11-2007

Inequitable Noncontribution

Roger Bernhardt
Golden Gate University School of Law, rbernhardt@ggu.edu

November 2007

Inequitable Noncontribution

Roger Bernhardt

Morgan Creek

Morgan Creek Residential v Kemp (2007) 153 CA4th 675, 63 CR3d 232, truly fits under the *Midcourse Corrections* caption of this column, since it really calls on attorneys to start giving new advice to their clients: First, because it presents an issue that has probably never occurred to most counsel; second, because the way that the issue was resolved by the court will inevitably be ungratifying to those who deal with the same problem and will force them into heavy negotiations to come up with a better solution.

As reported more fully on p 188, the several developers of the Morgan Creek Golf Course, to get a $6.5 million loan from Citicapital, posted partial guaranties that totaled $4.8 million. Citicapital wanted more security than that, and so the guarantors induced the master developer of the entire Morgan Creek project to add a letter of credit for another $1.4 million. This gave Citicapital a total of $6.2 million in additional security, over and above the deed of trust—enough for the loan to go through.

But, thereafter, the filing of some mechanics' liens threw matters into disarray. Citicapital responded to the situation by drawing down the letter of credit it was holding and using those funds to reduce the loan balance to $4.8 million, roughly what the project was then apparently worth. Because the parties regarded the loan as again in balance, the promoters refinanced a new $4.7 million loan with Citicapital, and the project was back on track. However, this left the plaintiff—the master developer—out of pocket for the $1.4 million it had been forced to pay to the letter of credit issuer as reimbursement after the L/C was drawn on; it sued the other guarantors to make them share this $1.4 million expense. (Plaintiff believed that since its letter of credit constituted only 22 percent of the total guaranteed debt of $6.2 million, its share should have been only 22 percent of the $1.4 million that was paid, and that the other guarantors should reimburse it for the other 78 percent.) Plaintiff's theories of equitable contribution and subrogation, however, were both rejected.

The foregoing raises an issue that, I suggest, does not occur to most attorneys involved in loan transactions. Attorneys for borrowers and their fellow venturers usually know enough to be able to both explain and help their clients negotiate the usual provisions in the loan documents (*e.g.*, the note and deed of trust) between borrower and lender. This is also true for counsel to a guarantor, who can be generally expected to explain to her the general nature of a guarantor's special liability to the lender, the effect of the waivers she will be asked to sign, and the limited nature of her rights of reimbursement against the borrower if she is later forced to honor her guaranty.

But, if there is more than one guarantor (often because, as here, the guaranties are all limited to specific amounts that are individually less than the total loan amount), I doubt that these secondary parties (the guarantors) are generally informed about their relative rights and duties *against each other* after some or all of them have been called on to pay some or all of the debt. I don't think that that has often commanded attention, and I think it is even less likely that any agreement has been drafted that specifies the rights or remedies of these secondary parties in that situation. Certainly, that contingency had not been thought out or worked out in the Morgan Creek Golf Course loan.

Counsel for the plaintiff in *Morgan Creek*—the one who took the hit on the letter of credit—thought that the other guarantors should have to reimburse him for their imputed prorata share of his loss, and that the mechanisms for doing so should be equitable contribution and/or equitable subrogation. (Both are called "equitable," as opposed to "contractual," because no formal agreements dictated that result. For simplicity here, I'm going to generally omit that adjective in the rest of this column. As for "subrogation" versus "contribution," I will come to that later.)

The argument for contribution states that a party who pays more than its share of an obligation that includes others may require proportionate contribution from those others. This is not a difficult principle to accept; indeed, it is a longstanding principle of equity and almost the literal wording of CC §1432. The court of appeal in *Morgan Creek*, however, read into that principle a requirement that there be the same "level of liability" for each of the secondary parties and then concluded that this special form of equality was missing in the transaction.

Equality of Commonality?

It is certainly true that the obligation satisfied by one must have been commonly imposed upon the others: If A is liable for X's liability on a note to Y and B is liable for X's liability to Y for a personal injury, neither A nor B can make the other share any part of whatever particular loss the other one had to cover. Rather, the requirement is that the obligation is a *common* one, and I have never seen it read to mean such perfect equality as was required here. If A guarantees payment of $40 of X's $100 note and B guarantees payment of $60 of that same note, §1432 expects that any dollar that one of them pays should be shared 40/60 with the other. The issue is whether the creditor could have turned to either of the co-obligors for payment. The facts are not entirely clear in this case, but it looks like the $6.2 million obligation to Citicapital was represented by a single note, with each dollar of it covered by all of the secondary security posted, thus making for a common, albeit secondary, obligation. (On that point, the argument for contribution was further buttressed by CC §2848, which states that a surety can require his "co-sureties to contribute thereto.")

The court of appeal thought otherwise; its reason was that all of the security posted by the defendants was in the form of personal guaranties, whereas the security posted by the plaintiff was in the form of a letter of credit. That mattered for the court, since CC §2787 distinctly states that a letter of credit is not a form of suretyship obligation, whereas the same section also no less distinctly merges guaranties into general suretyship obligations. Letters of credit are subject to the "independence" principal—a doctrine that makes the issuer pay even though the true obligor has good defenses; whereas guarantors, although themselves regarded as independent obligors, are not subject to that same exposure. Given that distinction, the *Morgan Creek* secondary parties did not qualify as liable under the rules of contribution.

Now, that is a conclusion that would not have occurred to me. If the lender told my client to purchase a letter of credit to further secure a borrower's loan that already was guaranteed by someone else, I probably would have told my client (had I thought of it) that the differences between her letter of credit and the other person's guaranty meant she would be more likely to be called on first, but not that those differences would destroy any right or liability to contribution if only one of them was called on to pay, as this case holds. I would have expected those differences to matter *vis a vis* the lender, but not *vis a vis* the borrower or *vis a vis* the two secondary parties. Had I been really cautious, I would have suggested an agreement between these two secondary parties—to settle all of the details of contribution between them—but not to create a right that would not otherwise exist because of their different levels of liability. But from now on, all of us had better insist on such an agreement. After this decision, who can say, for instance, whether there are contribution rights between two guarantors, one of whom has posted a deed of trust to secure his guaranty and the other had given an unsecured guaranty (or a guaranty secured by personal rather than real property)? Will there still be contribution if one guarantor has waived all defenses and the other has not?

When common liability was the only prerequisite to contribution, it did not matter that the theories or amounts of liability were different, and there was no great need for attorneys to make the agreements say more. But now that the standard is higher and narrower, attorneys should create contractual rights to contribution to fill in these gaps of equitable contribution (and hope that the courts will permit that to be done). Will that be hard to do?

Since, generally, neither party will be able to predict which one will be first called on to pay, it should not be hard to draft an agreement both will accept. It's probably what any two parties under such a veil of ignorance would want in any case: If one pays, the other shares. I would suggest boilerplate language, such as:

The parties agree that the principle of contribution as set forth in CC §1432 shall apply to any obligation they share in common in this transaction, notwithstanding the fact that their obligations are determined to be at different levels of liability or otherwise different.

A private regret I have about the *Morgan Creek* decision is that the court's broadside rejection of contribution also eliminated the opportunity to resolve several other interesting lesser questions that it would have had to answer if contribution was a possibility. The guarantors, for instance, argued that their guaranties did not cover the mechanics' lien dispute that triggered the fight in the first place, whereas that would have probably been irrelevant for the letter of credit. Would that difference have led to a denial of any contribution or to some reduction of it? To what extent might there be some balancing of the equities in contribution cases?

Equitable Subrogation as a Back Door

Under the Uniform Commercial Code, when a letter of credit is honored, its issuer is "subrogated" to all of the rights its beneficiary has against the primary debtor, the same as any other secondary obligor. See Com C §5117. The section then goes on to add that the applicant who then reimburses the issuer is subrogated to the issuer's rights, which is a roundabout way of saying that when the master developer reimbursed Northern Trust for what it paid to Citicapital, it could step into Citicapital's shoes on the loan. Since Citicapital had not only the right to foreclose on the deed of trust, but also the right to go against the guarantors, it too—as subrogee—could proceed against those same guarantors. That contention was rejected as confusing the goals of subrogation with those of contribution.

Plaintiff's subrogation argument may have been a bit too imaginative for a court to swallow. Subrogation is designed to let a party who pays another's debt get paid back by that other party, whereas here it was being used against other secondary debtors rather than the primary debtor. It is also designed to let the subrogee get paid back in full (at least to the extent of the security it inherits), whereas here its attempted use was to get only partial reimbursement from others, who might then have also claimed similar subrogation rights for whatever they paid, which could result in endless skirmishing.

Furthermore, courts generally require that the entire debt be paid in order for the payor to claim subrogation (and this plaintiff had paid only $1.4 million of a $6.2 million obligation). When the Restatement of Mortgages §7.6, proposing to afford subrogation rights only to a party "who fully performs the obligation of another," was being drafted, my argument for a doctrine of partial subrogation was politely considered and then soundly rejected. Not only were there no cases supporting that position, but partial subrogation could also wreak havoc with the priority rules. Just how would Citicapital's $6.2 million deed of trust be divided between the $1.4 million piece of the plaintiff and the $4.8 million piece of the lender?

Thus, even if subrogation was a good idea, it was just a little too different and complicated to fit into what happened here. But I don't regard it as dead, and slightly different facts could make it work far better than it did here. (Maybe the result would differ if the letter of credit had paid off the loan entirely, because then plaintiff would surely have been subrogated to the lender's deed of trust as against the primary debtor, and perhaps also to its rights to enforce the guaranties against the defendants; would the failure to be entitled to contribution still bar relief against them?)

A Colleague's Reaction

I was pleased to see that my colleague, Dan Schechter, of Loyola Law School, writing about this case in the Westlaw Commercial Finance Newsletter, reached essentially the same conclusions that I did on the contribution and subrogation issues. I asked him to look at a draft of this, and I am pleased to reprint his comments below. (His comments are excerpted from his article on *Morgan Creek*, published on Westlaw at 2007 Comm Fin News 60. Westlaw holds the copyright on his materials, and they are reproduced in part here with Westlaw's permission.)

I agree with Roger: I think that the court did not correctly apply the doctrine of contribution. It is true that a bank that issues of a letter of credit is not a surety and is not entitled to seek contribution. But the applicant for the letter of credit was certainly a surety: It incurred a contingent obligation (the reimbursement of the issuer of the letter of credit) in support of the primary debtor's obligation to the lender. There is no authority for the idea that an applicant for a standby letter of credit cannot qualify as a surety. Here, the applicant and the guarantors were co-sureties, entitled to contribution. The applicant is as much of a surety as someone who does not assume personal responsibility for the debt but who puts assets at risk in a nonrecourse hypothecation. See, e.g., Pearl v General Motors Acceptance Corp. *(1993) 13 CA4th 1023, 16 CR2d 805.*

The cases cited by the Morgan Creek *court were inapposite: They dealt with the rights of letter of credit issuers, rather than the rights of applicants. In fact, although the court placed primary reliance on the California Supreme Court's opinion in* Western Sec. Bank v Superior Court *(1997) 15 C4th 232, 62 CR2d 243, the court later dismissed one of the applicant's arguments that was based on language in* Western Security *by noting that "[t]he dispute in* Western Security Bank *was between the parties to the letter of credit transaction." Exactly!* Western Security *is off point, and the court erred by reading too much into that opinion.*

The facts of this case were particularly egregious: The guarantors apparently (1) got the benefit of the applicant's money and then (2) sold the property to themselves with a reduced debt load in a "sweetheart" deal. Although the facts of this case are strange, the underlying issue is of great commercial importance: What rules govern the contribution rights of co-sureties? Does the use of a letter of credit (a common device in large transactions) alter those rules?

Whatever happens in this case, however, I also predict that this problem will not arise very often in the future: From now on, sophisticated letter of credit applicants in this situation will demand express contractual contribution agreements from their co-sureties.

Letter of credit applicant could not assert equitable contribution or subrogation claims against loan guarantors.

Morgan Creek Residential v Kemp (2007) 153 CA4th 675, 63 CR3d 232

Land developer Morgan Creek obtained an unconditional letter of credit in the amount of $1.4 million for the benefit of Citicapital as security for a $10 million loan to a golf club to complete a golf course. The terms of the letter of credit allowed Citicapital to call the letter of credit on any default in the loan. As a condition of the loan, Citicapital required loan guaranties from defendants Kemp and Haws, principals of entities that were members of the golf club.

When Citicapital gave notice of loan defaults and opportunity to cure, the golf club took no action. Citicapital then called the letter of credit and was paid by the issuing bank. Morgan Creek satisfied the draw on the letter of credit, which was used to reduce the outstanding principal of the loan, not to cure the default.

Morgan Creek sued Kemp and Haws for equitable contribution and subrogation. The trial court sustained defendants' demurrer without leave to amend.

The court of appeal affirmed. Equitable contribution allows for loss sharing among co-obligors that share the same level of liability on the same risk as to the same principal. Morgan Creek put up an unconditional letter of credit, while Kemp and Haws put up guaranties. The liabilities inherent in these two kinds of security were markedly different.

A letter of credit is not a form of suretyship obligation, in which the surety's liability is secondary to, and derivative of the liability of the principal for that application. The liability of the issuer of a letter of credit is direct and independent of the underlying transaction between the beneficiary and the issuer's customer. Absent fraud, the issuer cannot refuse to pay based on extraneous defenses arising from the underlying transaction. When Citicapital called the unconditional letter of credit furnished by Morgan Creek, neither Morgan Creek nor the issuing bank could assert any defenses other than fraud to stop Citicapital from collecting on the letter of credit.

A guaranty is a form of suretyship obligation. CC §2787. As sureties, Kemp and Haws had defenses under CC §2845 to demands by Citicapital that were not available to Morgan Creek.

Because Kemp and Haws had suretyship defenses available to them, and Morgan Creek, as an applicant of the letter of credit, did not, the parties did not share the same level of liability to Citicapital. Accordingly, Morgan Creek had no viable claim for contribution against Kemp and Haws.

Morgan Creek also failed to allege a viable claim for equitable subrogation, which requires that:

- The subrogee must have made 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; and
- Subrogation does not work any injustice to the rights of others.

Caito v United Cal. Bank (1978) 20 C3d 694, 144 CR 751. Even assuming that Morgan Creek did not act as a volunteer, that its claim was not defeated by the fact that it was primarily liable on the letter of credit, and that the requirement that the entire debt be paid was satisfied by payment of the entire letter of credit rather than the total the golf club owed Citicapital, Kemp and Haws were not primarily liable on the Citicapital obligation; the golf club was primarily liable. Additionally, Kemp and Haws, as mere guarantors, bargained for limited exposure; to allow Morgan Creek to recover from them would work an injustice to their rights.

Morgan Creek claimed that California law establishes an equitable subordination right in favor of co-sureties that, under Com C §5117(b), was extended to it regardless of whether it was a co-surety. However, Morgan Creek cited nothing that allows a letter of credit issuer or applicant, by subrogation, to circumvent CC §2787 and step into Citicapital's separate rights against third parties not in default to the beneficiary and not liable for the portion of the indebtedness paid by the call on the letter of credit. Section 5117 might allow Morgan Creek to go after the golf club as the debtor on the underlying obligation, but it did not allow Morgan Creek to go after Kemp and Haws as mere guarantors. Using a subrogation theory to obtain apportionment from others who are not primarily liable was inconsistent with the aim of subrogation: to place the burden for loss on the party ultimately liable or responsible for it and by whom it should have been discharged.