' general waivers of defenses did not stop them from arguing the "unclean hands" defense.

The *Del Ponti* decision provides some clarification for creditors in their use of guaranties in California. A generally worded waiver of defenses will waive a guarantor's usual exoneration defenses if the guaranty needs to be enforced. However, equitable defenses such as "unclean hands," and public policy defenses such as the illegality of the underlying contract, will remain available to guarantors who are being pursued. This reinforces the need for creditors to complete adequate due diligence, to ensure that the underlying transaction is valid and legal, and that their actions with respect to borrowers and guarantors are undertaken in good faith.