Partial Guarantees

Kenneth R. Blumer
December 2007

Problems with Partial Guarantees — Need For Contribution Agreement

How many times have you seen the situation where the real estate lender requires at least partial loan guarantees from the principals of the developer/borrower? Better than a complete guarantee, you might say to yourself. However, based on the recent California Appellate Court case of *Morgan Creek Residential vs. Kemp*, 153 CA4th, 675, 63 CR3d 232 (2007), where the nature and amount of the individual guarantees were not equal as among the various guarantors, and the lender chose to pursue a letter of credit given by the plaintiff, one of the guarantors, the plaintiff, was held to have no remedy as against his fellow guarantors based upon various equitable theories.

In this case, the various principals of the Morgan Creek Golf Course posted partial guarantees that totaled $4.8 million in order to get a $10 million construction loan from CitiCapital. The lender wanted more security, and these partial guarantors induced the plaintiff, the master developer of the entire Morgan Creek Project, to add a bank letter of credit for another $1.4 million to the bundle. Obviously, the golf course was an important aspect of the entire project.

When the construction loan went into default for failure of the borrower to cure several significant mechanics' liens on the property, the lender chose to use the proceeds from the letter of credit to pay itself down and thereby rebalance the loan rather than cure the default. The developer/borrower was then able to sell the golf course to the guarantor principals and to refinance the property with the lender for $4.8 million, what the parties believed the property was then worth, but the plaintiff was left out in the cold. It had to repay the issuer of the letter of credit but received no benefit from the sale or refinancing. It sued its fellow guarantors for equitable contribution, and, in the alternative, for equitable subrogation. The trial court sustained the defendants' demurrer without leave to amend.

On appeal, the Fourth District Court of Appeal affirmed the demurrer. First, the court reasoned that the equitable contribution theory is only available for the sharing of loss among co-obligors that share the same level of liability on the same risk. Here the plaintiff put up a letter of credit while the defendants only put up partial guarantees. The liabilities inherent in these two different kinds of security, reasoned the court, are significantly different. Because the defendants had suretyship defenses available to them and the plaintiff, as an applicant of the letter of credit did not, the parties did not share the same level of liability to CitiCapital.

Second, the court reasoned that the plaintiff also failed to allege a viable claim for equitable subrogation because such a claim for equitable subrogation required that:

- the subrogee must have made a payment to protect its own interest
- the subrogee must not have acted as a volunteer
- the debt must be one for which the subrogee was not primarily liable
- the entire debt must have been paid
- the subrogation must not work any injustice to the rights of others

The court reasoned that using a subrogation theory to obtain apportionment from others who are not primarily liable was inconsistent with the intent of subrogation theory, which is to place the burden for loss on the party ultimately liable or responsible for it and by whom it should have been discharged originally.

While the equitable contribution analysis of this case has been severely criticized by legal scholars, the result could have been easily avoided by a contractual agreement among the various guarantors and the plaintiff

providing for contribution among them, notwithstanding that their individual obligations to the third-party lender are determined to be for different amounts and levels of liability or are otherwise different.