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California Court of Appeal Strictly Enforces Carveout Guaranty

In "what appears to be an issue of first impression, not only in California, but in the entire country," the California Court of Appeal in *Series AGI West Linn of Appian Group Investors De LLC v. Eves* (June 14, 2013) addressed the following question in its opinion: "If a surety specifically excludes a specified asset from a continuing guaranty, are the proceeds from the sale of that asset still excluded when the surety is called to answer for the guaranty?" In enforcing the guaranty in favor of the lender, the court relied strictly on the plain language of the guaranty and refused to "revise [the] agreement in the guise of construing it."

Series AGI involved a loan of $3.1 million to a limited partnership, VCP-OR, for the development of a "commercial marketplace" in Oregon. At the time of the loan, defendant Eves executed a "Continuing Guaranty" by which he "promise[d] to pay Lender [Series AGI] ... any and all indebtedness ... of Borrower [VCP-OR]." (p. 2) A "Guaranty of Loan Addendum" excluded from the Continuing Guaranty, among other things not at issue, "the personal residence of Robert J. Eves at Via Regina, 27 Moltrasio, Como, Italy[,] and its contents." (p. 2–3) In the summer of 2011, Eves sold the Como residence. After the senior lender foreclosed on the loan, Eves refused to honor the guaranty and Series AGI applied for a pre-judgment order of attachment. Eves opposed, claiming that the *proceeds* from the sale of the Como house were excluded from any attachment. (pp. 4–5) The trial court denied Eves's claim of "exemption" and the court of appeals affirmed.

In holding in favor of the lender, the court first held that a "guaranty is a form of contract and subject to the usual rules governing contract interpretation." (p. 7) The court then noted that parties have the freedom to contract "as they please" and emphasized that "the nonpaternalistic corollary to this freedom" to contract was that the courts should refrain from "rewrit[ing] contracts to relieve parties from bad deals nor make better deals for parties than they negotiated themselves." (p. 8) "It is widely recognized that the courts are not at liberty to revise an agreement under the guise of construing it. ... Neither abstract justice nor the rule of liberal interpretation justified the creation of a contract for the parties which they did not make themselves."

With these principles in mind, the court found that the "construction of the guaranty was not difficult" and held that the proceeds of sale of the Como residence were not included in the guaranty exclusion. According to the court, Eves was "bound by the guaranty's plain language limiting the exemption from the attachment to assets expressly excluded" and the proceeds from the sale of the Como residence were not excluded from the guaranty. (p. 10, internal quotes omitted) Because the plain language of the exclusion was limited to the "personal residence ... and its contents," the sale of this asset "essentially vitiated the exclusion." In support of its holding (although not the basis of the holding which is clearly the plain language of the exclusion), the court noted that Eves was "a knowledgeable

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and sophisticated person with wide experience in this particular type of transaction" (p. 9) and the loan documents contained numerous references to "proceeds" demonstrating "that the concept of proceeds was not overlooked by Series AGI, VCP-OR or Eves." (p. 10)

Series AGI follows a trend of the courts in various states to strictly enforce guaranties, most of those cases being centered around the enforceability of so-called bad-boy carveout guaranties. Thus, *Bank of America, NA v. Freed*, 2012 Westlaw 6725894 (Ill. App.), a recent decision from the Illinois Court of Appeal, involved a construction loan where the borrower executed a guaranty for $50 million, subject to "carveouts" that would provide for full liability (more than $200 million) in the event of certain contingencies. Following the borrower's default, the lender sought to enforce the guaranty in full. On appeal, the guarantors argued that the carveouts were unenforceable "penalty provisions." The court disagreed, upholding the carveout and finding that carveouts "operate principally to define the terms and conditions of personal liability." *Series AGI* stands out because of California's unique statutory scheme embodied in the "one-form-of-action and anti-deficiency rules" which is very protective of borrowers as a matter of public policy. The courts in California have signaled that, at least as of the current moment, they will be more reticent in any decision to intervene in contracts between lenders and guarantors. Please note that this decision is a recent lower court opinion; it is not yet known whether it will be appealed.

Legislative response in three states—Michigan, Nevada and Ohio—recently enacted legislation that may limit recovery against loan guarantors and result in courts second-guessing contract provisions among sophisticated parties. California has not followed that trend.