

SHAM GUARANTYS AND FEDERAL PREEMPTION

CALIFORNIA STATE BAR FINANCIAL INSTITUTIONS COMMITTEE MEETING

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PRESENTED BY

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BASIC PRINCIPLES

- CALIFORNIA'S ANTI-DEFICIENCY LAWS
 - CCP § § 580A, 580B, 580D AND 726
- LIMIT LENDERS' REMEDIES AGAINST BORROWERS OF REAL ESTATE SECURED LOANS



BASIC PRINCIPLES

- SECURITY FIRST
- ONE FORM OF ACTION
- LIMITATIONS ON DEFICIENCY JUDGMENTS
 - CREDIT BORROWER WITH FMV OF SECURED PROPERTY (580A)
 - NO DEFICIENCY FOR CERTAIN LOANS (580B)
 - NO DEFICIENCY AFTER NON-JUDICIAL FORECLOSURE UNDER DEED OF TRUST (580D)



BASIC PRINCIPLES

- DIFFERENCE BETWEEN GUARANTOR AND A BORROWER
 - GUARANTOR IS ONE WHO PROMISES TO ANSWER FOR THE DEBT OF ANOTHER— CIVIL CODE § 2787
 - ANTI-DEFICIENCY PROTECTIONS SET FORTH IN CCP § 580A, 580B, 580D DO NOT APPLY TO GUARANTOR
 - GUARANTOR MAY WAIVE SECURITY FIRST RULE OR ONE ACTION RULE PER CIVIL CODE § 2856



SHAM GUARANTY DEFENSE

- FACT-SPECIFIC CREATURE OF CASE LAW USED TO ARGUE THAT A GUARANTY IS NOT VALID
- ARISES FROM CONCEPT THAT A BORROWER CANNOT ALSO BE THE GUARANTOR OF ITS OWN DEBT
- GUARANTOR MUST BE A “TRUE GUARANTOR” AND NOT JUST PRINCIPAL OBLIGOR UNDER A DIFFERENT NAME



SHAM GUARANTY DEFENSE CRITERIA

- WAS THE BORROWER A LEGITIMATE ENTITY OR A MERE SHELL FOR THE GUARANTORS?
- DID THE LENDER INQUIRE ABOUT THE FINANCIAL STANDING OF THE NAMED BORROWER?
- WAS THE PURPOSE OF THE LOAN AGREEMENTS TO SUBVERT THE ANTI-DEFICIENCY LAWS?
- WAS THE BORROWER BROUGHT INTO EXISTENCE MERELY FOR THE PURPOSE OF THE LOAN?
- WAS THE BORROWER ADEQUATELY CAPITALIZED?
- DID THE LENDER INSTRUCT THE BORROWER ON ITS STRUCTURE AS A CONDITION OF THE LOAN?
- DID THE GUARANTORS CAPITALIZE THE BORROWER?
- ARE THE GUARANTORS THE ONLY OWNERS/MEMBERS/SHAREHOLDERS OF THE BORROWER?



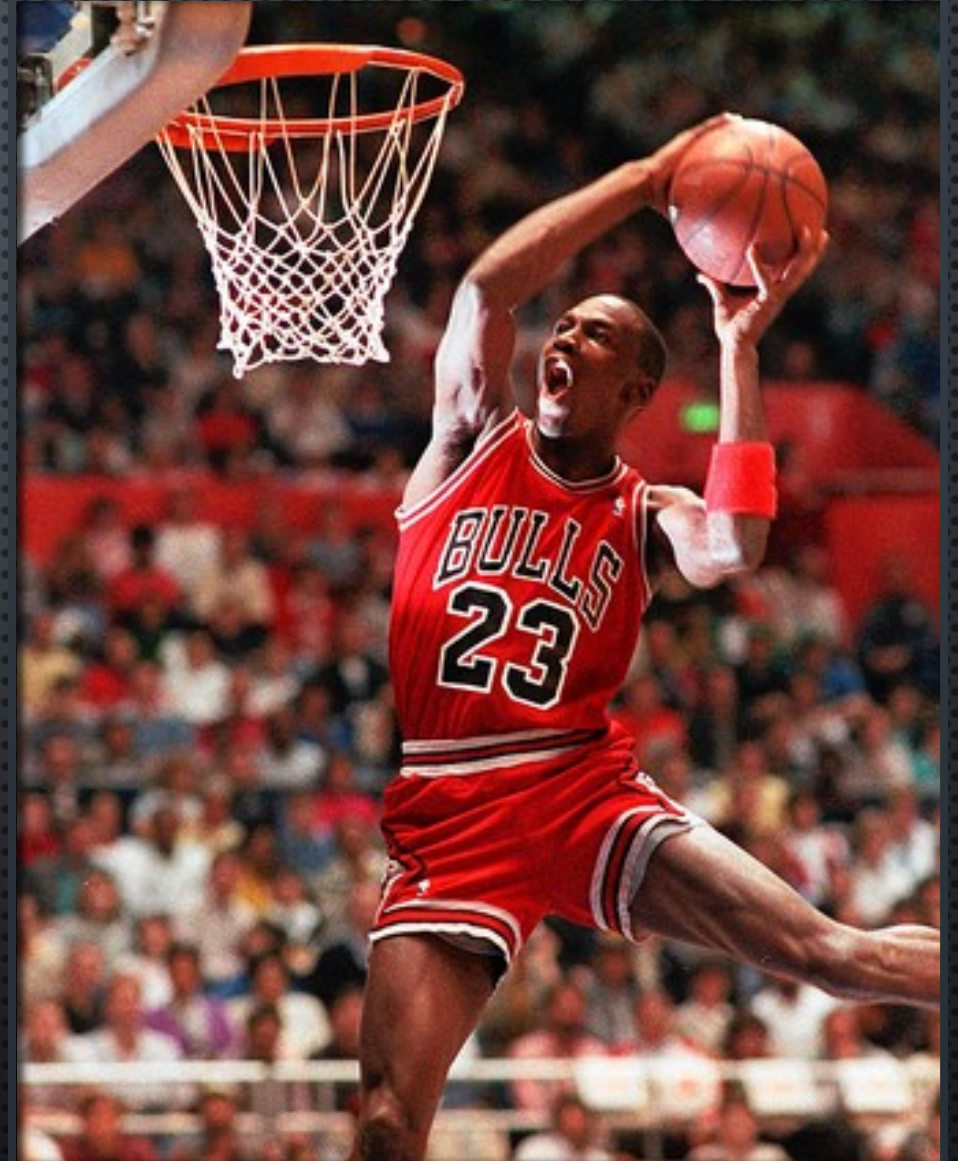
SHAM GUARANTY DEFENSE EXAMPLES

- SAME PARTY
- REVOCABLE TRUSTS
- GENERAL PARTNERSHIPS
- LIMITED PARTNERSHIPS
- CORPORATIONS
- LIMITED LIABILITY COMPANIES



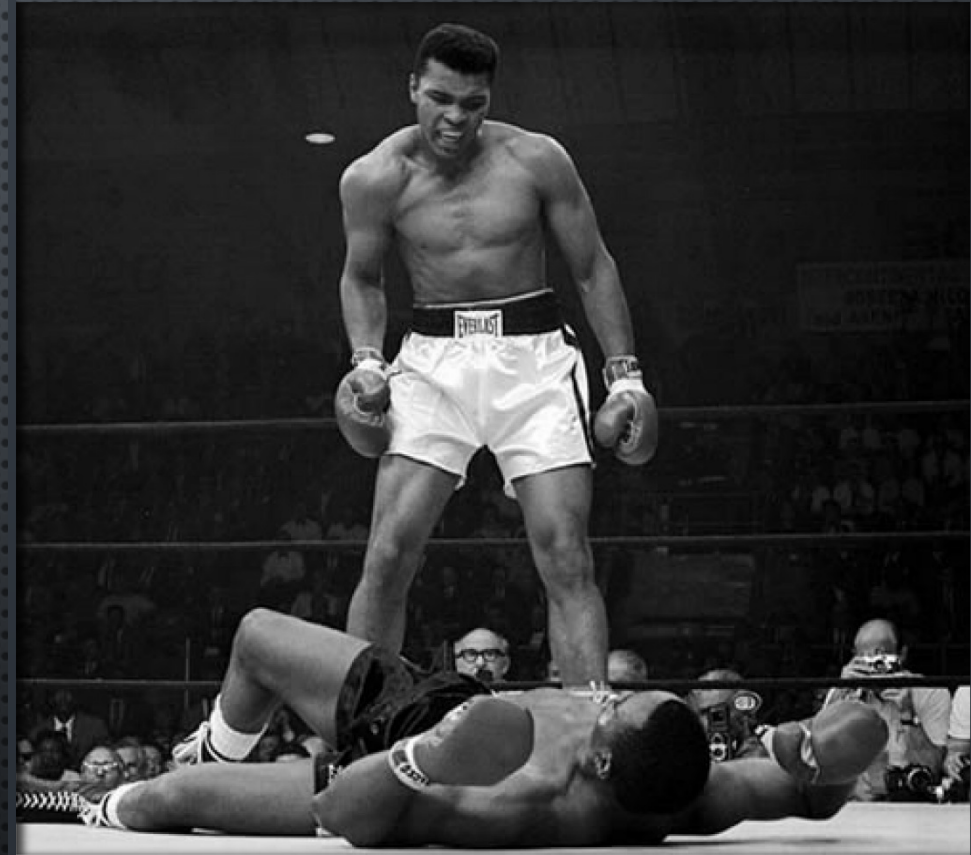
PREEMPTION AND THE SHAM GUARANTY DEFENSE

- PREEMPTION MAY BE USED TO SHUT DOWN THE SHAM GUARANTY DEFENSE
- GUARANTY MUST HAVE ORIGINALLY BEEN EXECUTED BY A LENDER THAT FAILED AND WAS SEIZED BY FDIC
- CONCEPT IS BORNE OUT OF SUPREMACY CLAUSE OF THE CONSTITUTION
 - FEDERAL LAW THAT CONFLICTS WITH STATE LAW CAN TRUMP STATE LAW



PREEMPTION: FEDERAL LAW REQUIREMENTS

- FEDERAL LAW HAS STRINGENT REQUIREMENTS FOR ENFORCING AGREEMENTS THAT ARE AGAINST THE INTERESTS OF THE FDIC
- UNDER 12 U.S.C. § 1823E, A FAILED BANK'S PRE-CLOSING AGREEMENT THAT COMPROMISES ITS RIGHTS TO ENFORCE ITS LOAN AND OTHER ASSETS DOES NOT BIND THE FDIC, AS THE BANK'S RECEIVER UNLESS THE AGREEMENT IS:
 - IN WRITING;
 - EXECUTED CONTEMPORANEOUSLY WITH BANK'S ACQUISITION OF THE ASSET
 - APPROVED BY THE BANK'S BOARD OR LOAN COMMITTEE, WITH APPROVAL REFLECTED IN MINUTES;
 - CONTINUOUSLY PARTY OF BANK'S RECORDS



PREEMPTION: POLICY CONSIDERATIONS

- PURPOSE IS TO ALLOW BANK EXAMINERS TO RELY ON A BANK'S RECORDS IN EVALUATING THE WORTH OF A 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
- DESIGNED TO PRECLUDE CLAIMS THAT A DOCUMENT MEANS SOMETHING OTHER THAN WHAT IT SAYS ON ITS FACE
- FEDERAL AND STATE COURTS HAVE HELD THAT SECTION 1823E APPLIES TO ASSIGNEES OF THE FDIC WHO ACQUIRE FAILED BANKS



PREEMPTION: CASE STUDY

- RECENT DECISION IN *COASTLINE RE HOLDINGS CORP. V. OROVILLE SELF STORAGE, LLC ET AL.* GRANTED SUMMARY JUDGMENT IN FAVOR OF LENDER FOR BREACH OF GUARANTY
- COURT HELD THAT SHAM GUARANTY DEFENSE WAS PREEMPTED BY SECTION 1823E
- FIRST DECISION IN CALIFORNIA REGARDING FDIC SPECIAL POWERS AND SHAM GUARANTY DEFENSE



PREEMPTION: CASE STUDY

FACTS

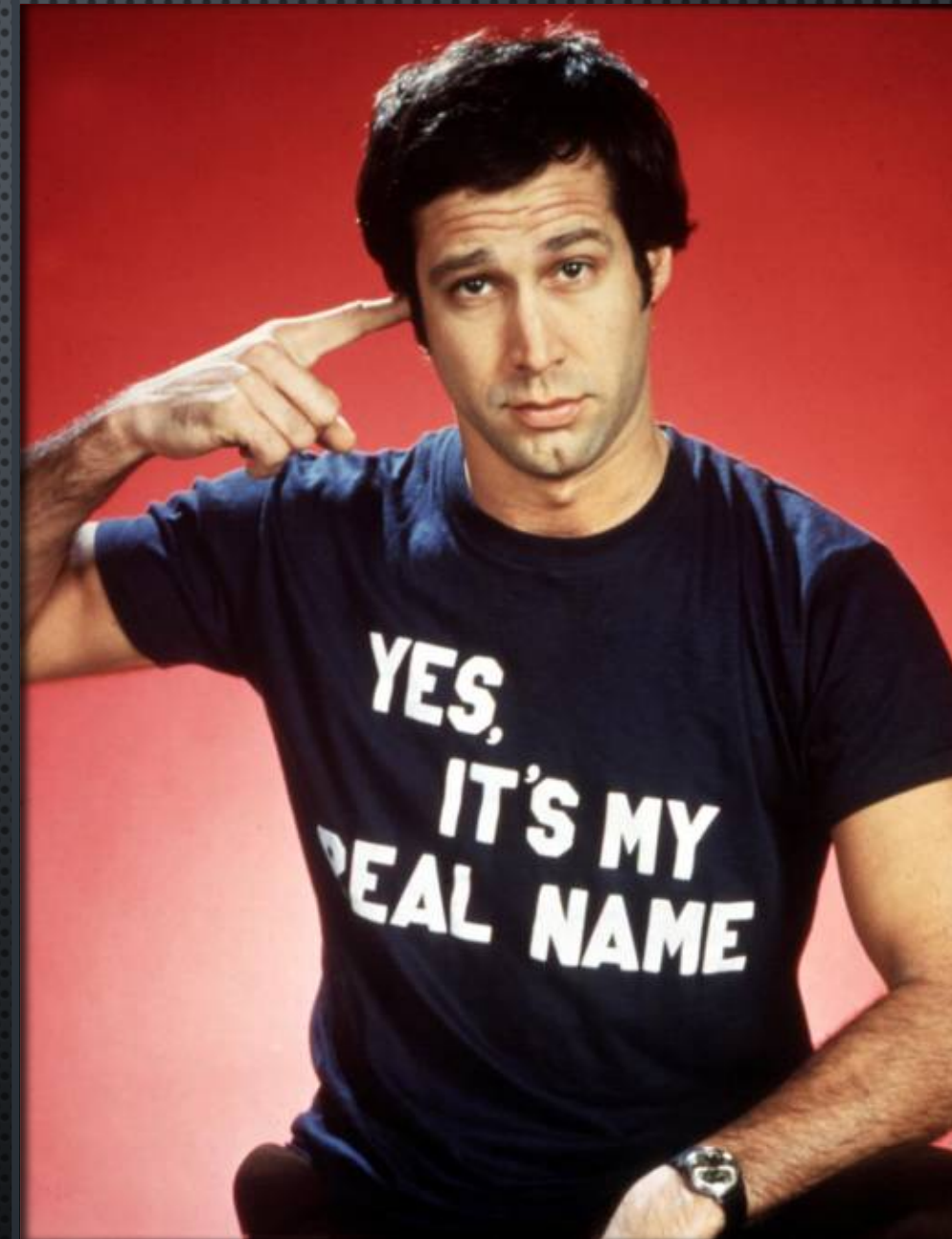
- NEWLY-CREATED LLC BORROWER COMPOSED OF 2 MEMBERS
- \$5 MILLION LOAN SECURED BY REAL PROPERTY MADE IN 2007
- LLC MEMBERS EACH SIGNED A PERSONAL GUARANTY. AT TIME OF LOAN, COLLATERAL WAS VALUED AT NEARLY \$7 MILLION
- IN 2009, ORIGINAL LENDER FAILS AND IS SEIZED BY FDIC. FDIC ENTERS INTO A PURCHASE AND ASSUMPTION AGREEMENT PURSUANT TO WHICH A DIFFERENT LENDER ACQUIRES THE LOAN DOCUMENTS
- IN 2011, LLC DEFAULTS ON LOAN. VALUE OF REAL ESTATE COLLATERAL HAS FALLEN TO APPROXIMATELY \$3 MILLION
- NEW LENDER FORECLOSES NON-JUDICIALLY ON REAL PROPERTY COLLATERAL AND FILES BREACH OF GUARANTY LAWSUIT TO RECOVER A \$3 MILLION DEFICIENCY



PREEMPTION: CASE STUDY

GUARANTORS' EVIDENCE

- LOAN APPLICATION ALLEGEDLY IDENTIFIED GUARANTORS AS BORROWER
- BORROWER WAS BROUGHT INTO EXISTENCE FOR LOAN
- GUARANTORS ALLEGEDLY CAPITALIZED BORROWER, WHO HAD NO OTHER SUBSTANTIAL ASSETS
- GUARANTORS ALLEGED THAT LENDER INSTRUCTED THEM TO FORM LLC AS A CONDITION OF THE LOAN
- GUARANTORS WERE SOLE MEMBERS OF BORROWERS
- GUARANTORS ALLEGED THAT LENDER DID NOT INVESTIGATE FINANCIAL WHEREWITHAL OF BORROWER
- LENDER REVIEWED GUARANTORS' INDIVIDUAL TAX RETURNS AND PERSONAL FINANCIAL STATEMENTS



PREEMPTION: CASE STUDY

LENDER'S EVIDENCE

- LOAN DOCUMENTS UNAMBIGUOUSLY IDENTIFIED BORROWER ON NOTE AND LOAN AGREEMENT AND GUARANTORS ON GUARANTYS
- BORROWER FOLLOWED CORPORATE FORMALITIES AND HAD THE BENEFITS OF LIMITED LIABILITY
- GUARANTORS NEVER COMPLAINED ABOUT THE LOAN STRUCTURE UNTIL SUED NEARLY FIVE YEARS AFTER LOAN MADE
- COMMITMENT LETTER AND LOAN COMMITTEE MINUTES CORRECTLY IDENTIFIED BORROWER, GUARANTORS, AND LOAN TERMS
- APPRAISAL AT THE TIME OF THE LOAN SHOWED LOAN WAS OVERSECURED BY NEARLY 40%



PREEMPTION: CASE STUDY

LENDER'S ARGUMENTS

- SECTION 1823E PREEMPTS STATE LAW DEFENSES
- 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 1823E AND WERE NOTHING MORE THAN PRE-DEAL SCRAPS OF PAPER THAT SHOULD BE IGNORED
- EVIDENCE THAT MET SECTION 1823E'S CRITERIA (COMMITMENT LETTER AND LOAN COMMITTEE MINUTES) CONFIRMED THAT LLC WAS PRIMARY OBLIGOR AND ITS MEMBERS WERE GUARANTORS
- CONDUCT OF THE PARTIES CONFIRMED THE DEAL AS GUARANTORS NEVER QUESTIONED THE LOAN DOCUMENTS, SIGNED THE GUARANTYS, AND ACCEPTED THE BENEFIT OF THE BARGAIN FOR NEARLY FIVE YEARS



PREEMPTION: CASE STUDY

GUARANTORS' ARGUMENTS

- SECTION 1823E DOES NOT APPLY BECAUSE GUARANTORS WERE NOT ALLEGING A SEPARATE “AGREEMENT”
 - SHAM GUARANTY DEFENSE IS NOT IN THE NATURE OF AN AGREEMENT BUT IS A LEGAL DEFENSE
- SECTION 1823E DOES NOT APPLY BECAUSE THERE IS NO ASSET
 - THE GUARANTYS WERE VOID AS A MATTER OF LAW WHEN THEY WERE SIGNED AND THUS UNENFORCEABLE
- SECTION 1823E DOES NOT PREEMPT LEGAL DEFENSES THAT ARISE UNDER STATE LAW
- FDIC AND ITS ASSIGNEES ACQUIRE ASSETS “AS-IS” AND SUBJECT TO WHAT IS IN THE FILE, AND FILE ALLEGEDLY PROVIDED NOTICE OF SHAM GUARANTY
- SHOULD BE A QUESTION OF FACT FOR JURY TO DETERMINE WHETHER SECTION 1823E’S CRITERIA ARE MET



PREEMPTION: CASE STUDY

COURT'S RULING

- SHAM GUARANTY DEFENSE AND AFFIRMATIVE DEFENSES BASED ON ANTI-DEFICIENCY LAWS ARE BARRED BY SECTION 1823E PURSUANT TO THE DOCTRINE OF FEDERAL PREEMPTION
- “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”



CONCLUSION

- PREEMPTION MAY PROVIDE A POWERFUL DEFENSE TO A SHAM GUARANTY CLAIM
- BY ASSERTING THE SHAM GUARANTY DEFENSE, A GUARANTOR IS ESSENTIALLY ARGUING THAT THE LOAN DOCUMENTS DO NOT REALLY MEAN WHAT THEY SAY
- GUARANTOR CANNOT ESTABLISH A SHAM GUARANTY UNLESS HE CAN MEET THE REQUIREMENTS OF SECTION 1823E



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