

THE SHAM GUARANTY DEFENSE

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➤ Sham Guaranty Defense

- A defense asserted by Guarantors in litigation over guaranty of real estate secured loan made to an entity borrower
- Entity borrower is usually a corporation or limited liability company
- Guarantors are shareholders of the borrower corporation or members of the borrower LLC
- After borrower defaults on real estate secured loan, the Lender can proceed to foreclose on the real property
- Usually, the Lender chooses to non-judicially foreclose (by trustee's sale) on the real property

➤ Sham Guaranty Defense

- Due to California's antideficiency and one action/security first rules, the Lender may not look to the borrower to recover the deficiency after a non-judicial foreclosure, if the proceeds from the sale are not sufficient to pay off the loan
- However, if there are guarantors, and the guaranty is not secured by real property, the Lender can sue the guarantor to recover a deficiency judgment without violating the antideficiency laws in California
- Due to this type of scenario, the so-called "sham guaranty doctrine" developed to protect guarantors from deficiency actions after non-judicial foreclosure under certain circumstances

➤ Sham Guaranty Law

- However, in order to collect a deficiency judgment against a guarantor, the guarantor “must be a true guarantor and not merely the principal debtor under a different name” -i.e., the guaranty cannot be a “sham.” (*Cadle Company II v. Harvey* (2000) 83 Cal.App.4th 927)
- Case law states that the correct inquiry is:
 - Courts must look to the “purpose and effect of the agreements ...” and whether the purported debtor is anything other than an instrumentality used by the individuals who guaranteed the debtor’s obligation;
 - whether such instrumentality actually removed the individuals from their status and obligations as debtors.
 - Put another way, are the supposed guarantors nothing more than the principal obligors under another name? (*Torrey Pines Bank v. Hoffman* (1991) 231 Cal.App.3d 308, 320)

➤ Sham Guaranty Law

River Bank America v. Diller (1995) 38 Cal.App. 4th 1400:

Seminal case that guarantors rely upon to mount a sham guaranty defense.

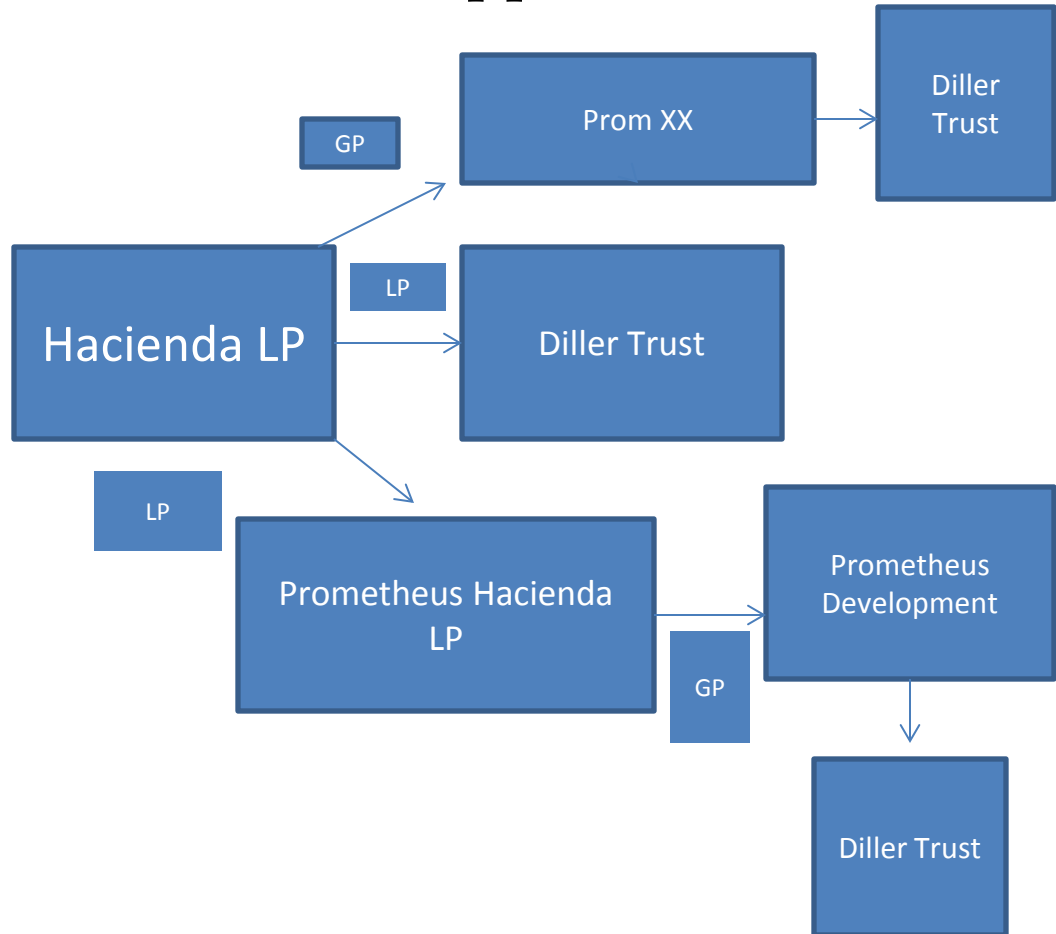
- The lender in *River Bank*:
 1. Insisted on a new entity borrower to be brought into existence;
 2. Specifically set up the loans to be non-recourse to the borrower;
 3. Backed out of a previously agreed upon joint venture agreement; and
 4. Restructured the agreement with a new borrower and with the principals as guarantors.
- According to the guarantor, he and his wife executed the documents memorializing the loan and guarantees “[u]nder economic duress.”
- “...counsel River Bank insisted that in order to render ‘enforceable’ the ‘guaranty’ being given by Prometheus, a new ‘borrower’ should be brought into existence. “
- The court did not find a sham guaranty existed, but that there were triable issues of fact that precluded summary adjudication in favor of River Bank.

> Sham Guaranty Law

River Bank America v. Diller (1995) 38 Cal.App. 4th 1400:

Lender required this ownership structure for borrower (Hacienda LP)

- Dillers and Diller Trust are the guarantor **and** Dillers are (1) the owner of Prom XX, the Borrower's GP; (2) one of the Borrower's LPs; (3) the indirect owner, through Prometheus development, of the Borrower's other LP
- "The Dillers have effective control over the entire partnership"
- Diller intended to use Prometheus Hacienda to develop the project but counsel for lender "insisted that in order to render 'enforceable' the 'guaranty' ... a new 'borrower' should be brought into existence."



➤ Sham Guaranty Law

Valinda Builders, Inc. v. Harold J. Bissner, et al. (1964) 230 Cal.App.2d 106

•The guarantors were actually contractually bound, as individuals, to purchase and develop the property. “[T]heir agreement was...that in any event they [guarantors], personally, would carry out the agreement and pay the purchase money.”

Union Bank v. Dorn (1967) 254 Cal.App.2d 157

•The lender made a loan to a general partnership which was personally guaranteed by the partners of the general partnership, and the court recognized that general partners are fully liable for the obligations of a general partnership. The guarantors in *Union Bank v. Dorn* did not purport to waive any anti-deficiency protections as that case predated the amendment to Civil Code section 2856 allowing for guarantor waivers.

Cadle Company II v. Harvey (2000) 83 Cal.App.4th 927

•A revocable trust obtained a loan secured by a deed of trust on certain real property. The trustee of the trust signed a personal guaranty in support of the trust’s obligations under the loan. The Cadle court concluded that the trustee’s personal guaranty of the revocable trust’s obligation was unenforceable because the trust and the trustee were one and the same.

Torrey Pines Bank v. Hoffman (1991) 231 Cal.App.3d 308, 320

•A loan was made to an inter vivos trust which was personally guaranteed by the trustees of the trust. As in *Cadle*, the court denied recovery to the lender with respect to its cause of action for breach of guaranty on the basis that the borrower – the revocable trust – and the guarantor – the trustee of the trust were one in the same. The court stated “We emphasize that our holding is necessarily limited to these facts. While it would be possible in a living trust to create a greater degree of separation of interest between settlor, trustee, and beneficiary (e.g., by the use of a separate trustee), this particular trust device did not accomplish enough division between these interests...”

➤ Sham Guaranty Law

Talbott v. Hustwit (2008) 164 Cal.App.4th 148

- Husband and wife who guaranteed a real property secured loan made to their inter vivos trust by the lender were true guarantors because the trust was not a "mere instrumentality" under the facts of the case, unlike the grantor inter vivos trust in *Torrey Pines*.
- "Here, the trust arrangement provided the Hustwits a significantly greater degree of separation than that in *Torrey Pines*...the Hustwits are not trustees of the Trust; instead, the Hustwits used a limited liability company as trustee, thus limiting their personal liability for the Trust's obligations. The Hustwits became true guarantors because the Hustwits' trust arrangement "actually removed the[m] from their status and obligations as debtors."
- "...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 and at the same time claim an obligation is really theirs at the same time"

Mariners Sav. & Loan Ass'n v. Neil (1971) 22 Cal.App.3d 232

- The wife took out a loan secured by her separately-owned real property, and the husband signed a personal guaranty. The court 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.
- "Thus, when defendant's wife executed a note and secured it with a trust deed on her separate property, no obligations were thereby imposed on defendant. Defendant's obligation on the contract of guarantee was separate and distinct from the primary obligation of his wife."

➤ Sham Guaranty Law

NFT Parcel A LLC v. Marix 2009 WL 5215373 (C.D. Cal. 2009)

- The only citable case where the borrower was an LLC.
- The Court granted lender's motion for summary judgment, with affirmative finding that guaranty was not a "sham"
- Sham Guaranty Factors listed in *NFT Parcel*:
 1. whether or not the guarantor was also personally obligated under the underlying loan agreement (i.e., , general partner of partnership borrower);
 2. whether or not the primary debtor, if a corporate entity, was created for the sole purpose of entering into the underlying loan;
 3. whether or not the vendor insisted on structuring the transaction so as to substitute a corporate entity as a borrower in place of individuals;
 4. the ownership interests of the primary debtor, if a corporate entity;
and
 5. whose financial information was reviewed by the vendor before entering into the loan (i.e., was the lender looking primarily to the guarantors or borrower for repayment of the loan).

➤ Sham Guaranty Law

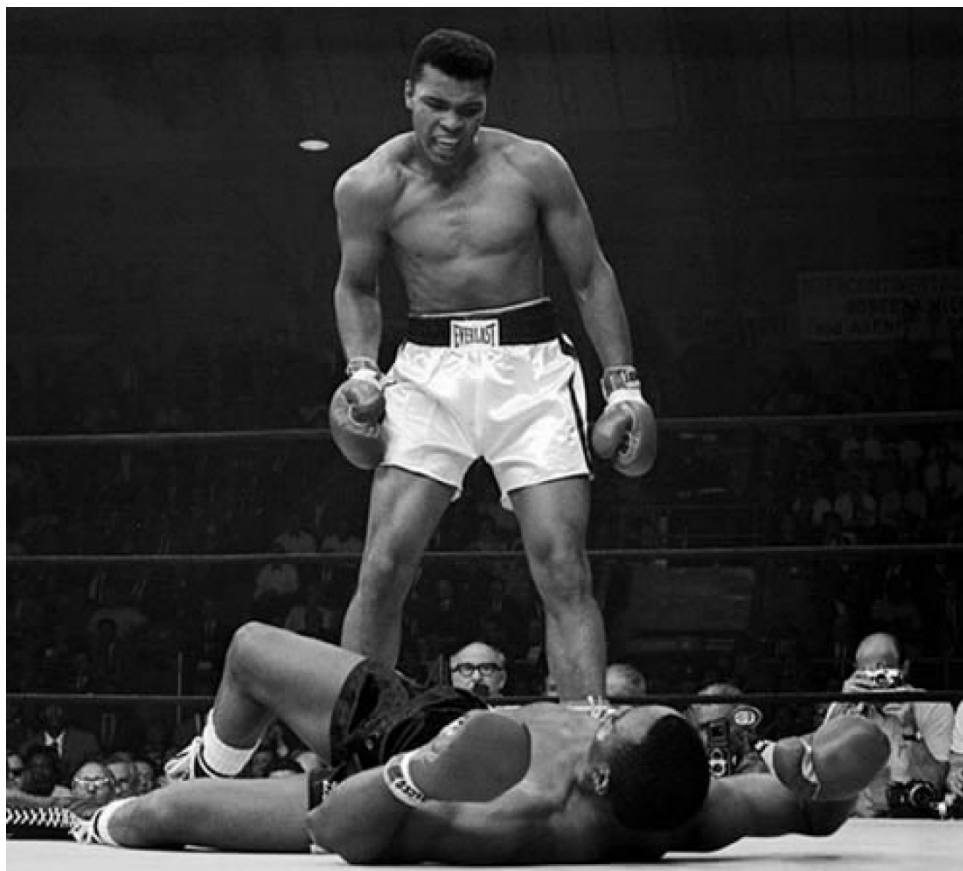
NFT Parcel

“...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...[and] whether the use of that instrumentality actually removed any primary liability of the individual debtor.”

- “Here, Palm Desert, the primary debtor, is admittedly a limited liability company; its members therefore are not personally liable for its debts. Cal. Corp.Code § 17101(a). Accordingly, assuming that Palm Desert is an instrumentality of Defendants, it is one that actually removes Defendants from their status as debtors.”
- **“A guarantor’s protection from personal liability is a weighty factor in considering whether or not they are, in fact, the primary debtor....one of the two primary concerns behind the enactment of section 580b “is not as strong where the guarantor is a corporation whose owners are protected by the central feature of corporations: limited liability.”**
- **“Where a guarantor is effectively protected from personal liability for the underlying debt, that guarantor has a greater burden of demonstrating that the guaranty is a sham.”**
- Evidence that the lender only reviewed the financial information of the guarantors was not enough to create a triable issue of material fact.

➤ Sham Guaranty – Preemption Defense

- If you have a guaranty that was originally executed for a lender that failed and was seized by the FDIC, you may be able to shut down the sham guaranty defense on the basis of federal preemption. Federal law has stringent requirements for enforcing agreements that are against the interests of the FDIC.
- Concept is borne out of the Supremacy Clause of the United States Constitution. A federal law that conflicts with a state law can trump (i.e. preempt) the state law.



➤ Sham Guaranty – Preemption Defense (Cont'd)

- Under 12 U.S.C. 1823(e), a failed bank's pre-closing agreement that compromises its rights to enforce its loans and other assets does not bind the FDIC, as the bank's receiver, unless the agreement is:
 - (1) in writing
 - (2) executed contemporaneously with the bank's acquisition of the asset;
 - (3) approved by the bank's board or loan committee, with approval reflected in their minutes;
 - (4) continuously a part of the bank's records.



➤ Sham Guaranty – Preemption Defense (Cont'd)

- The purpose behind Section 1823(e) is to allow federal and state bank examiners to rely on a bank's records in evaluating the worth of the bank's assets, enable a swift transition of a failed bank, prevent debtors from profiting from fraudulent insertion of new terms, and avoid saddling deposit insurers, taxpayers, or creditors with inequitable losses.



➤ Sham Guaranty – Preemption Defense (Cont'd)

- Section 1823(e) is designed to preclude claims that a document means something different than what it says on its face. “A document that purports to represent more than is clear on the fact of it leaves bank regulators without warning as to the true nature and extent of a savings and loan’s financial commitment.” *Weber v. New West Federal Savings & Loan*, 10 Cal. App. 4th 97, 105 (1992).



➤ Sham Guaranty – Preemption Defense (Cont'd)

- Courts have held that Section 1823(e) applies to assignees of the FDIC who acquired failed banks. *Weber v. New West Federal Savings & Loan*, 10 Cal. App. 4th 97, 105 (1992); *Newton v. Uniwest Financial*, 967 F. 2d 340, 347 (9th Cir. 1992).



➤ Sham Guaranty – Preemption Defense (Cont'd)

- A guarantor may try to use *River Bank* criteria as evidence that he is really the borrower.
- By asserting the sham guaranty defense, a guarantor is essentially contending that loan documents do not really mean what they say.



➤ Sham Guaranty – Preemption Defense (Cont'd)

- Newly-created LLC, comprised of two individuals as members.
- In 2007, LLC takes out a \$5 million loan secured by real property. Individual members sign personal guarantys. Collateral valued at \$7 million.
- In 2009, original lender fails and is seized by FDIC. FDIC enters into a Purchase and Assignment Agreement with new lender, who acquires the Loan and Guarantys.
- In 2011, LLC defaults. New lender forecloses on collateral, which has declined in value to \$3 million. Sues individual members on guarantys to collect \$3 million deficiency.

➤ Sham Guaranty – Preemption Defense (Cont'd)

- Guarantors assert sham guaranty defense:
 - Loan Application allegedly listed individual guarantors as borrower, not LLC
 - LLC was created solely for purpose of Loan, allegedly at instruction of lender
 - Lender did not review LLC's financial information, only individual members.



➤ Sham Guaranty – Preemption Defense (Cont'd)

- Lender defends:
 - Loan Documents clearly listed LLC as borrower, and individual members as guarantors.
 - Borrower follows all corporate formalities and has benefit of limited liability.
 - Borrower never complains about structure for almost 5 years, makes payments from LLC checking account.
 - Commitment Letter and Loan Committee minutes identify LLC as borrower and individual members as guarantors.



➤ Sham Guaranty – Preemption Defense (Cont'd)

- Enter Section 1823(e):
 - In the case of a failed bank, FDIC & its assignees must be allowed to rely on loan documents that are clear on its face.
 - Guarantors' evidence did not satisfy Section 1823e and were nothing more than pre-deal scraps of paper that should be ignored.
 - Commitment Letter and Loan Committee Minutes met Section 1823e's requirements and confirmed that individual members were guarantors.



➤ Sham Guaranty – Preemption Defense (Cont'd)

- Guarantors argue that Section 1823(e) does not apply:
 - Not alleging a separate “agreement”; merely asserting a legal defense.
 - There is no “asset” because guarantys were void as a matter of law when signed.
 - FDIC acquires assets “as is” and subject to what is in the file. File allegedly provided notice of sham guaranty.
 - Should be a question of fact for jury to determine.



➤ Sham Guaranty – Preemption Defense (Cont'd)

- Court in *Coastline RE Holdings Corp. v. Oroville Self Storage LLC*:
 - Sham guaranty and anti-deficiency law defenses barred by Section 1823e pursuant to preemption doctrine.
 - “Theory underlying defendant’s sham guaranty defense does constitute a side agreement because it relies on an understanding between the parties which does not appear from the face of the operative documents”
 - “Although there may be some ambiguity created by certain documents generated during the application and negotiation process, the fdic and its successors are entitled to rely upon the final agreement between the parties”



➤ Sham Guaranty Case Study – The Cast

- Borrower: Sunset Avenue Townhomes, LLC
- Guarantors:
 - Lloyd Christmas
 - Harry Dunne
 - Wilshire Street Condos, LLC (“WSC”)
- Lender: Bank, N.A.
- Banker: Jeff Banks
- Guarantors’ related companies:
 - Christmas Construction, Inc. (“CCI”)
 - Lloyd and Harry Construction, Inc. (“LHCI”)

➤ Sham Guaranty Case Study – Guarantors’ Evidence

Mr. Lloyd Christmas
Mr. Harry Dunne
Sunset Avenue Townhomes, LLC
1133 Candy Lane
Los Angeles, CA 91367

May 12, 2006

Sunset Ave. Townhomes, LLC

RE: Proposed Construction for Sunset Avenue Townhomes
512-522 Sunset Avenue, Venice, California

Dear Lloyd and Harry:

This letter is a proposal for construction financing (“Loan”) based upon the preliminary information you have provided Bank, National Association (“Bank”), regarding the proposed construction of a six-unit townhome style condominium complex in Venice, California (“Property”). **The proposed financing would be structured as follows:**

Borrower: Sunset Avenue Townhomes, LLC.

Guarantors: Lloyd Christmas, Harry Dunne and any related trusts.

Purpose: Construction of a six-unit townhome style condominium complex in Venice, California.

Loan Amount: The Loan amount will be the lesser of (i) \$7,100,000, (ii) 75% of the Bank approved appraised value of the Project, or (iii) 85% of the Bank approved Project Costs.

Term: 24 months.

Loan Fee: 1% of the loan amount.

Interest Rate: A variable rate of interest equal to Bank’s Prime Rate plus 0.50%, adjusted daily. “Bank’s Prime Rate” is a fluctuating reference rate used for loan pricing and is not necessarily the Bank’s lowest or best interest rate.

Repayment: Interest payable monthly (“Interest”). Principal paid at maturity or through sale of the collateral property.

Collateral: A first priority deed of trust encumbering the Borrower’s fee title interest in the Project.

- Borrower has one other project in process, a 5-unit condo property in Santa Monica. The project is nearing completion and the model is opening June 7. Asking prices range from \$1.5 to \$1.8MM. Loan is \$6MM. They also own a future development site in Mar Vista, appraised within 6 months for \$4MM. They own this property free and clear. They do not intend to commence construction on this project until they have closed sales in the Santa Monica and Venice projects.
- The principals demonstrate acceptable financial strength with adequate liquidity of \$561M liquid (verified 4/29) and good net worth of \$16.7MM (as of 12/07) with low leverage (8% and 10%). They are seasoned real estate professionals and are positioned to perform on their obligations as agreed.
- Interesting note: Wilshire is 2 miles south of Sunset, closer than any of the comps in the appraisal. Asking prices start at \$1.5MM, over \$1,00/sf. The Sunset condos are 1,000 sf larger and the appraisal concluded at \$1.2MM, or \$500/sf.

➤ Sham Guaranty Case Study – Guarantors' Evidence

Fax

To: Harry Dunne
Fax: (310) 555-5556
Phone: (310) 555-5555
From: Jeff Banks
Pages: 2
Date: July 3, 2006
Re: Sunset Ave.
CC:

Urgent For Review Please Comment Please Reply Please Recycle

• **Comments:**

Harry-

Here is a quick balance sheet for Sunset Avenue Townhomes, LLC that I put together. If it looks OK, please sign it and fax it back to me at 626-555-5556.

Thanks, and enjoy the 4th!

Jeff

SUNSET AVENUE TOWNHOMES, LLC

Balance Sheet as of 6/30/06

ASSETS

Cash	\$ 17,500	
Real Estate	\$ 2,000,000	
		\$ 2,017,500

LIABILITIES

None

NET WORTH		\$ 2,017,500
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➤ Sham Guaranty Case Study – Guarantors' Evidence

Financial:

Sunset Avenue Townhomes, LLC is a single asset entity formed in 2004 for the sole purpose of developing the subject project. Sunset Avenue is the borrowing entity because it holds title to the subject property. **It does not add any financial support to the subject credit. Financial support comes from the two guarantors, Lloyd Christmas and Harry Dunne.**

Current financial statements were requested but not supplied. The following analysis is based on 7/08 financial statements and current information where available.

- Their combined verified liquidity is \$283M (verified per SVP as of 2/23/2010) and combined net worth is \$17,492M. Liquidity is 49% lower than the prior quarter.
- Based on 7/2008 financial statements, Christmas and Dunne are lowly leveraged (6% and 12%, respectively).

Description of Changes

Purpose:

Borrower rating substituted for guarantors Lloyd Christmas and Harry Dunne because the borrowing entity is a single asset entity with no income other than the sale of the collateral and the primary financial support for this loan is provided by the guarantors. Downgrade from 5G to 6G based on the declined value of the subject collateral and LTV of 98%.

➤ Sham Guaranty Case Study – Guarantors' Evidence

Sunset Avenue Townhomes, LLC was formed in 2004 as a single asset entity for the sole purpose of developing the subject project and as such, **it does not add any financial support. Financial support comes from the two guarantors, Lloyd Christmas and Harry Dunne.** Guarantors have combined liquidity of \$561M (verified per SVP as of 4/29/08). **We have received personal financial statements for Christmas and Dunne,** both dated 12/11/07. Christmas' PFS reflects total assets of \$10,669M centered in partnerships \$3,405M and notes receivable \$5,124M. Liquidity is \$410M (down from \$584M on 5/16/06) and total liabilities equal \$856M. Leverage is 8%. Net worth is \$9,813M, which is \$10M higher than when the loan was originally approved. Dunne's PFS reports total assets of \$7,623M centered in partnerships \$4,062M and personal residence \$2,000M. Liquidity is \$62M (down from \$63M on 5/16/06) and total liabilities are \$693M. Net worth is \$6,930M, which is \$357M higher than when originally approved. Leverage is 10%. Contingent liabilities as of 4/30/08 for both Christmas and Dunne are \$13,560M. The Guarantors combined net worth as of 12/07 is \$16.7MM with reported liquidity of \$472M and verified liquidity as of 4/29/08 of \$561M. Additionally, Christmas is the sole trustee of the Sharon Christmas Trust, which has \$532M on deposit at the Bank. This is a portion of his mother's estate and will eventually be distributed to Lloyd and his two siblings.

The borrowers have one other project under construction: Wilshire Street Townhomes in Santa Monica. This is a 5-unit project with projected asking prices from \$1.5MM to \$1.7MM. The construction loan commitment on this property is \$6.3MM. Construction is estimated to be complete in 5 weeks and direct marketing will begin at the end of May. This and the subject loan comprise their \$13,560M contingent liabilities. Both projects are located in areas where price declines have not been noted, and as sales commence, their contingent liabilities will decline and cash position will improve. The guarantors are obtaining entitlements for their next project, a condominium building in Mar Vista, but this property is owned free and clear and the borrower does not intend to begin the development of this project until they have closed sales in their current projects. The guarantors are seasoned real estate professionals with adequate liquidity and low leverage. They are positioned to perform on their obligations as agreed.

Sunset Avenue Townhomes, LLC is a single asset entity formed in 2004 for the sole purpose of developing the subject project. Sunset Avenue is the borrowing entity because it holds title to the subject property. It does not add any financial support to the subject credit. Financial support comes from the two guarantors, Lloyd Christmas and Harry Dunne. *Please see guarantor financial analysis.*


Guarantors:

Financial sponsorship for this loan is based on the two guarantors, Lloyd Christmas and Harry Dunne as follows:

- Their combined verified liquidity is \$669M (as of 7/31/08) and combined net worth is \$17,492M.
- Both Christmas and Dunne are very lowly leveraged at 6% and 12%, respectively.
- They currently have one completed project, 5 condos in Santa Monica held in Sunset St. LLC which had its grand opening two weeks ago. The units are priced between \$1.5MM-\$1.8MM. Expected net cash flow from the sale of the project is \$740M \$370M for each partner).
- Their contingent liabilities are low at \$13,560M (consist of the subject loan \$7.2MM and Sunset St., LLC project \$6,360M).
- Christmas and Dunne own all their real estate partnerships 50/50.

➤ Sham Guaranty Case Study – Bank's Evidence

- SAT was formed on November 16, 2004, one year and seven months before Loan Documents were executed.

 <p>State of California Kevin Shelley Secretary of State</p> <p>LIMITED LIABILITY COMPANY ARTICLES OF ORGANIZATION</p> <p>NOTE: A limited liability company is not permitted to render professional services.</p> <p>A \$70.00 filing fee must accompany this form.</p>	<p>File # 200401094857689498</p> <p>ENDORSED - FILED In the office of the Secretary of State of the State of California</p> <p>NOV 16 2004</p> <p>KEVIN SHELLEY, Secretary of State</p> <p>This Space For Filing Use Only</p>
<p>IMPORTANT – Read instructions before completing this form.</p>	
<p>1. NAME OF THE LIMITED LIABILITY COMPANY (END THE NAME WITH THE WORDS "LIMITED LIABILITY COMPANY," "LTD. LIABILITY CO.," OR THE ABBREVIATIONS "LLC" OR "L.L.C.")</p> <p>Sunset Ave. Townhomes, LLC</p>	

➤ Sham Guaranty Case Study – Bank’s Evidence

Operating Agreement:

<u>Member's Name</u>	<u>Member's Address</u>	<u>Member's Capital Contribution</u>	<u>Member's Membership Interest</u>
Harry Dunne	1129 Anywhere Los Angeles CA	½ of land value	50%
Lloyd Christmas	2102 Somewhere Los Angeles CA	½ of land value	50%

- Christmas testified that “1/2 of land value” was the Property:

8 Q Uh-huh. Do you see on the last page, where
9 it says “Members’ Capital Contribution, 1/2 of land
10 value,” that column?

11 A I do.

12 Q Was that the Sunset land?

13 A I would say yes.

- Dunne testified that “1/2 of land value” was the Property:

8 Q Do you know what that “land value” is
9 referring to, what land?

10 A I don’t know. Sunset Avenue Townhomes, I
11 would assume -- but I could be wrong -- I would assume
12 that it’s regards to Sunset Avenue.

➤ Sham Guaranty Case Study – Bank’s Evidence

The Property was transferred to SAT on March 22, 2006, over one month BEFORE Guarantors ever contacted Bank to inquire about the Loan.

QUITCLAIM DEED

The undersigned grantors declare:

Documentary Transfer Tax is: \$0. "This is a bona fide gift and the grantor received nothing in return, R & T 11911."

- computed on full value of property conveyed, or
- computed on full value less value of liens and encumbrances remaining at time of sale
- Unincorporated area: City of _____, and

FOR VALUABLE CONSIDERATION, receipt of which is hereby acknowledged,

Lloyd and Harry Construction, Inc.

hereby REMISES, RELEASES and QUITCLAIMS to

Sunset Ave. Townhomes, LLC

the following described real property in the County of Los Angeles, State of California:

Lots 12, 13, and 14 in block H of Ocean Park Village Tract, in the City of Los Angeles, County of Los Angeles, State of California, as per map recorded in Book 4, Page 23 of Maps, in the office of the County Recorder of said County.

Commonly known as: 512-522 1

Sunset Avenue, Venice, CA

Lloyd and Harry Construction, Inc.

Dated: 3/22/06

Lloyd Christmas

Lloyd Christmas

STATE OF CALIFORNIA

COUNTY OF LOS ANGELES

} ss.

Eric Dunne

NOTARY PUBLIC

personally appeared

On 3/22, 2006 before me,

Lloyd Christmas

Eric Dunne, personally known to me (or proved to me on the basis of satisfactory evidence)

is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s) or the entity upon behalf of which the person(s) executed the instrument.

Eric Dunne



Eric Dunne
Notary Public - California
Los Angeles County
My Comm. Expires Jan. 10, 2009

[Signature]

A deed is not merely evidence of a gift or other grant, but is the gift or grant itself, and ipso facto operates to transfer the title of the property described to the grantee. *Hamilton v. Hubbard* (1901) 134 Cal. 603, 65 P. 321, affirmed 134 Cal. 603, 66 P. 860

➤ Sham Guaranty Case Study

On May 18, 2006, Bank requested information from SAT, including tax returns and information relating to the Property and project to assist in determining the value of the Property owned by SAT.

From: jeffbanks@bank.com
Sent: Thursday, May 18, 2006 10:58 AM
To: Lloyd Christmas
Subject: Sunset Ave. Townhomes, LLC

Lloyd

Here is a list of the information we need to complete the file for Sunset Avenue

Sunset Ave. Townhomes, LLC

- Operating Agreement, LLC-1 and Tax ID No. for the LLC. If a tax return was filed for 2005, please include that as well.
- 3 complete sets of plans for the project -
- Closing statement on purchase of land
- Soils report
- Copies of permits and approvals from city
- Environmental questionnaire
- Architect's contract
- We will also need evidence of builders risk insurance, liability insurance and workers comp; please refer to the information in the application packet for more details. This needs to be in place prior to signing loan documents.

> Sham Guaranty Case Study

More importantly, Bank obtained an appraisal on June 1, 2006 that provided a post-construction value of **\$10,425,000.00**:

VALUE CONCLUSIONS: Commercial Property	APPRAISCO	FEE APPRAISER	COMMENTS
Value Premise			
As-Is Value (\$)	\$2,800,000	\$2,800,000	Land only
Upon Construction Complete (\$)	\$10,425,000	\$10,425,000	6 townhouses
Stabilized Value (\$)	\$10,425,000	\$10,425,000	

The post-construction value of **\$10,425,000.00** means that Bank had an equity cushion built into the Loan of **\$3,225,000.00**.

➤ Sham Guaranty Case Study

Bank's Credit Approval Memorandum of June 12, 2006 unequivocally showed that Bank intended to look to the Property first to satisfy the Loan:

Bank, N.A.

CREDIT APPROVAL MEMORANDUM

Repayment Sources

Primary Source of Repayment:

Primary source of repayment will be from the sale of the townhome condo units.

Secondary Source of Repayment:

The secondary source of repayment will be from a refinance of the subject loan and/or recourse to guarantor.

Bank, N.A.

CREDIT APPROVAL MEMORANDUM

Comments:

The primary source of repayment will be from the sale of the homes. As previously mentioned, interest reserve is sufficient to carry the loan through maturity with a .5% spread plus 1% cushion for fluctuations. A 5% contingency for direct construction costs is deemed adequate for the project. Borrower/Guarantor's experience and liquidity (\$1,824M verified) also mitigate the budget risk.

Christmas and Dunne had a liquidity of \$1.824M and Bank would not have lent \$7.2MM based upon their liquidity.

➤ Sham Guaranty Case Study

Christmas and Dunne both testified that they never asked if they could act as the borrower under the Loan. Christmas testified as follows:

22 Q Prior to his statement, did you ask him if
23 you could be the individual borrower under the loan?

24 A It wasn't an option. No, is the answer to
25 your question.

3 Q But you never told the bank that you were
4 going to be the borrower; true?

5 A Not in those words.

7 Q Prior to execution of this note, did you
8 ever tell the bank that you had a problem with
9 Sunset Avenue Townhomes, LLC acting as the borrower for the
10 transaction?

11 A I don't believe so.

Dunne testified as follows:

21 Q Did you request from Bank, N.A. b
22 the construction loan be issued in your name
23 personally?

24 A I can't say that, no.

17 Q When you were presented with loan documents,
18 did you ever inform the bank that you wanted to be the
19 primary borrower under the loan?

20 A Not me personally, no.

➤ Sham Guaranty Case Study

Christmas and Dunne both testified that they were not personally obligated under the Loan Agreement and Note. Christmas testified as follows:

4 Q And at the time you signed the loan
5 documents, you understood that individually you were
6 not obligated to repay the bank under the promissory
7 note; true?

8 A Probably.

9 Q You said "Probably."

10 Is there something in my question that is
11 causing you pause?

12 A No.

13 Q So you did understand that?

14 A Yes.

Dunne testified as follows:

5 Q And you were not obligated, under this note,
6 to repay 7.2 million to the bank; true?

7 MR. GROSSBART: Objection, calls for a legal
8 conclusion.

9 THE DEPONENT: I guess -- I guess so.

➤ Sham Guaranty Case Study

- Guarantors enjoyed the benefits of limited liability. In this regard, Christmas testified as follows:

12 Q Generally what is the purpose of having a
13 limited liability company hold title to a property that
14 you're developing, as opposed to individually holding
15 title?

16 A I suppose limiting liability.

17 Q So as an example, if you hold title to a
18 property individually and someone gets hurt on your
19 property, for example, they could sue you individually;
20 right?

21 A Yes.

22 Q And if you have a limited liability company
23 and you're a member of that limited liability company,
24 they would have to sue the limited liability company if
25 they got hurt on your property?

3 THE DEPONENT: I would say that's correct.

5 Q Yeah, so the -- the idea of the limited
6 liability company is that it insulates its members from
7 personal liability; true?

1 THE DEPONENT: Well, I think it calls for a legal
2 conclusion, but I think yes.

➤ Sham Guaranty Case Study

- Guarantors enjoyed the benefits of limited liability. In this regard, Dunne testified as follows:

19 Q Do you understand the concept generally of
20 "limited liability"?

21 A Yes, generally.

22 Q What is your understanding of that?

23 A You form a corporation to limit liability.

24 Q Okay. So that if someone sues the
25 corporation, they cannot go after the assets -- the

1 personal assets of the shareholders; is that generally
2 your understanding?

3 A Generally --

4 MR. GROSSBART: Just let me pose an objection,
5 calls for a legal conclusion. You can answer.

6 THE DEPONENT: Generally, yes.

➤ Sham Guaranty Case Study

- Christmas admitted that SAT was “formed to hold title to this asset” as follows:

Lloyd Christmas

From: Lloyd Christmas
Sent: Thursday, October 19, 2006 10:02 AM
To: jeffbanks@bank.com
Subject: RE: tax returns

Hi Lloyd:

See attached. The return for Sunset Avenue Townhomes, LLC is a zero return because there was no activity in this entity which was formed to hold title to this asset.

If you have questions, please let me know.

Lloyd Christmas

- The statement is consistent with the SAT Operating Agreement and Quitclaim Deed transferring the Property from Lloyd and Harry Construction to SAT on March 22, 2006.

➤ Lessons Learned

- Be careful with the language in your credit approval memoranda:
 - Take care not to call the individual guarantor the “borrower”;
 - Reiterate that the PRIMARY source of repayment is from the borrower, and the SECONDARY source of repayment is from the guarantor;
 - Reiterate that the borrower is the entity that owns the real estate, and therefore is adequately capitalized;
- Request financials from the borrower, even if you know it is a single asset entity; and
- Make sure the loan application identifies the entity borrower as the applicant.