2d Civil No. B237360

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION __

BANK OF AMERICA etc.,

Plaintiff and Respondent,

v.

DANNY LAHAVE and TOP TERRACES, INC.,

Defendants and Appellants.

Appeal from The Los Angeles County Superior Court
Honorable Mary Strobel, Barbara A. Meiers and Brett C. Klein, Judges
Los Angeles County Superior Court Case No. BC415243

APPELLANTS' OPENING BRIEF

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TO BE FILED IN THE COURT OF APPEAL

APP-008

COURT OF APPEAL, SECOND APPELLATE DISTRICT, DIVISION p	Court of Appeal Case Number: B237360
ATTORNEY OR PARTY WITHOUT ATTORNEY (Name, State Bar number, and address): Kent J. Bullard, State Bar No. 176194, Greines, Martin, Stein & Richland LLP, 5900 Wilshire Boulevard, 12th Floor, Los Angeles, California 90036; TELEPHONE NO.: (310) 859-7811; FAX NO. (Optional): (310) 276-5261; E-MAIL ADDRESS (Optional): ; ATTORNEY FOR (Name): Danny Lahave and Top Terraces, Inc.	Superior Court Case Number: BC415243
APPELLANT/PETITIONER: DANNY LAHAVE and TOP TERRACES, INC. RESPONDENT/REAL PARTY IN INTEREST: BANK OF AMERICA	FOR COURT USE ONLY
CERTIFICATE OF INTERESTED ENTITIES OR PERSONS (Check one): ☑ INITIAL CERTIFICATE ☐ SUPPLEMENTAL CERTIFICATE	

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1. This form is being submitted on behalf of the following party (*name*): Danny Lahave and Top Terraces, Inc.

2. a. ☐ There are no interested entities or persons that must be listed in this certificate under rule 8.208.

   b. ☑ Interested entities or persons required to be listed under rule 8.208 are as follows:

Full name of interested entity or person	Nature of interest (Explain):
(1) BANK OF AMERICA, National Association, as successor by merger with LaSalle Bank National Association, as Trustee for Paine Webber Mortgage Acceptance Corporation V, Commercial Mortgage Pass-Through Certificates, Series 1999-C I, acting by and through its Special Servicer ORIX Capital Markets, LLC	Full name of plaintiff and respondent

☐ Continued on attachment 2.

The undersigned certifies that the above-listed persons or entities (corporations, partnerships, firms, or any other association, but not including government entities or their agencies) have either (1) an ownership interest of 10 percent or more in the party if it is an entity; or (2) a financial or other interest in the outcome of the proceeding that the justices should consider in determining whether to disqualify themselves, as defined in rule 8.208(e)(2).

Date: November 29, 2011

GREINES, MARTIN, STEIN & RICHLAND LLP

Kent J. Bullard
(TYPE OR PRINT NAME)

▶ [signature]
(SIGNATURE OF PARTY OR ATTORNEY)

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INTRODUCTION

It has long been the case, in California and elsewhere, that contract provisions in violation of public policy are unenforceable. Here, a federal bankruptcy court found a "late fee" provision (to be charged on top of default interest and attorney's fees) in a balloon-payment mortgage to be an illegal penalty under applicable New Mexico law. Nonetheless, the plaintiff lender (a party to the bankruptcy proceeding bound by the bankruptcy court's determination) sought to enforce in this action that same, illegal late-fee against the defendant guarantors. Its theory? That the guarantors had contractually waived any illegality.

But one can no more waive the public policy barring onerous contractual penalty provisions than one could waive usury, unconscionability, or the Thirteenth Amendment. And, regardless of what New Mexico might do (although it is clear that New Mexico public policy bars penalty provisions and bars the waiver of such illegality just as much as California's does), fundamental California public policy bars enforcing penalty provisions.

Yet, the trial court here enforced the penalty provision against the guarantors, even though it had been conclusively found to be illegal and unenforceable as against the borrower. Why? Because the trial court concluded that the guarantors could and did contractually waive in advance any and all conceivable illegality. The conclusion that they could do so is simply wrong as a matter of law.

And it is even wrong as a matter of contract construction. The bankruptcy court also conclusively determined the late fee did not even apply. And the loan documents themselves disavow any illegal fee. There was, therefore, no illegal late fee owed by the borrower and, hence, none ever guaranteed by the guarantors.

The judgment should be reversed with directions to enter judgment in defendants' favor.

STATEMENT OF FACTS AND PROCEEDINGS

A. Background: Defendants Guarantee Loan Obligations For A Shopping Center In New Mexico.

1. The parties.

Defendants and appellants Danny Lahave and Top Terraces, Inc. ("Guarantors") are substitute guarantors of a commercial real estate loan. (1 Appellants' Appendix ("AA") 2, 4; 2 AA 288, 296.) The loan was assumed by Market Center East Retail Property, Inc. ("MCE" or "Borrower"), upon MCE's purchase of a shopping center in Albuquerque, New Mexico. (1 AA 4; 2 AA 288, 296.) Lahave, a California resident, is the principal shareholder of MCE, a New Mexico corporation, and he is the sole shareholder of Top Terraces, a California corporation. (2 AA 288, 296, 510-511 ¶ 2.)

Plaintiff and respondent ORIX Capital Markets, LLC ("ORIX") is the "special servicer" for the loan's noteholder, by assignment, Bank of America ("Lender").[1/]

[1/] The full name that plaintiff used in its pleadings below is: "BANK OF AMERICA, National Association, as successor by merger with LaSalle Bank National Association, as Trustee for PaineWebber Mortgage Acceptance Corporation V, Commercial Mortgage Pass-Through Certificates, Series 1999-C1, acting by and through its Special Servicer ORIX Capital Markets, LLC." (1 AA 1.)

2. The original loan and guaranty documents.

The Note. The original borrower executed a "Deed of Trust Note" ("Note") in favor of the original lender in the amount of $9,175,000, with a maturity date of May 1, 2009. (1 AA 83.)

The Heightened Default Remedies. In the event of default—i.e., missing a payment by five days—the Note provided that "[t]he whole of the principal sum of this Note, together with all interest accrued and unpaid thereon and all other sums due . . . shall without notice become immediately due and payable at the [Lender's] option . . . ." (1 AA 83.) The Note also provided that in the event of default, default interest would be at a rate 5 percent higher than the normally applicable (7.74 percent) interest rate, i.e., a default interest rate of 12.74 percent. (1 AA 85.) The borrower would also be liable for "a reasonable attorney's fee" if it became "necessary to employ counsel to collect the Debt or to protect or foreclose the security." (1 AA 83.)

The Late Fee. At issue in this case, the Note provided an *additional* 5 percent late fee as to any amount "not paid on or before the fifth (5th) day after the date on which it is due," or, if less, "the maximum amount permitted by applicable law to defray the expenses incurred by Payee in handling and processing such delinquent payment and to compensate Payee for the loss of the use of such delinquent payment . . . ." (1 AA 86.)

Governing Law. The Note was to "be governed and construed in accordance with the laws of the State of New Mexico and the applicable laws of the United States of America." (1 AA 89.)

The Deed of Trust. To secure payment of the Note, the original borrower concurrently executed a "Deed of Trust, Security Agreement, Assignment of Leases and Rents and Financing Statement" for the shopping center property ("Deed of Trust") in favor of the original lender, as beneficiary. (1 AA 96; see also 1 AA 154.) The Note expressly incorporated all the terms of the Deed of Trust. (1 AA 83.)

The Deed of Trust provided that "[i]f any term, covenant or condition of the Note or this Deed of Trust is held to be invalid, illegal or unenforceable in any respect, the Note and this Deed of Trust shall be construed without such provision." (1 AA 132 ¶ 47.)

The Guaranty. Contemporaneously, an original guarantor executed a "Guaranty of Recourse Obligations" ("Guaranty") in favor of the original lender. (1 AA 167.) It guaranteed "the payment and performance of the Guaranteed Obligations as and when the same shall be due and payable, whether by lapse of time, by acceleration of maturity or otherwise" and to be "liable for the Guaranteed Obligations as a primary obligor." (1 AA 167 ¶ 1.1.) Under the section entitled "Definition of Guaranteed Obligations," the Guarantor became "liable for the full amount of the Debt and all obligations of Borrower to Lender under the Loan Documents in the event that[,]" among other things, "the first full monthly payment of principal and interest on the Note [was] not paid when due" or Borrower filed for bankruptcy. (1 AA 167-169 ¶ 1.2.)

The Waiver Provision. Central to this case, the Guaranty contained a provision that the Guarantor's obligations would not be reduced by—and that the Guarantor "waives any common law, equitable, statutory or other rights (including without limitation rights to notice) which Guarantor might otherwise have as a result of or in connection with"—a number of events and circumstances, including "[t]he invalidity, illegality or unenforceability of all or any part of the Guaranteed Obligations, or any document or agreement executed in connection with the Guaranteed Obligations." (1 AA 171 & ¶ 2.4.) The specified waived illegalities included "that (i) the Guaranteed Obligations, or any part thereof, exceeds the amount permitted by law, . . . (iv) the Guaranteed Obligations violate applicable usury laws, (v) the Borrower has valid defenses, claims or offsets (whether at law, in equity or by agreement) which render the Guaranteed Obligations wholly or partially uncollectible from Borrower . . . ." (1 AA 171-172 ¶ 2.4.) The "Guarantor [was to] remain liable . . . regardless of whether Borrower or any other person be found not liable on the Guaranteed Obligations or any part thereof for any reason[.]" (*Ibid.*)

The Guarantor's representations and warranties included that the "Guaranty is a legal and binding obligation of Guarantor and is enforceable in accordance with its terms, *except as limited by* bankruptcy, insolvency or *other laws of general application relating to the enforcement of creditors' rights*." (1 AA 174 ¶ 3.5, emphasis added.)

Governing Law. Like the Note, the Guaranty was to be "governed by and construed in accordance with the laws of the State in which the real property encumbered by the Mortgage is located [i.e., New Mexico] and the applicable laws of the United States of America." (1 AA 176 ¶ 5.3.)

3. The assignment to subsequent noteholder.

Eventually, the Note, Deed of Trust, and Guaranty were assigned to LaSalle Bank National Association. (1 AA 181, 185, 189, 193; see also 1 AA 3-4 ¶¶ 9-12.) At some point, LaSalle merged with plaintiff Bank of America, National Association. (See fn. 1, *ante*.)

4. Defendants assume the Guaranty in 2006.

Thereafter, MCE assumed the loan obligations, and Lahave and Top Terraces became the substitute guarantors, with the previous borrower and guarantors released from their obligations. (1 AA 197, 221; 2 AA 296.)

B. After The Last-Minute Collapse Of A Deal To Sell The Shopping Center To Lowe's, The Borrower Defaults On The Loan And Sues Lowe's.

MCE entered into a written agreement to sell the shopping center to Lowe's Home Centers, Inc. ("Lowe's") for $13.5 million. (2 AA 511 ¶ 4.) Lowe's repeatedly extended the closing date until February 2009. (2 AA 512 ¶ 4.) Meanwhile, because of tenant evictions that Lowe's required before closing, the shopping center's rental income substantially declined. (2 AA 512 ¶ 5.) In late December 2008, Lowe's announced it had

determined not to proceed with the purchase, citing changing economic conditions and its curtailment of new store development. (*Ibid.*)

Through the end of December 2008, MCE was current on the Note. (2 AA 297.) But by then the shopping center no longer generated sufficient cash flow to service the Note and fund acquisition of new tenants. (2 AA 512 ¶ 5.) MCE thus advised ORIX that MCE would be unable to continue making payments until a sale or re-tenanting of the center was accomplished. (*Ibid.*) MCE did not make the January 2009 payment when due. (2 AA 297.) MCE made several proposals to re-structure the loan, but ORIX rejected them. (2 AA 512 ¶ 5.)

MCE sued Lowe's for breach of contract in California. (2 AA 513 ¶ 6; see also 2 AA 300.) MCE and Lowe's proceeded to engage in settlement negotiations for Lowe's to ultimately purchase the shopping center. (2 AA 513 ¶ 6; see also 2 AA 300.)

C. Despite Knowing Of A Likely Settlement With Lowe's That Would Allow Loan Repayment, Plaintiff ORIX Files Collection Actions In New Mexico And California, And Borrower Files For Bankruptcy In New Mexico.

Despite the ongoing Lowe's settlement discussions, ORIX sued in New Mexico to foreclose, appoint a receiver, and to enforce the guaranties. (2 AA 513 ¶ 6; see also 2 AA 298; 3 AA 633, 644.) Faced with this action and ORIX's refusal to renegotiate, MCE filed a voluntary Chapter 11 bankruptcy petition in New Mexico. (2 AA 272, 299, 513 ¶ 6.) ORIX

treated this as a triggering event obligating Guarantors for all payments then due from MCE under the Note. (2 AA 514 ¶ 8; see also 1 AA 5 ¶ 16.)

After ORIX had applied certain escrow reserves, the principal balance on the Note was approximately $7.5 million. (2 AA 298-299.) On May 1, 2009, the Note matured. (2 AA 299.)

ORIX voluntarily dismissed its claim to enforce guaranties in the New Mexico state court action (2 AA 299) but weeks later, in June 2009, ORIX filed this breach of guaranty action the Los Angeles County Superior Court. (1 AA 1; 2 AA 299.)

D. From The Borrower's Successful Settlement With Lowe's, ORIX Receives Full Repayment Of The Loan Amount Plus Non-Default Interest—At Which Point, As The Bankruptcy Court Determined, The Guaranty Collection Action Should Have Ceased.

A couple of months later, in August 2009, MCE disclosed that it had reached a tentative settlement for Lowe's to purchase the property for $9.75 million. (2 AA 300.) At that point, the bankruptcy court later concluded, "ORIX of course was entitled to wait to see if the sale resulting [from] the settlement actually closed, before it halted the guaranty action altogether." (2 AA 354.) But, the court continued, ORIX's counsel both in the bankruptcy action and here, Jeffer, Mangels, Butler & Marmaro, LLP ("Jeffer, Mangels") "should have started to throttle back as it became clearer that the settlement was likely to be consummated." (*Ibid.*)

ORIX, however, continued to actively pursue this action against the Guarantors, obtaining, in September 2009, an order authorizing attachment of the Guarantors' assets. (2 AA 533.)

The sale proceeded with bankruptcy court approval, closing on December 2, 2009. (2 AA 302.) That same day, the bankruptcy court authorized $7.9 million to be disbursed to ORIX, representing the $7.5 million unpaid principal balance plus $400,000 in unpaid interest at the non-default contract rate. (*Ibid.*; see also 2 AA 450 [ORIX receives disbursement].)[2/]

This was as expected. According to the bankruptcy court, "[b]y the end of August everyone was on notice that a tentative settlement for a sale of $9.75 million had been reached, and no later than November 30, 2009, everyone knew that the Lowe's sale had closed resulting in what would be a deposit into the Court registry of an amount that was more than double the maximum amount still being claimed by ORIX." (2 AA 353.) The bankruptcy court continued: "[O]nce the closing contemplated by the settlement took place, *the guaranty collection action should have ceased altogether*." (2 AA 354, emphasis added.)

[2/] For clarity and ease of reading, we use round numbers.

E. The Bankruptcy Court Allows ORIX Additional Default Interest And Some Attorney Fees, But Holds The Late Fee At Issue Here To Be An Illegal Penalty.

Not satisfied with having been paid in full, ORIX sought various additional amounts in the bankruptcy court, including: $241,000 in default-rate interest; $47,000 in bankruptcy attorney fees and $124,000 in non-bankruptcy attorney fees; and a $377,000 late fee on the principal balance (the same late fee at issue in this action). (2 AA 302-303; see also 2 AA 281-285, 442-445.)

In issuing a 77-page order (2 AA 287-363), the bankruptcy court allowed ORIX default-rate interest and some requested attorney fees and disallowed certain attorney's fees but, most significantly, *disallowed* the $377,000 late fee on the principal balance as an invalid, unreasonable liquidated damages provision barred as an unenforceable penalty in violation of public policy.

1. The allowed default-rate interest.

The bankruptcy court allowed ORIX to receive $241,000 in default-rate interest. (2 AA 361.)

2. The partially allowed attorney fees, including for collecting on the Guaranty.

ORIX requested attorney fees for three law firms—two New Mexico firms and ORIX's counsel in this case, Jeffer, Mangels—which the bankruptcy court partially allowed and partially disallowed. (See 2 AA 341-357.) Regarding the Jeffer Mangels fees, the bankruptcy court

found that the guaranty collection action fees (i.e., those in this action up to the end of January 2010) were recoverable in the bankruptcy action but only allowed $121,000 of the $140,000 requested. (*Ibid.*) It held that with the Lowe's sale and payment to Orix, "the California litigation [this action] was [as of December 2009] effectively now moot." (2 AA 355.) Accordingly, it substantially reduced Jeffer Mangels's December fees; it disallowed all of Jeffer Mangels's January 2010 fees, as "[a] fortiori, the January 2010 billings are unreasonable in their entirety." (*Ibid.*)

3. ORIX's 5 percent balloon payment late fee—the same late fee at issue here—violates public policy as an unreasonable liquidated damages provision and arbitrary penalty.

"ORIX claim[ed] a late fee of 5 percent, or $377,438.82 because the principal was not paid in full within five days of May 1, 2009." (2 AA 322-323.) The Borrower (MCE) "argue[d] that this [was] an unenforceable penalty and that it [was] duplicative of the accrual of default interest and attorney fees." (2 AA 323.) The bankruptcy court agreed, holding that "ORIX's 5 percent late fee as applied to the principal balance in this case is an unenforceable penalty." (2 AA 331.)

Although "New Mexico has not yet formulated a specific 'test' regarding whether a liquidated damages clause is enforceable[,]" it "does, however, follow the Restatement (Second) of Contracts." (2 AA 326, citing *Nearburg v. Yates Petroleum Corp.* (Ct.App. 1977) 123 N.M. 526 [943 P.2d 560, 566] [citing the Restatement Second of Contracts, section 356].)

Under the Restatement, "'[a] term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.'" (2 AA 327.) Public policy is violated because:

- "'[T]he parties to a contract are not free to provide a penalty for its breach.'"
- "'The central objective behind the system of contract remedies is compensatory, not punitive.'"
- "'Punishment of a promisor for having broken his promise has no justification on either economic or other grounds and a term providing such a penalty is unenforceable on grounds of public policy.'"

(*Ibid.*, quoting Rest.2d Contracts, § 356 com. a.)[3]

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[3] The Restatement comports with hornbook law, as recited by the bankruptcy court, that courts will only "'enforce such an agreement, so long as the amount agreed upon is not unconscionable, is not determined to be an illegal penalty, and is not otherwise violative of public policy. . . . A liquidated damages provision will be held to violate public policy, and hence will not be enforced, when it is intended to punish, or has the effect of punishing, a party for breaching the contract, or when there is a large disparity between the amount payable under the provision and the actual damages likely to be caused by a breach, so that it in effect seeks to coerce performance of the underlying agreement by penalizing non-performance and making a breach prohibitively and unreasonably costly. . . . [R]ather than establishing damages that approximate or are proportional to the harm likely to flow from a particular breach, [such a clause] actually constitutes a penalty, and, since penal clauses are generally unenforceable, provisions having this effect are declared invalid; and this is generally true even where the provision is negotiated in good faith, at arms' length and between parties of equal bargaining power.'" (2 AA 324-325, quoting 24 Williston on Contracts (4th ed. 1995) § 65:1.)

The standard test to determine whether a liquidated damages provision such as the late fee in this case violates public policy is:

1) was the anticipated injury difficult or incapable of accurate estimation at the time the contract was made?

2) are the stipulated damages extravagant or disproportionate to the injury anticipated from a breach at the time the contract was made? and

3) were the agreed upon stipulated damages designed to punish, or have the effect of punishing, a party for breaching the contract or merely to compensate the nonbreacher for the other party's failure to perform?

(2 AA 329-331, footnotes omitted.)

Applying that test, the bankruptcy court found the "ORIX's 5 percent late fee as applied to the principal balance in this case [to be] an unenforceable penalty." (2 AA 331.)

Bankruptcy court finding: "The anticipated injury is not difficult or incapable of accurate estimation." "The Note states that the purpose of the late fee is to defray the expenses incurred by Payee in handling and processing a delinquent payment and to compensate Payee for the loss of the use of the delinquent payment." (2 AA 332; see also 1 AA 86.) Given that purpose, the "damages were not difficult to estimate if the breach was failure to pay the balloon when due." (2 AA 334.) Rather, any "damages were accruing interest (at the default rate), attorneys fees and costs (which

are provided for), and minimal administrative costs" and "[t]here was no evidence put on of any direct administrative costs except some travel expenses, which will be allowed." (*Ibid.*; see also 2 AA 361 [allowing $3,600 postpetition travel expenses].)

Bankruptcy court finding: "The stipulated damages are both extravagant and disproportionate to the injury anticipated from a failure to pay the balloon when due." The late fee was extravagant here because (1) the lender already receives default interest, fees and costs, and administrative expenses; "[a] late fee of 5 percent of a missed monthly payment may be reasonable, but as applied to the balloon it serves as a windfall for the creditor"; (2) "a creditor should not get both an above market default interest rate and late fees on the same debt"; (3) "it is unreasonable to interpret a late fee provision as applying to a balloon payment"; (4) "creditors are usually denied late fees after acceleration or maturity"; and, (5) "the stipulated damages are disproportionate to the injury anticipated at the time the contract was made from a failure to make the balloon payment when due. The late fee is 5 percent no matter whether a payment is one day late, one year late, or never paid at all." (2 AA 334-339.)

Bankruptcy court finding: "The stipulated damages have the effect of punishing Debtor for breaching the contract." The late fee had "no purpose other than ensuring" timely payments and "functions as penalty to

spur compliance rather than as a proportionate charge based on estimated damages." (2 AA 340.)

F. ORIX Gets Its Pound Of Flesh: ORIX Persuades The Superior Court To Award It The $377,438.82 Late Fee Against The Guarantors, Even Though The Bankruptcy Court Had Held It To Be An Illegal And Unenforceable Penalty.

Based on the bankruptcy court's ruling, the superior court, per Judge Meiers, initially stayed and eventually vacated the writ of attachment, stating "this court cannot find that plaintiff has established that it is likely to succeed as to interest and or late fee amounts and that it has established or can establish with the degree of certainty required as amount of attorney fees and/or costs to be secured by a Writ." (2 AA 535; see also 1 AA 58-59.) The matter nonetheless proceeded to trial before Judge Strobel based on stipulated operative facts and the parties' competing briefing.

1. Trial on briefs and stipulated facts.

The parties stipulated to the operative facts, including to the genuineness and authenticity of ten relevant loan and guaranty documents (1 AA 77-80)[4/] and the *amount* of the late fee if it was recoverable: "The amount of the five percent (5 percent) late fee set forth on Page 4 of the

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[4/] The ten documents were the exhibits to the complaint, consisting of the four April 9, 1999 original loan documents (note, deed of trust, assignment of leases and rents, and guaranty), the four January 10, 2003 assignments of those documents, the November 2, 2002 consent and assumption agreement, and the January 13, 2006, consent and assumption agreement. (1 AA 78-80; see also 1 AA 2-4.)

Note claimed by Plaintiff Noteholder to be owed by Defendant Guarantors pursuant to the Guaranty is $377,438.82 ('Late Fee')." (1 AA 80-81.) They also stipulated that the "[t]he only issue to be adjudicated at trial in this Action is whether under New Mexico law the Late Fee found by the [bankruptcy court] . . . is enforceable against Defendants Guarantors and whether the Late Fee can be collected by the Plaintiff Noteholder from Defendant Guarantors." (1 AA 81.) The matter was submitted on the stipulated facts and the parties' briefs.

The Guarantors' opening brief argued that (1) collateral estoppel and res judicata barred ORIX's action, (2) the late fee did not constitute part of the guaranteed obligations and was therefore not collectible from the Guarantors, and (3) the Guaranty's waiver provisions were ambiguous and against New Mexico public policy and therefore unenforceable. (2 AA 372.) ORIX in its opening brief countered by arguing that (1) claim preclusion did not bar ORIX's claim, (2) that the waivers contained in the Guaranty must be strictly enforced, and (3) the New Mexico Commercial Code did not apply to the Guaranty. (1 AA 250.) In reply, the Guarantors also argued that even if enforceable under New Mexico law, fundamental California public policy barred enforcement of the late fee as a penalty. (3 AA 617.)

At the trial court's request, ORIX filed a supplemental brief addressing whether "the public policy exception to enforcement of the choice of law provisions requires that the Court apply California law rather

than New Mexico law to the question of whether the late fee is enforceable" and whether "under California law the late penalty would not be enforceable." (3 AA 662, 664.)

Both sides requested judicial notice of various documents, including the bankruptcy court's order disallowing the late fee. (2 AA 269-270, 437-440; 3 AA 628-629.) The trial court granted both sides' requests. (3 AA 676.)

2. The trial court enforces the illegal late fee penalty as against the Guarantors.

The trial court (Judge Strobel), addressing the question as one of law on undisputed facts, held the late fee penalty enforceable as against the Guarantors despite being illegal under New Mexico law as against the Borrower. According to the trial court, Guarantors "agreed to repay the obligations under the loan documents, including certain obligations from which the Borrower has been relieved, i.e., the Late Fee." (3 AA 681.) In the trial court's view, "[t]he Guaranty contains a number of provisions which obligate the Guarantor even when the Borrower has been relieved of certain obligations, and in which the Guarantor waives certain defenses." (3 AA 679, relying on Guaranty ¶ 1.4 [Guaranteed Obligations not reduced by offset] and ¶ 2.4 [waiver of invalidity, illegality or unenforceability of Guaranteed Obligations].) It concluded that the Guarantors' obligations encompassed provisions unenforceable against the Borrower as illegal and in violation of public policy.

The trial court reasoned that:

- the Guarantors "expressly waived any right to avoid payment of the Late Fee obligation under the loan documents, even in the event a judge relieved the Borrower of such an obligation." (3 AA 682.)
- that "the Late Fee was an unenforceable penalty was a determination made with respect to the borrower, and not with respect to the obligations of the Guarantors." (3 AA 683.)
- as to "res judicata/collateral estoppel[,]" "the determination by the Bankruptcy court that the Late Fee was an unenforceable penalty as to the borrower did not encompass a determination of the Guarantor's liability or the enforceability of the waivers contained in the Guaranty." (3 AA 683-684.)
- the Guarantors were "judicially estopped" from arguing that the court should apply California law in determining whether "the waiver provision in the Guaranty is unenforceable as it pertains to Guarantor's obligation to pay the Late Fee found to be an invalid penalty by the Bankruptcy court." (3 AA 684.)
- "New Mexico law applies to the analysis of whether the Defendant Guarantors waived their defense with respect to collectability of the Late Fees." (3 AA 686.)

- Under New Mexico law, the common law rather than the Uniform Commercial Code applied, and that under either one, Guarantors had "not shown that the defense that the Late Fee was an unenforceable penalty could not be waived in advance via the Guaranty." (3 AA 687.)

Finally, the trial court declined to determine "whether the Late Fee provided for under the Note is an unenforceable penalty as to the Defendants." (3 AA 688-689.) It reasoned that "[t]hat analysis is not warranted" because "[t]he $377,438.82 sought by Plaintiffs in this action is not a late fee assessed against Defendants for failure to timely fulfill an obligation to make payment" but "[r]ather it is a contractual provision under which Defendants agreed to pay sums which became due by virtue of their contractual obligations under the Guaranty." (3 AA 689.)

The trial court ordered judgment for Orix "in the stipulated amount of the Late Fee, $377,438.82." (3 AA 689.)

G. Guarantors Appeal The Ensuing Judgment.

The trial court entered judgment on November 9, 2011. (3 AA 696-697.) The next day, the clerk served notice of entry of judgment by mail. (3 AA 698-699.) Five days after that, on November 15, 2011, Guarantors timely filed a notice of appeal. (3 AA 705-706.)[5]

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[5] ORIX has since moved in the superior court for an additional award of over $332,000 in attorneys fees and costs. (See 3 AA 711-712.)

STATEMENT OF APPEALABILITY

The judgment finally resolves all issues between the parties (other than contractual attorney's fees, claimed as an element of costs). It is appealable under Code of Civil Procedure section 904.1, subdivision (a)(1).

STANDARD OF REVIEW: DE NOVO ON ALL ISSUES

Everything at issue in this appeal is subject to this Court's independent, de novo, review. This Court independently reviews questions of law on undisputed facts, as here. (*Ghirardo v. Antonioli* (1994) 8 Cal.4th 791, 799; *Crocker National Bank v. City & County of San Francisco* (1989) 49 Cal.3d 881, 888; *Nguyen v. Calhoun* (2003) 105 Cal.App.4th 428, 437-438.)

The determination of the preclusive effect of a bankruptcy court ruling is subject to de novo review. (*Noble v. Draper* (2008) 160 Cal.App.4th 1, 10.)

The enforceability of a late fee against a guarantor after the same late fee has been determined to be an illegal penalty in violation of public policy falls squarely in the realm of legal issues reviewed de novo on appeal. (See, e.g., *Ghirardo, supra*, 8 Cal.4th at pp. 800-801 [question of whether transaction is usurious]; *Gatton v. T-Mobile USA, Inc.* (2007) 152 Cal.App.4th 571, 579 [whether contract provision is unconscionable]; *Harbor Island Holdings, LLC v. Kim* (2003) 107 Cal.App.4th 790, 794 [whether amount to be paid upon breach is to be treated as liquidated damages or as unenforceable penalty]; see also *Brack v. Omni Loan Co., Ltd.* (2008) 164 Cal.App.4th 1312, 1320 [interpretation of contractual choice-of-law provision and whether, on undisputed facts, it supplants law which would otherwise apply]; *Campbell v. Scripps Bank* (2000) 78 Cal.App.4th 1328, 1333 & fn. 2 [existence of collateral estoppel].)

Contract interpretation issues likewise are reviewed de novo where, as here, interpretation does not turn on the credibility of extrinsic evidence. (*Parsons v. Bristol Development Co.* (1965) 62 Cal.2d 861, 865.)

ARGUMENT

I.

THE LATE FEE—AS ALREADY DETERMINED BY THE BANKRUPTCY COURT—CONSTITUTES AN INVALID PENALTY IN VIOLATION OF PUBLIC POLICY AND THEREFORE IS AS UNENFORCEABLE AGAINST THE GUARANTORS AS IT IS AGAINST THE BORROWER.

The bankruptcy court found that "ORIX's 5 percent late fee as applied to the principal balance in this case is an unenforceable penalty" explaining that (1) "[t]he anticipated injury is not difficult or incapable of accurate estimation," (2) "[t]he stipulated damages are extravagant and disproportionate to the injury anticipated," "[a]nd, [(3)] the stipulated damages have the effect of punishing [the Borrower] for breaching the contract." (2 AA 331; see also 2 AA 331-340.)

The trial court repeatedly acknowledged the bankruptcy court's determination that the late fee was an invalid penalty as to the Borrower: "The Bankruptcy judge determined that ORIX could not be paid the Late Fee from the debtor's estate on the ground that it was an 'unenforceable penalty' under New Mexico law." (3 AA 679; see also 3 AA 681-682, 683-684 [acknowledging that bankruptcy court determined late fee was an invalid, unenforceable penalty].) Nonetheless, the trial court held that the bankruptcy court's ruling did not bind Orix as against the Guarantors, reasoning that the Guarantors could waive any and all illegality and public

policy and California courts are bound to enforce such a waiver. That is dead wrong—as a matter of both law and common sense.

A. The Bankruptcy Court's Holding That The Late Fee Violates Public Policy Binds ORIX In This Case As A Matter Of Issue Preclusion; In Any Event, It Is Indisputable That, As A Matter of Law, The Late Fee Is An Illegal Penalty Under Both New Mexico And California Law.

1. Collateral estoppel binds Orix to the bankruptcy court determination that the late fee is an illegal penalty.

"Collateral estoppel, or issue preclusion, 'precludes relitigation of issues argued and decided in prior proceedings.'" (*Mycogen Corp. v. Monsanto Co.* (2002) 28 Cal.4th 888, 896, citation omitted.) The doctrine applies whenever (1) the issue to be re-litigated is identical to an issue actually and necessarily decided in a final decision on the merits in a former proceeding, and (2) the party against whom preclusion is sought is the same or in privity with the party to the former proceeding. (*Hernandez v. City of Pomona* (2009) 46 Cal.4th 501, 511.) Issue preclusion applies even when the "issues bear on different claims raised in a later case." (*Roos v. Red* (2005) 130 Cal.App.4th 870, 879.)

California law recognizes that "[a] federal court judgment has the same effect in the courts of this state as it would have in a federal court." (*Martin v. Martin* (1970) 2 Cal.3d 752, 761.) A bankruptcy court's final

order—i.e., one not reversed on appeal or set aside or modified by the rendering court[6]—allowing or disallowing a claim on the merits is entitled to preclusive effect in a state court action. (*Nathanson v. Hecker* (2002) 99 Cal.App.4th 1158, 1162-1666, citing, inter alia, *Siegel v. Federal Home Loan Mortgage Corp.* (9th Cir. 1998) 143 F.3d 525, 529 ["a bankruptcy court's allowance or disallowance of a claim is a final judgment" and "'is binding and conclusive on all parties or their privies, and being in the nature of a final judgment, furnishes a basis for a plea of res judicata,'" citation omitted]; see also *Martin, supra,* 2 Cal.3d at p. 759 [bankruptcy court's interpretation of property settlement agreement given issue preclusive effect]; *Roos, supra,* 130 Cal.App.4th at p. 874 [bankruptcy court's finding that wrongful death claims were not discharged given issue preclusive effect].) The same is true under New Mexico law. (*Rhoades v. Rhoades* (Ct.App. 2003) 135 N.M. 122, 126 [85 P.3d 246, 250] [bankruptcy court decision in dischargeability proceeding would have issue preclusive effect on issues decided by bankruptcy court].)

There is no dispute here that Orix was a party to the bankruptcy court proceeding or that it actually and necessarily litigated (and lost) whether the balloon payment late fee was an illegal penalty unenforceable under New Mexico public policy. That should end the matter. The bankruptcy court's decision on Orix's claim that the late fee did not apply and constituted an

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[6] ORIX has never disputed that the bankruptcy court's order is final.

invalid penalty meets all the collateral estoppel requirements; it is entitled to preclusive effect in this action.

2. The late fee is as illegal under the Guaranty as it is under the Note.

The trial court's apparent idea that the issue was not identical because the late fee can be illegal depending on who it is charged against makes no sense. Certainly, such a theory is unsupported by any authority. To the contrary, "[w]hen, in an action by the [lender] against the [borrower] to enforce the underlying obligation, a judgment is given in favor of the [borrower], the judgment bars the [lender] from asserting a claim against [a guarantor] to enforce [a guarantee] to the same extent that the [lender] is barred from reasserting its claim against the [borrower], unless the [lender] establishes that the judgment in favor of the [borrower] is based on a defense that is unavailable to the [guarantor] under § 34." (Rest.3d Suretyship & Guaranty, § 67(1), p. 271.) Section 34 of the Restatement, in turn, allows a guarantor—subject to contractual provisions to the contrary—to raise *any* defenses (e.g., illegality) available to the borrower, except for discharge in bankruptcy and lack of capacity to contract, against which a guarantee is designed to protect. (Rest.3d Suretyship & Guaranty, § 34 & com. a, pp. 144.)

Nor is there any rule of law that says that guaranty contracts are not subject to the same rules of unconscionability, illegality, and violation of public policy as are any other contracts. Penalty provisions are as barred in guaranty contracts as they are in other contracts. (Rest.3d Suretyship &

Guaranty, § 48(1) & com. a, pp. 208-209 ["The secondary obligation is a contract and, accordingly, rules concerning unconscionability place limits on the parties' freedom to contract, and rules concerning good faith and fair dealing place limits on the parties' freedom to act within the confines of the contract"].)

The Guaranty does not exist in a vacuum and cannot be interpreted against Guarantors as if it does. The Guaranty's recitals expressly incorporate the Note—"dated of even date herewith"—and other loan documents. (1 AA 167.) The Note and the Guaranty have to be interpreted together. (See *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 39-40.)

"It is not the purpose of the secondary obligation to assure the obligee of performance to which it is not entitled pursuant to its contract with the principal obligor." (Rest.3d Suretyship & Guaranty, § 34 & com. a, pp. 143-144.) If enforcing the Note's obligations would violate public policy, then so would enforcing the Guaranty as to those obligations. ORIX cannot insulate or "launder" the same late fee's illegality and violation of public policy by collecting it under the Guaranty instead of the Note.

That the bankruptcy court found the late fee was an invalid penalty against the *Borrower* rather than the Guarantor is a distinction without a difference. The late fee is not just some abstract amount of money owed; it's an unenforceable penalty, whether exacted against the borrower or

against the guarantor. And it's not for the benefit of a particular party—here, the Borrower versus the Guarantors—that courts don't enforce contracts that violate public policy; it's for the benefit of the public and to prevent courts from becoming tools for parties seeking to enforce agreements that violate public policy.

As the United State Supreme Court has explained, this "general doctrine, rooted in the common law . . . derives from the basic notion that no court will lend its aid to one who founds a cause of action upon an immoral or illegal act, and is further justified by the observation that the public's interests in confining the scope of private agreements to which it is not a party will go unrepresented unless the judiciary takes account of those interests when it considers whether to enforce such agreements." (*United Paperworkers Internat. Union, AFL–CIO v. Misco, Inc.* (1987) 484 U.S. 29, 42 [108 S.Ct. 364, 98 L.Ed.2d 286].) Refusing to enforce the late fee is necessary whether the fee is applied directly to the Borrower under the Note or to the Guarantor under the Guaranty.

Under ORIX's theory, the Note could have required the Borrower to embezzle $377,000 from the shopping center tenants and pay that amount to ORIX, and even if the Borrower successfully argued that the contract was illegal and thus unenforceable against it, ORIX would still be able to collect the $377,000 from the Guarantors. That is not the law.

The bottom line is, absent some other showing (the waiver issue we discuss below), the illegality finding is as binding a bar on Orix's claim

against the Guarantors as it was against the Borrower. Either the late fee is illegal or it is not. The bankruptcy court determined that it is illegal. That should end the matter.

3. In any event, it is clear that, for the reasons the bankruptcy court detailed, the late fee is an illegal penalty.

The bankruptcy court held that Orix's 5 percent late fee is an unenforceable penalty in violation of public policy because the anticipated injury is not difficult or incapable of accurate estimation, the damages under the late fee are extravagant and disproportionate to the injury anticipated, and those damages would have the effect of imposing punishment for breaching the contract. (2 AA 340.) "[P]enal clauses are generally unenforceable, [and] provisions having this effect are declared invalid; and this is generally true even where the provision is negotiated in good faith, at arms' length and between parties of equal bargaining power." (24 Williston on Contracts (4th ed. 1995) § 65:1.)

B. Parties May Not Contractually Waive Public-Policy Dictated Illegality.

Orix and the trial court attempted to dodge the undeniable illegality (and the preclusive effect of the bankruptcy court's ruling to that effect) not by claiming that the late fee wasn't an illegal penalty, but that illegal, public-policy barred provisions were freely enforceable against the Guarantors, even if not enforceable against anyone else. Their link for such an astounding argument? The claim that the Guarantors could and did

waive any conceivable illegality. But neither precedent nor logic supports such an untoward result.

1. The illegality of a penalty provision cannot be contractually waived.

A fundamental maxim of jurisprudence is that "a law established for a public reason cannot be contravened by a private agreement." (Civ. Code, § 3513.) "A contract that contravenes public policy thus is illegal." (*Abramson v. Juniper Networks, Inc.* (2004) 115 Cal.App.4th 638, 658.) "[W]hen the evidence shows that the plaintiff in substance seeks to enforce an illegal contract or recover compensation for an illegal act, the court has both the power and duty to ascertain the true facts in order that it may not unwittingly lend its assistance to the consummation or encouragement of what public policy forbids." (*Lewis & Queen v. N. M. Ball Sons* (1957) 48 Cal.2d 141, 147-148, superseded by statute on other grounds as stated in *McBarron v. Kimball* (1963) 210 Cal.App.2d 218, 220.) "A law established for a public reason cannot be waived or circumvented by a private act or agreement, . . . nor will a court enforce a contract made in violation of established public policy." (*Tower Acton Holdings v. Los Angeles County Waterworks Dist. No. 37* (2002) 105 Cal.App.4th 590, 601; see also *Panzer-Hamilton Co. v. Bray* (1929) 96 Cal.App. 460, 464 ["'The doctrines of estoppel and waiver do not in general apply in transactions that are forbidden by statute or that are contrary to public policy,'" citation omitted].)

"[A] defense of illegality cannot be waived either by agreement or the failure to raise or plead it." (*Downey Venture v. LMI Ins. Co.* (1998) 66 Cal.App.4th 478, 511, fn. 36; see also *Cook v. King Manor & Convalescent Hospital* (1974) 40 Cal.App.3d 782, 793 ["'For the same reason the defense of illegality cannot be waived by stipulation in the contract,'" citation omitted]; 1 Witkin, Summary of Cal. Law (10th ed. 2005) Contracts, § 432, pp. 473-474; 17A Am.Jur.2d (2004) Contracts, § 309.)

Specifically, a contracting party cannot waive the public policy against unreasonable liquidated damages. (*Cook, supra*, 40 Cal.App.3d at p. 793.) These principles apply as much to guaranty contracts as to any other contracts. Thus, while a guarantor may contractually waive certain defenses, it cannot waive the unenforceability of the principal obligation because of illegality, for example, usury. (*WRI Opportunity Loans II, LLC v. Cooper* (2007) 154 Cal.App.4th 525, 544.)

This comports with the approach taken in the Restatement Third of Suretyship & Guaranty. It provides that "the secondary obligor is free to contract to be liable on the secondary obligation even when the principal obligor has a defense to the underlying obligation." (Rest.3d Suretyship & Guaranty, § 34 & com. a, p. 144, citing Rest.3d Suretyship and Guaranty, § 6.) *But*, importantly, "[t]he freedom of contract afforded by this section is subject, of course, to general doctrines of contract law such as good faith and unconscionability that protect against overreaching and abuse." (*Id.*, § 6, com. b, p. 29.)

Of course, a bedrock general doctrine of contract law is that penalty provisions are unenforceable because they violate public policy:

- "[T]he parties to a contract are not free to provide a penalty for its breach." (Rest.2d Contracts, § 356, com. a.)
- "The central objective behind the system of contract remedies is compensatory, not punitive." (*Ibid.*)
- "Punishment of a promisor for having broken his promise has no justification on either economic or other grounds and a term providing such a penalty is unenforceable on grounds of public policy." (*Ibid.*)

That the Guaranty is a separate contract from the Note containing the illegal late fee does not make the Guaranty a license to violate this public policy. The Guaranty does not exist in a vacuum, and the obligations guaranteed are not abstract obligations but are the actual obligations created by the Note.

If one could enforce a guaranty that waives any defense—even an illegal violation of public policy—a mobster would never need to hire "muscle" to enforce deals; the mobster could use the courts. That can't be, and is not, the law in New Mexico. And even if it were, such an agreement could not be enforced in California.

2. New Mexico law: Parties to a guaranty cannot waive in advance illegal penalty provisions that violate New Mexico public policy; any such waiver would be unconscionable.

Just like California and the vast majority if not uniformity of courts, New Mexico courts "will not enforce a contractual provision that violates public policy." (*Padilla v. State Farm Mut. Auto. Ins. Co.* (2003) 133 N.M. 661, 665 [68 P.3d 901, 905] (striking down a facially neutral contract provision because application of the provision benefitted only the insurer, not the insured].) Even the "plain language" of a contract provision in a guaranty will not be enforced where it "violates long-standing New Mexico law." (*First State Bank v. Muzio* (1983) 100 N.M. 98, 99 [666 P.2d 777, 778], overruled on other grounds in *Huntington Nat. Bank v. Sproul* (1993) 116 N.M. 254 [861 P.2d 935, 944].)[7] That includes the unenforceability of contractual penalties. "A penalty is a term fixing unreasonably large liquidated damages and is ordinarily unenforceable on grounds of public policy because it goes beyond compensation into punishment." (*Nearburg, supra*, 943 P.2d at p. 565.)

A contract provision that violates public policy is also substantively unconscionable under New Mexico law: "Substantive unconscionability relates to the content of the contract terms and whether they are illegal,

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[7] New Mexico appellate courts review unconscionability of a contract de novo as a matter of law. (*Cordova v. World Finance Corp. of N.M.* (2009) 146 N.M. 256 [208 P.3d 901, 905]; *Fiser v. Dell Computer Corp.* (2008) 144 N.M. 464, 470 [188 P.3d 1215, 1221].)

contrary to public policy, or grossly unfair." (*Fiser*, *supra*, 188 P.3d at p. 1221.) An "inherently one-sided agreement is against New Mexico public policy and is therefore void as unconscionable"; under New Mexico law "[c]ontract provisions that unreasonably benefit one party over another are substantively unconscionable." (*Cordova, supra*, 208 P.3d at pp. 904, 908 [arbitration provision].) For substantive unconscionability, "[i]t is sufficient if the provision is grossly unreasonable and against [New Mexico] public policy under the circumstances." (*Id.* at p. 909; cf. *Little v. Auto Stiegler, Inc.* (2003) 29 Cal.4th 1064, 1071 ["Substantively unconscionable terms may take various forms, but may generally be described as unfairly one-sided"]; *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, 117 [contract provision needs at least "'modicum of bilaterality'" to survive unconscionability review].)

Here, the Guaranty's waiver provision invoked by ORIX couldn't be more one-sided and substantively unconscionable. It purports to have the guarantor waive all defenses in equity, statute, common law, and even illegality, usury, and forgery (1 AA 171-172 ¶ 2.4; on the other hand, it provides that the lender doesn't waive a single defense (1 AA 175 ¶ 5.1).

"Under New Mexico principles of contract law, a finding of unconscionability may be based on *either* procedural or substantive unconscionability, or a combination of both." (*Rivera v. American General Financial Services, Inc.* (2011) 150 N.M. 398 [259 P.3d 803, 817],

emphasis added.) Thus, substantive unfairness or unreasonableness, standing alone, renders a contract unenforceably unconscionable.

And, under New Mexico law, unconscionability restricts the enforceability of guaranties, just as it does other contracts. (*WXI/Z Southwest Malls v. Mueller* (Ct.App. 2005) 137 N.M. 343, 347 [110 P.3d 1080, 1084].) The waiver of illegality and public policy is as unenforceable as the underlying illegal provision itself. Otherwise, every contract could avoid public policy illegality and unconscionability by simply stating that such considerations are waived. That can't be the law.

Under controlling New Mexico Supreme Court authority, where a contract provision violates public policy and is void as substantively unconscionable, the "court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result." (*Cordova, supra*, 208 P.3d at p. 911.) Here, that means the waiver provision in the Guaranty—at a minimum to the extent it purports to expressly waive illegality—could not be enforced as to the late fee, which the bankruptcy court already determined violated New Mexico pubic policy.[8]

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[8] If the Court has any doubt as to how this issue should be resolved under New Mexico, it may ask the New Mexico Supreme Court. (N.M. Stat. Ann. 1978, § 39-7-4 ["The supreme court of this state may answer a question of law certified to it . . . by an appellate court of another state . . . if the answer may be determinative of an issue in pending litigation in the certifying court and there is no controlling appellate decision, constitutional (continued...)

3. The authorities that the trial court relied on do not suggest that parties can waive illegality under New Mexico law.

In holding that New Mexico law would allow the waiver of illegality, the trial court relied on "authority that under New Mexico law, the liability of a guarantor can exceed that of a borrower, depending upon the terms of the guaranty." (3 AA 686.) The cited authorities, however, provide no support for the breathtaking proposition that the *illegality* of a contract provision can be waived in advance by a guarantor:

- *Ward v. First Nat. Bank in Albuquerque* (1980) 94 N.M. 701, 703 [616 P.2d 414, 416], according to the trial court, held "that a guarantor's agreement is not discharged by the borrower's bankruptcy and that it was not improper for a guarantor to be liable in [an] amount greater than the borrower's liability." (3 AA 686.) But it is a far leap from saying the borrower's bankruptcy does not discharge the guarantor's obligation to concluding that a guarantor can waive in advance a provision's illegality. A borrower's discharge in bankruptcy is one of two textbook instances of defenses that are unavailable to a guarantor (the other being the borrower's lack of capacity to enter the contract). (Rest.3d Suretyship & Guaranty, § 34 & com. a, pp. 143-144.)

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[8] (...continued)
provision or statute of this state"].)

As *Ward* itself explained, this is precisely when the creditor most needs a surety. (616 P.2d at p. 416.) That's not the concern here—despite the borrower's bankruptcy, the lender collected 100 percent of what was owed plus every imaginable expense, but not the illegal late penalty. *Ward* doesn't stand for the proposition that obligations that are illegal as to the bankrupt borrower are somehow legal as to the guarantor.

- *Sunwest Bank of Clovis, N.A. v. Garrett* (1992) 113 N.M. 112 [823 P.2d 912] enforced a guaranty's express provision allowing the lender to release co-guarantors without reducing other guarantors' liability. (823 P.2d at p. 917.) Again, there was no issue as to the illegality of the initial contractual promise or of the co-guarantors' release.
- *Levenson v. Haynes* (Ct.App. 1997) 123 N.M. 106, 112 [934 P.2d 300, 306] held generically that "[t]he language of the written guaranty agreement governs the rights of the Guarantors." But that is a truism. It says nothing about the issue of public policy and illegal contract provisions. In *Levenson*, the parties' written guaranty agreement merely reinforced the "general rule" that "a change in the underlying agreement which materially modifies the legal effect of the instrument has the effect of discharging a guarantor from his

or her obligation, unless the guarantor consents to the change." (*Id.* at pp. 306-307.) The court was not asked to enforce any illegal obligation. *Levenson* relied on section 6 of the Restatement Third of Suretyship and Guaranty in asserting that "[t]he parties to a suretyship arrangement are free to determine for themselves by contract the effect of suretyship status and the duties and obligations which follow." (934 P.2d at p. 306.) But the comments to that very section direct that "[t]he freedom of contract afforded by this section is subject, of course, to general doctrines of contract law such as good faith and unconscionability that protect against overreaching and abuse." (Rest.3d Suretyship and Guaranty, § 6, com. b, p. 29.)

- *Western Bank v. Aqua Leisure, Ltd.* (1987) 105 N.M. 756 [737 P.2d 537] and *Ward, supra*, 616 P.2d at p. 416, merely illustrate instances where the parties' guaranty agreements were found to override commercial code standards and other standards of commercial reasonableness, *not* violations of public policy. (*Western Bank*, 737 P.2d at p. 540 [the requirement of disposal of collateral in a commercially reasonable manner did not apply when the terms of the contract provided otherwise]; *Ward, supra*, 616 P.2d at p. 416 ["the provisions of an express unconditional guaranty

override the general rules laid out by the Uniform Commercial Code, § 55-1-101 et seq."].)

C. Even Were The Guaranty's Illegality Waiver Somehow Enforceable Under New Mexico Law, It Cannot Be Enforced By California Courts.

1. Enforcing a waiver of illegality would violate fundamental California public policy.

Even if, as the trial court erroneously concluded, the Guaranty's waiver of illegality were enforceable under New Mexico law, it still could not be enforced in this action because to do so violates fundamental California public policy. The law is clear. Even with a contractual choice of law provision, California courts may not enforce against California residents a provision which violates fundamental California public policy: "[I]f application of [a] chosen [state's] law conflicts with a fundamental policy of this state, our courts must consider the impact application of the law will have on California's interests[,]" and [i]f California's interests are materially greater than the interests of the state whose law was chosen by the parties, California will apply its law." (*Brack*, *supra*, 164 Cal.App.4th at p. 1316.) Under this principle, the Guaranty is unenforceable as to the illegal late fee in California.

There is no dispute that the Guarantors are California residents. ORIX chose to invoke the California courts, pursuing this action in California and dismissing its collection action in New Mexico state court. California is the only state with any remaining interest in this guaranty

collection action. When "resort is made to the California courts, and implicates the equitable treatment of California citizens, California has a great material interest in the [enforcement of the contract provision at] issue." (*ABF Capital Corp. v. Grove Properties* (2005) 126 Cal.App.4th 204, 220.) New Mexico, on the other hand, lacks even a "general interest in enforcing the provisions of contracts made by one of its citizens." (*Brack, supra*, 164 Cal.App.4th at p. 1329 [held: general interest as to citizenship of contracting party was outweighed by California's interest in loans made to California residents].)

As the Restatement explains, generally the obligee (the Lender) may pursue enforcement of the secondary obligation (the Guaranty) independently of the primary obligation (the Note). (Rest.3d Suretyship and Guaranty, § 50, com. a, p. 218.) While the primary obligor (the bankrupt Borrower) was a New Mexico entity and the property was in New Mexico, ORIX brought this breach-of-guaranty action solely to enforce the Guaranty and solely against two Californians—guarantors Lahave and Top Terraces—in a California court. (1 AA 1.) California's public policy exception therefore applies. (See *ABF Capital, supra*, 126 Cal.App.4th at pp. 219-223 [California public policy exception applies even to "New York partnership agreement [with a New York choice-of-law provision] to be performed (payment rendered) in New York, and concern[ing] oil and gas operations in Oklahoma and Texas" where plaintiff chose to avail itself of California court].)

Nor can there be any real argument that allowing a guarantor to waive an illegal penalty provision conflicts with fundamental California policy. First, California's policy against penalties like the late fee is longstanding and substantial, so much so that it can never be waived by contract or otherwise. (*Cook, supra*, 40 Cal.App.3d at p. 793.) The late fee has been conclusively determined to violate that policy. In finding the late fee an unenforceable penalty, in fact, the bankruptcy court relied heavily on California law. (2 AA 324 fn. 29, 333, 337-338, citing, inter alia, *Garrett v. Coast & Southern Federal Savings & Loan Assoc.* (1973) 9 Cal.3d 731, 741 [late payment measured against unpaid balance of loan was penalty under former Civil Code sections 1670-1671] and *Poseidon Development, Inc. v. Woodland Lane Estates, LLC* (2007) 152 Cal.App.4th 1106, 1115-1116 [purpose of the late charge provision was to compensate lender for administrative expenses, and applying provision to final balloon payment is not a reasonable attempt to estimate actual administrative costs incurred under current Civil Code section 1671, subdivision (b)].)

Second, under California law guarantors cannot be liable for more than the principal borrower and can't waive defenses based on illegality of the principal obligation. Under Civil Code section 2809, "[t]he obligation of a surety must be neither larger in amount nor in other respects more burdensome than that of the principal; and if in its terms it exceeds it, it is reducible in proportion to the principal obligation." Although guarantors may expressly waive certain specified defenses (see Civ. Code § 2856),

those do not include illegality in the principal obligation. (*WRI Opportunity Loans, supra*, 154 Cal.App.4th at p. 544.)

WRI Opportunity Loans is on point. There, in a written, secured real-property loan guaranty, the guarantors waived their defenses arising under California's statutes concerning guarantors' obligations or "by operation of law." (154 Cal.App.4th at p. 542.) The Court of Appeal held that such a waiver could not be enforced against the guarantors' usury defense. If the loan was usurious, then it was void on the grounds of illegality and unlawfulness, and, under the rule against the enforcement of unlawful transactions, any usurious provisions of the loan could not be enforced against the guarantors. (*Id.* at 542-544.) Directly applicable here, *WRI Opportunity* cited our Supreme Court's holding in *Wells v. Comstock* (1956) 46 Cal.2d 528, 533, that "[s]ince the principal obligation of the contract is unenforceable because of illegality, the guaranty too is unenforceable." (*WRI Opportunity Loans, supra*, 154 Cal.App.4th at p. 543.)

Thus, even if the law in New Mexico were otherwise, enforcing the guarantee of an illegal penalty would violate fundamental California policy. On the other hand, enforcing California's policy would violate no New Mexico policy. "That is to say, nothing in [New Mexico] law prevented [ORIX] from fully complying with California law." (*Brack, supra*, 164 Cal.App.4th at p. 1329.) Fundamental California public policy thus bars enforcing the illegal penalty provision.

2. Guarantors are not judicially estopped from arguing that the illegal penalty provision cannot be enforced in California courts.

The trial court dodged the issue of whether enforcing the illegal penalty provision would violate California public policy, finding the Guarantors judicially estopped from relying on California law. (3 AA 684.) In doing so, it was mistaken. The doctrine simply has no application under these circumstances.

"Judicial estoppel precludes a party from gaining *an advantage* by taking one position, and then seeking a second advantage by taking an incompatible position." (*Aguilar v. Lerner* (2004) 32 Cal.4th 974, 986, emphasis added, citations and internal quotation marks omitted.) Guarantors are not doing that. The trial court pointed to *no advantage* taken.

"The [judicial estoppel] doctrine's dual goals are to maintain the integrity of the judicial system and to protect parties from opponents' unfair strategies." (*MW Erectors, Inc. v. Niederhauser Ornamental & Metal Works Co., Inc.* (2005) 36 Cal.4th 412, 422, citations and internal quotation marks omitted.) There was no unfair strategy here or imposition on judicial integrity here. The California public policy issue was fully briefed and squarely before the trial court. At the trial court's request, ORIX provided supplemental briefing on whether "the public policy exception to enforcement of choice of law provisions requires that the Court apply California rather than New Mexico law" and whether "under California law

the late penalty would not be enforceable." (3 AA 662.) These legal issues, presented on stipulated facts and documents, were squarely before the trial court even before it rendered any decision and could have been raised in the first instance even on appeal. (Cf. *C9 Ventures v. SVC-West, L.P.* (2012) 202 Cal.App.4th 1483, 1492 [party may change legal theory even on appeal so long as new theory presents question of law based on undisputed facts].)

Nor were the core elements for judicial estoppel satisfied. Judicial estoppel generally requires that a party *achieve success* from a *factual* position taken in litigation. (*New Hampshire v. Maine* (2001) 532 U.S. 742, 750-751 [121 S.Ct. 1808, 1815, 149 L.Ed.2d 968] ["Absent success in a prior proceeding, a party's later inconsistent position introduces no 'risk of inconsistent court determinations,'. . . and thus poses little threat to judicial integrity," citation omitted]; *Aguilar*, *supra*, 32 Cal.4th at pp. 986-987 [for judicial estoppel to apply, party must have been successful in asserting first position].) Guarantors did not achieve any success attributable to arguing that New Mexico law applied; the trial court identified none.

Another missing requirement is that the party's positions be "totally inconsistent." *Aguilar*, *supra*, 32 Cal.4th at p. 987. There is nothing inconsistent about arguing that New Mexico law governs the contract in the first instance but that if somehow New Mexico law would allow collection of an illegal late fee, then it is nevertheless unenforceable in California courts under the California public policy exception. The latter argument *assumes* the former. Guarantors accept that the parties chose New Mexico

law as governing the Guaranty in the first instance—and, as demonstrated above, the late fee can *not* be collected from Guarantors under New Mexico law. But that does not obviate an inquiry—if the court were to determine the late fee *can* be collected from Guarantors under New Mexico law—into whether doing so would violate fundamental *California* public policy.

But even were all of the requirements for judicial estoppel satisfied, it *still* would be inappropriate to invoke the doctrine here because what is at stake is violation of fundamental California public policy. "Consistent with [its] purposes, numerous decisions have made clear that judicial estoppel *is an equitable doctrine*, and its application, even where all necessary elements are present, is discretionary." (*MW Erectors, Inc.*, *supra*, 36 Cal.4th at p. 422, emphasis added.) Thus, *MW Erectors* rejected application of judicial estoppel where it would contravene California's strong public policy against allowing a contractor to recover for work done while unlicensed. (*Id.* at pp. 422-424.)

Even if its requirements were met, therefore, judicial estoppel would be unavailable in this case. "An illegal contract is void; it cannot be ratified by any subsequent act, 'and no person can be estopped to deny its validity.'" (*Downey Venture, supra*, 66 Cal.App.4th at p. 511, citations omitted.) "It is clear that estoppel cannot be relied upon to defeat the operation of a policy protecting the public." (*Ibid.*) "[E]stoppel cannot operate as against positive law or public policy." (*Panzer-Hamilton Co., supra*, 96 Cal.App. at p. 464.) Thus, the illegality of a penalty provision "'may be raised at any

time, in the trial court *or on appeal*, by the parties or on the court's own motion.'" (*Cook, supra*, 40 Cal.App.3d at p. 793, emphasis added.)

No matter what else, as a matter of fundamental California public policy, the Guaranty's waiver provision is unenforceable in this action.

II.

IN ANY EVENT, THE TRIAL COURT ERRED IN READING THE LATE FEE AS CONTRACTUALLY APPLICABLE HERE.

There is another problem with Orix's case: Under basic principles of collateral estoppel and contract construction, no late fee ever applied to the balloon payment.

A. The Bankruptcy Court Conclusively Determined That The Late Fee Never Applied To The Balloon Payment Here.

The bankruptcy court expressly interpreted the late fee as being inapplicable to the final, balloon payment. (2 AA 337-338.) The court reasoned that the parties could not reasonably have intended for the same late fee that applied to monthly payments to apply to a final balloon payment on maturity. (*Ibid.*, citing, inter alia, *Poseidon Development, supra*, 152 Cal.App.4th at pp. 1115-1116 ["no reason to believe that processing and accounting expenses from failure to make an installment payment would vary appreciably depending on the amount of the overdue payment"; while overdue interim installment payment would result in $600 late charge, overdue final payment would result in a $78,000 late charge].)

That determination is as much a matter of collateral estoppel as the bankruptcy court's illegality determination. (See Argument I.A.1, *ante*.)

If no balloon-payment late fee was ever due, there was nothing to guaranty in the first place: the purported late fee was never part of the "Debt and all obligations of Borrower to Lender *under the Loan Documents*" for which Guarantors could be liable under the Guaranty. (1 AA 168 ¶ 1.2, emphasis added.)

B. Under The Express Terms Of The Loan Documents, The Trial Court Erred In Concluding That The Late Fee Applied; The Note And Deed Of Trust Excise Any Illegal Obligation From Amounts To Be Guaranteed.

The bankruptcy court's finding that the late fee constitutes an invalid penalty place it outside the guaranteed obligations for an additional reason: The Deed of Trust (and hence the guaranteed Note which incorporated it) directs that "[i]f any term, covenant or condition of the Note or this Deed of Trust is held to be invalid, illegal or unenforceable in any respect, *the Note and this Deed of Trust shall be construed without such provision.*" (1 AA 132 ¶ 47, emphasis added; see also 1 AA 83.)[9] "[A]bsent evidence indicating a contrary intention, 'instruments executed at the same time, by

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[9] The trial court refused to consider this provision in the Deed of Trust, claiming that it was raised too late—in objections to the proposed statement of decision. (3 AA 692 ¶ 17.) But contract interpretation is a question of law. (*Parsons*, *supra*, 62 Cal.2d at p. 865; *Levenson*, *supra*, 934 P.2d at p. 307].) And questions of law on undisputed facts (as here) can be raised at any time, even on appeal. (*C9 Ventures*, *supra*, 202 Cal.App.4th at p. 1492 [new legal issue properly raised on appeal in case, as here, tried on stipulated facts].)

the same parties, for the same purpose, and in the course of the same transaction, are, in the eye of the law, one instrument, and will be read and construed together." (*Levenson, supra*, 300 P.2d at p. 305.) This "savings" provision, thus, is as applicable to the guaranteed Note as it is to the Deed of Trust.

As the trial court repeatedly acknowledged, the bankruptcy court found the late fee invalid. (3 AA 681-684.) According to the Deed of Trust, that means that both it and the Note must be construed "without such provision," that is, as *not* including the late fee. Accordingly, the Borrower *never undertook* the illegal late-fee obligation in the first place, and no such obligation was ever guaranteed. The evanescent late fee formed *no* part of obligations for which Guarantors could be liable under the Guaranty.

C. The Loan Documents, At A Minimum, Are Ambiguous As To Whether Waivers Of Public Policy Constraints Were Intended, Ambiguity Which Must Be Construed Against Orix.

The above straightforward reading of the loan documents reveals that they do *not* include a late fee on the matured principal balance and that they *expressly exclude* any illegal penalty. But, at a minimum, the late fee and Deed of Trust provisions create a conflict with the Guaranty's waiver provision and render the agreement ambiguous. As the bankruptcy court pointed out, "[u]nder New Mexico law a contract is ambiguous if separate sections appear to conflict with one another or when the language is reasonably and fairly susceptible of more than one meaning." (2 AA 312,

citing *Heye v. American Golf Corp., Inc.* (Ct.App. 2003) 134 N.M. 558, 563 [80 P.3d 495, 500] [citing *Allsup's Convenience Stores, Inc. v. N. River Ins. Co.* (1999) 127 N.M. 1 [976 P.2d 1].])

And any ambiguity must be resolved in favor of Guarantors. "A guarantor is similar to a surety, is a favorite of the law, is entitled to a strict construction of his agreement, and 'his liability is not to be extended by implication beyond the express limits or terms of the instrument or its plain intent.'" (*Levenson, supra*, 300 P.2d at p. 306; see also *Airlines Reporting Corp. v. United States Fidelity & Guaranty Co.* (1995) 31 Cal.App.4th 1458, 1464 [surety not liable for anything that extends beyond the letter of its contract and surety's obligation is strictly construed not to impose burden not contained in or clearly inferable from contract language.].)

D. The Court Erred In Concluding That Guarantors Agreed To Waive Even Public Policy Violations In The Note's Provisions.

A similar analysis applies to the Guaranty's waiver provision. In concluding that the Guaranty's waiver provision applied here, the court erroneously relied on two provisions—paragraphs 1.4 and 2.4—while eschewing a critical third provision—paragraph 3.5. (3 AA 679-680.)

Paragraphs 1.4 and 2.4, respectively, provided that Guarantors' obligations would "not be reduced, discharged or released because or by reason of any existing or future offset, claim or defense of Borrower" or by the "[t]he invalidity, illegality or unenforceability of all or any part of the Guaranteed Obligations, ..." (1 AA 169 ¶ 1.4, 171 ¶ 2.4.)

The trial court relied on these "waivers in the Guaranty" to find Guarantors liable for the late fee. (3 AA 679-681.) But another provision of the Guaranty, paragraph 3.5, provides that the Guaranty "is enforceable in accordance with its terms, except as limited by bankruptcy, insolvency or *other laws of general application relating to the enforcement of creditors' rights*." (1 AA 174.)

The trial court expressly refused to apply "the general law of contracts, in particular, unenforceability of illegal penalties, [as] limit[ing] the terms of the Guaranty." (3 AA 683.) But, as discussed above, principles of illegality, public policy, and unconscionability apply as much to guaranties as to any other contract. And, as discussed above, the Guaranty has to be construed in conjunction with the Note, the provisions of which are incorporated by reference. (*Levenson, supra*, 300 P.2d at p. 305]; see also *Cates Construction, supra*, 21 Cal.4th at pp. 39-40.) A provision cannot be unenforceably illegal under one but not under the other.

Further, at a minimum these provisions render the agreement ambiguous, and guaranties are strictly construed so as not to expand the liability of guarantors. (*Levenson, supra*, 300 P.2d at 306; *Airlines Reporting Corp., supra*, 31 Cal.App.4th at p. 1464.) Here, the Guaranty expressly limits liability in accordance with generally applicable laws. The trial court erred in extending liability beyond that to an obligation—the late fee—that violates public policy by imposing an invalid penalty.

CONCLUSION

This is a classic case of using semantic formalism to create a manifest injustice at odds with more general, fundamental legal principles. Respondent persuaded the trial court to enforce against appellants a provision conclusively declared to be an illegal penalty by a United States bankruptcy court. Neither New Mexico nor California law or public policy justifies such an egregiously wrong result.

For the foregoing reasons, the judgment must be reversed, with instructions to enter judgment in appellants' favor.

DATED: April 2, 2012

Respectfully submitted,

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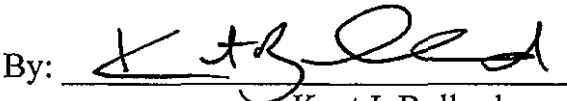
By: 
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CERTIFICATION

Pursuant to California Rules of Court, Rule 8.204(c)(1), I certify that this **APPELLANTS' OPENING BRIEF** contains 11,285 words, not including the tables of contents and authorities, the caption page, signature blocks, or this Certification page.

DATED: April 2, 2012

Kent J. Bullard

PROOF OF SERVICE

STATE OF CALIFORNIA, COUNTY OF LOS ANGELES

I am employed in the County of Los Angeles, State of California. I am over the age of 18 and not a party to the within action; my business address is 5900 Wilshire Boulevard, 12th Floor, Los Angeles, California 90036-3697.

On **April 2, 2012**, I served the foregoing document described as **APPELLANTS' OPENING BRIEF** on the interested parties in this action by placing a true copy thereof enclosed in sealed envelopes addressed as follows:

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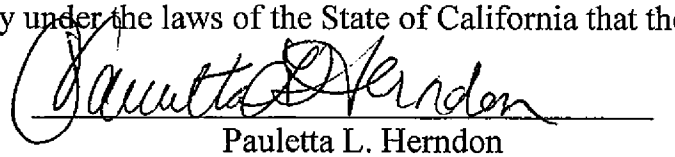
(✓✓) By Federal Express: by placing ( ) the original (✓✓) a true copy thereof enclosed in a sealed envelope addressed to the respective address(es) of the party(ies) stated above and placed the envelope(s) for collection and pickup, following our ordinary business practices:

As follows: I am "readily familiar" with this firm's practice of collection and processing correspondence for delivery by Federal Express. Under that practice, it would be deposited with Federal Express on that same day at Los Angeles, California, in the ordinary course of business. I am aware that on motion of party served, service is presumed invalid if date is more than 1 day after date of deposit.

Executed on **April 2, 2012**, at Los Angeles, California.

I declare under penalty of perjury under the laws of the State of California that the above is true and correct.



Pauletta L. Herndon