2d Civil No. B237360

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION 1

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

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INTRODUCTION

Try as it might, respondent ORIX cannot hide the fundamental circumstance here: It is seeking to enforce against appellant Guarantors a contractual penalty provision that is unenforceable as against public policy equally under New Mexico and California law. What is against public policy to enforce against a borrower is against public policy to enforce against a guarantor. A "pound of flesh" is no more acceptable because it is sought against the guarantor (Antonio) than it would be against the borrower (Bassanio). (Shakespeare, The Merchant of Venice, act IV, scene 1, line 307.) One cannot "waive" public policy, one cannot "waive" illegality. Guarantors' predecessor (the original guarantor) could not be forced to do so nor could Guarantors when they assumed the Guaranty.

Not only is ORIX's position wrong as a matter of fundamental principles and fairness, it is equally wrong as a matter of legal doctrine. California public policy applies to lawsuits brought in this State. It supervenes another state's silence on a subject. It is undeniable that the provision sought to be enforced here—a pure, windfall, penalty provision—is against California public policy. Nor is New Mexico law different. Nothing in New Mexico law relieves guaranties from the same public policy constraints that apply to other contracts. New Mexico bars substantively unconscionable contract terms and terms that violate public policy.

The centerpiece, indeed the lynchpin, of ORIX's argument is that the Guaranty waives any and all illegality. But if that onerous provision is not enforceable, then ORIX's whole argument collapses. ORIX cannot contest

that the late fee penalty is illegal, unconscionable, and unenforceable as violating public policy under either or both New Mexico or California law. There is no way that the blanket waiver of illegality can be enforceable. ORIX cites no case enforcing such a waiver of illegality provision anywhere in the United States, for there is none. It cites and can cite no case allowing a provision unenforceable *as a matter of public policy* against a borrower to nonetheless be enforced against a guarantor.

This is not the mere waiver of a procedural defense; it is an attempt to enforce a penal, substantive contract provision that is against public policy. Nowhere does ORIX begin to explain how such can be justified. And if ORIX can enforce illegal penalty provisions under its interpretation, why can't it enforce penalties for subletting to minorities or provisions requiring other untoward conduct? ORIX never explains why any such provision would be different than the penal late fee here; the necessary implication of its argument is that it would not be. Rather, ORIX's attitude is that somehow illegal penalty provisions in guaranty contracts should not be considered "as" contrary to public policy as other illegal provisions. That is not the law.

The judgment should be reversed with directions to enter judgment in Guarantors' favor and to award Guarantors their attorney's fees.

ARGUMENT

I.

THIS COURT'S DE NOVO REVIEW ALLOWS IT TO ADDRESS ANY LEGAL ISSUE AFFECTING THE QUESTION ON APPEAL.

As ORIX begrudgingly acknowledges, the pure questions of law based on undisputed facts here are subject to de novo review on appeal. (Respondent's Brief ("RB") 15.) The central issue here—enforceability of a penal late fee against a guarantor after the same late fee has been determined to be unenforceable as a violation of public policy against the borrower—involves precisely such questions subject to this Court's de novo review. (See authorities listed in Appellants' Opening Brief ("AOB") 22.) ORIX fails to identify a single issue that does not invoke this Court's independent, law-explicating function.

Instead, ORIX asks this Court to turn a blind eye to the law as it relates to arguments that ORIX thinks were not set forth in precisely the same form in the trial court. ORIX provides no valid basis to do so.

First, much of ORIX's complaint is that additional *authorities* are presented on appeal for issues that, in fact, were squarely raised in the trial court. (E.g., RB 16 [repeating three times that "none of the *authorities*" cited in the AOB were cited in the trial court], emphasis added.) But there is *no* prohibition in doing so, let alone where the issues on appeal are ones of law: "Simply put, [ORIX is] wrong. [It] confuse[s] the concepts of new issues not presented below—which generally cannot be raised for the first time on appeal . . . with new legal authority for the issue being appealed.

We are aware of no prohibition against citation of new *authority* in support of an *issue* that was in fact raised below . . . ." (*Giraldo v. California Dept. of Corrections & Rehabilitation* (2008) 168 Cal.App.4th 231, 251, internal citations omitted.)

Second, "'[t]here are many situations where appellate courts will consider [matters raised for the first time on appeal]. They will often be considered where the issue relates to questions of law only.'" (*Resolution Trust Corp. v. Winslow* (1992) 9 Cal.App.4th 1799, 1810, brackets in original, citation omitted.) Indeed, "[t]he general rule confining the parties upon appeal to the theory advanced below is based on the rationale that the opposing party should not be required to defend for the first time on appeal against a new theory that 'contemplates a factual situation the consequences of which are open to controversy and were not put in issue or presented at the trial.'" (*Ward v. Taggart* (1959) 51 Cal.2d 736, 742, citation omitted.) "Consequently, 'an appellate court may allow an appellant to assert a new theory of the case on appeal where the facts were clearly put at issue at trial and are undisputed on appeal.'" (*Mansouri v. Superior Court* (2010) 181 Cal.App.4th 633, 639, citation omitted; accord *Peterson Development Co. v. Torrey Pines Bank* (1991) 233 Cal.App.3d 103, 117, fn. 11; cf. *Yee v. City of Escondido* (1992) 503 U.S. 519, 534-535 [federal takings claim properly raised in state court could be supported in Supreme Court by argument even if argument not raised below].)

The facts here are undisputed. They appear on the face of the contractual documents that the parties stipulated were the record. ORIX has not even suggested how any issue on appeal would involve any different

factual showing. And, the issue presented—contract construction on undisputed facts—is one of pure law for de novo review. Again, there is on-point authority: "[E]ven if we were to accept the . . . assertion that a line of analysis . . . *was* a new issue, it is clearly one susceptible to appellate analysis *now* because it is the archetypical 'issue of law'—construction of language in a contract" under undisputed facts. (*Behniwal v. Mix* (2005) 133 Cal.App.4th 1027, 1038, fn. 13.) That is exactly the case here.

Contrary to ORIX's arguments (see RB 15), a party *may* change its legal theory, even on appeal, as long as the new theory presents a question of law based on undisputed facts. (*C9 Ventures v. SVC-West, L.P.* (2012) 202 Cal.App.4th 1483, 1492.) Even one of the cases *ORIX* cites (RB 15)—*Curcio v. Svanevik* (1984) 155 Cal.App.3d 955, 960—points this out: "[T]he exception to this rule [against changing theories on appeal] exists where a question of law only is presented on the facts appearing in the record."

And the same rule applies in the trial court. It should not turn a blind eye to "late-raised" issues of pure law on undisputed facts and when it does the appellate court will address the issue: "The trial court concluded that appellants had forfeited [their] contention by failing to present it in a timely manner before trial, but nonetheless proceeded to address and reject it on the merits. Because the contention presents a question of law on essentially undisputed facts, we examine it on appeal." (*Planning & Conservation League v. Castaic Lake Water Agency* (2009) 180 Cal.App.4th 210, 234, fn. 17, citation omitted.)

Thus, ORIX's repeated protestations that unconscionability was not adequately raised below (e.g., RB 12, 16, 26) are unfounded. Guarantors raised the issue in their objections to the trial court's statement of decision, and the court *addressed* this purely legal argument on the merits by referring to its existing discussion of enforceability of the Guaranty's waiver provision. (3 Appellants' Appendix ("AA") 691, ¶ 12 [trial court response to objections to statement of decision, cross-referring to ¶ 8, which in turn refers to court's discussion upholding enforceability of waiver provision at 3 AA 686-688].)

Likewise, ORIX's invitation to ignore Section 47 of the Deed of Trust (e.g., RB 16-17, 42-43)—under which the illegal late fee never even applied—is baseless. In the trial court, Guarantors repeatedly raised the issue of whether the late fee ever applied at all. (E.g., 2 AA 392-393, 3 AA 608.) As acknowledged in the opening brief, the trial court refused to consider this specific Deed of Trust provision ostensibly because it was raised too late. (AOB 48, fn. 9 [citing 3 AA 692 ¶ 17].) But as just demonstrated, that simply was not a proper reason. The provision is part and parcel of the contract that the trial court was interpreting, and that this Court must interpret, on undisputed facts. As such, the provision presents a pure issue of law. Such questions 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].)[1/]

[1/] ORIX's claim that a party can only raise additional legal issues in a Code of Civil Procedure section 662 *post*-judgment motion to vacate and not in objecting to a statement of decision (RB 17) is unsupported by any

(continued...)

The bottom line is that the arguments raised in the opening brief—all addressing pure questions of law based on an undisputed and immutable factual record—are all properly before this Court in its de novo review on quintessential questions of law: the proper construction and enforceability of written contract language.

II.

THE PENAL LATE-FEE PROVISION IS UNENFORCEABLE AGAINST THE GUARANTORS UNDER BOTH NEW MEXICO AND CALIFORNIA LAW AND THUS POSES NO CONFLICT OF LAW.

ORIX spends a lot of effort arguing that this Court should ignore on-point California law and New Mexico authority adopting the same general

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[1/] (...continued)
authority and makes no sense. Under Code of Civil Procedure section 634 and California Rules of Court, rule 3.1590(g), a party may raise any omitted issue in responding to a proposed statement of decision.

Likewise, ORIX's argument that Guarantors somehow "invited" the trial court's error is specious—ORIX points to no "'deliberate trial strategy'" not to advert the trial court to the provision sooner. (RB 17, quoting *Mesecher v. County of San Diego* (1992) 9 Cal.App.4th 1677, 1686.) In any event, the doctrine would not apply. Invited error is directed at invited rulings, not at arguments made. (*Giuliano v. Inland Empire Personnel, Inc.* (2007) 149 Cal.App.4th 1276, 1290 ["The doctrine of invited error does not apply, however, because [the party] did not request an erroneous ruling. . . . In this case, the doctrine of invited error does not apply because [the party] never asked the trial court to invalidate the arbitration agreement under *Armendariz*, but argued against doing so"].) Guarantors consistently argued against enforcing the late fee, not the contrary. As discussed in the text, pure issues of law (even if contrary to a legal position taken in the trial court, see pp. 23-24, *post*) can be raised for the first time even on appeal to support a position—non-enforcement—taken in the trial court.

rule and instead focus myopically on at best tangentially relevant New Mexico authorities and from them interpolate the wide-ranging, anything-goes-in-a-guaranty rule that ORIX advocates. Nothing in New Mexico law supports ORIX's construct. ORIX attempts to invent a conflict that does not exist. Its approach skips the first step in any choice of law analysis (including one involving a choice of law clause). That first step is to determine whether the law in New Mexico even *conflicts* with that in California (the forum state). If it doesn't there's no choice of law to be made and the law of both jurisdictions applies equally. Thus, "[f]irst, the court determines whether the relevant law of each of the potentially affected jurisdictions with regard to the particular issue in question is the same or different." (*Kearney v. Salomon Smith Barney, Inc.* (2006) 39 Cal.4th 95, 107.) Only "if there is a difference, [does] the court examine[] each jurisdiction's interest in the application of its own law under the circumstances of the particular case to determine whether a true conflict exists." (*Id.* at pp. 107-108) "The fact that two states are involved does not in itself indicate that there is a 'conflict of laws' or 'choice of law' problem." (*Hurtado v. Superior Court* (1974) 11 Cal.3d 574, 580.)

Any New Mexico-California dichotomy here is a nonissue and a red-herring. That the contract chose New Mexico law in the first instance makes no difference if the law in New Mexico and California is congruent. As we now discuss, the law in New Mexico and California is consistent. In *both* New Mexico and California, public policy bars contractual penalty provisions. In *both* New Mexico and California, a contracting party (whether borrower, guarantor, or something else) may waive certain

procedural protections, but no party may contractually waive public policy and illegality.

A. Under Both New Mexico And California Law, A Contractual Penalty Provision Is Unenforceable As Against Public Policy.

ORIX does not dispute that its "late fee" in this context is other than a pure, windfall penalty without any economic justification. The bankruptcy court so found as to the borrower and ORIX proffers no distinguishing justification as to the guarantors.

The law across the country is clear that such contractual penalty provisions are unenforceable as against public policy. That's the position of the Restatement Second of Contracts, section 356. (See also 24 Williston on Contracts (4th ed. 1995) § 65:1.) ORIX does not even mention these authorities or this universal rule, let alone dispute it. (See AOB 12-14, 30.) As explained by a New Mexico court in a case that ORIX studiously ignores, New Mexico follows the Restatement rule: "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 v. Yates Petroleum Corp.* (Ct.App. 1997) 123 N.M. 526, 531-532 [943 P.2d 560, 565-566] [citing the Restatement Second of Contracts, section 356].) The New Mexico bankruptcy court likewise opined. (2 AA 326-327.) As the bankruptcy court explained, "'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.)

And, it is abundantly clear that contract provisions that are against public policy are as unenforceable in New Mexico as they are in other states, including California. New Mexico courts "will not enforce a contractual provision that violates public policy." (*Padilla v. State Farm Mutual Automobile 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].) Guaranties are not exempt from this universal rule in New Mexico. Even a guaranty contract's "plain language" is unenforceable 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, 263 [861 P.2d 935, 944].) There is no hint that New Mexico is some rogue jurisdiction allowing illegality that no other jurisdiction would countenance.

California recognizes this same universal principle, applying it to the precise circumstance here. (*Garrett v. Coast & Southern Federal Savings & Loan Assn.* (1973) 9 Cal.3d 731, 741 [late payment measured against unpaid balance of loan was unenforceable penalty]; *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]; see *Ridgley v. Topa Thrift & Loan Assn.* (1998) 17 Cal.4th 970,

981, fn. 5 [public policy bar to contractual penalties applies as much in commercial context as consumer context].) That New Mexico may not have had occasion to consider the precise facts here (as California has) does not suggest that there is any difference between New Mexico and California law. Rather, New Mexico and California both conform to the same, universal Restatement rule: contractual penalty provisions are against public policy and thus unenforceable.

And ORIX does not and cannot dispute the bankruptcy court's determination that the late fee constitutes an illegal penalty, a determination that collaterally estops ORIX. (See AOB 25-27.) Rather, ORIX narrowly misconstrues Guarantors' argument as simply that because the late fee is not enforceable against the borrower, it is not enforceable derivatively against the guarantors, whose obligations are purely derivative of the borrower's. But that's not the argument. The argument is that the penalty provision is not enforceable against Guarantors even it were a direct obligation that applied only under the Guaranty. It's unenforceable as a penalty, not just because the borrower owed no such obligation.

ORIX utterly fails to grapple with Guarantors' argument that the late fee is unenforceable against the guarantor because it is a public-policy-barred, penalty provision. Period. It is independently unenforceable and illegal as against the guarantor. The violation of public policy need not be derivative of the borrower. The penalty provision is unenforceable as a promise directly made by the guarantors. It is as much an illegal penalty provision as against the guarantor as it is against the borrower. The provision does not change its illegal stripes just because enforcement is

sought against a different party. And it is for the benefit of the public, not particular parties, that courts refuse to be tools used to enforce contracts that violate public policy. (See AOB 29.)

Nor does ORIX's attempt to refute even its artificially narrow version of Guarantors' argument succeed. As demonstrated in the opening brief, under the widely accepted principles set out in the Restatement, the late fee's illegality under the Note infects the Guaranty as well because the two documents must be read together. (AOB 27-28.) ORIX suggests the Restatement and California principles do not apply under New Mexico law. (RB 22-23.) But on the contrary, "[f]or authoritative guidance on the common law [New Mexico courts] look to the Restatement." (*Venaglia v. Kropinak* (Ct.App. 1998) 125 N.M. 25, 30 [956 P.2d 824, 829]; see also *id.* at p. 29 [956 P.2d at p. 828] [identifying Restatement Third of Suretyship and Guaranty].) And, under New Mexico law, guaranties are contracts subject to "all of the general rules regarding application and construction of contracts." (*WXI/Z Southwest Malls v. Mueller* (Ct.App. 2005) 137 N.M. 343, 346 [110 P.3d 1080, 1083].) One of those principles is that "absent evidence indicating a contrary intention, 'instruments executed at the same time, by 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 v. Haynes* (Ct.App. 1997) 123 N.M. 106, 112 [934 P.2d 300, 305]; see AOB 48-49; see also *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 39-40 [surety agreement and underlying agreement must be read together].) Thus, that a guaranty may be a separate contract from a loan does not mean this Guaranty—which refers

on its face to the Note (1 AA 167 [Guaranty recitals referring to Note "dated of even date herewith" and other loan documents])—can escape illegality appearing on the face of the loan agreement. (E.g., *Automotive Finance Corp. v. Ridge Chrysler Plymouth L.L.C.* (N.D.Ill. 2002) 219 F.Supp.2d 945, 956 [illegal prepayment penalty "can no more be enforced against [guarantor] than it can be against [borrower]"].)

Section 117 of the Restatement of Security "addresses the availability of the defense of illegality to a surety," and the comment to the section summarizes the uniform rule: "'Where the principal's promise is itself illegal in its inception, and the performance of the surety's contract is subject to the laws of the same jurisdiction as that of the principal, it is against public policy to give legal effect to the surety's obligation.'" (*WRI Opportunity Loans II LLC v. Cooper* (2007) 154 Cal.App.4th 525, 543, citing Rest., Security, § 117, com. d, p. 313.) Cases to this effect are longstanding, legion, and widespread.[2/]

[2/] E.g., *Bassidji v. Goe* (9th Cir. 2005) 413 F.3d 928, 930 [guaranty signed in Hong Kong and ostensibly governed by its law unenforceable as underlying contract violated Executive Order barring trade with the government of Iran]; *McGinley v. Massey* (1987) 71 Md.App. 352, 361 [525 A.2d 1076, 1080] [rejecting plaintiffs' argument that the guaranty was enforceable separately from the underlying agreement and stating "[a] promise of guaranty . . . cannot exist without reference to the obligation that it secures. When the principal obligation is illegal and therefore unenforceable, 'enforcement [of the guaranty] would . . . defeat the intention of the legislature or the policy of the law which declared the [principal] obligation illegal.' . . . [T]he guaranty securing the agreement, even if viewed as a separate transaction, is not separately enforceable," citations omitted]; *Savin Corp. v. Copy Distributing Company, Inc.* (Tex.Ct.App. 1986) 716 S.W.2d 690, 692 [where underlying contract

(continued...)

The bottom line: The penal late fee is unenforceable against the Guarantors.

B. The Late-Fee Penalty Provision Is Also Unenforceably Unconscionable.

ORIX does not and cannot contend that the rules of unconscionability do not ordinarily operate as much as regards to guarantors as to any other contracting party. Again, that is the generally applicable law across the country recognized in the Restatement of Suretyship and Guaranty (and thereby in New Mexico). "The secondary obligation [i.e., the guaranty] 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

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[2/] (...continued)
violated state antitrust laws, guaranty agreement was unenforceable: "'If [the creditors] require any aid from the illegal contract to establish their case, they should not be permitted to recover. . . . To hold otherwise would place the court in the unenviable position of enforcing the provisions of an unlawful contract.' A guaranty based on an illegal contract is as unenforceable as the contract itself," citations omitted]; *International Multifoods Corp. v. Mardian* (S.D. 1985) 379 N.W.2d 840, 844 ["It is . . . axiomatic that the parties to a [guaranty] contract are free to construct their agreement and understanding as they see fit—except for those contracts which violate the law or public policy"]; *Dean Leasing, Inc. v. Van Buren County* (1989) 27 Ark.App. 134, 140 [767 S.W.2d 316, 319] ["A promise of guaranty will not be enforced when the obligation which it secures is invalid or illegal"]; *Metropolitan Model Agency USA, Inc. v. Rayder* (N.Y. 1996) 168 Misc.2d 324, 326-327 [643 N.Y.S.2d 923, 925-926] ["The court will not permit plaintiff to collect damages under the guaranty since to do so would effectively avoid the State's public policy"]; *Southern Cotton Oil Company v. Knox* (1919) 202 Ala. 694 [81 So. 656, 658] [where underlying contract was illegal because it was made to destroy competition, guaranty contract was also illegal and unenforceable].

to act within the confines of the contract." (Rest.3d Suretyship & Guaranty, § 48(1) & com. a, pp. 208-209, emphasis added.) ORIX does not and cannot dispute that this general rule that the unconscionability doctrine applies as much to guaranty contracts as to any other applies in New Mexico. (E.g., *WXI/Z Southwest Malls, supra*, 110 P.3d at p. 1084.)

ORIX's emphasis on procedural unconscionability cases (RB 27-28) is misplaced. ORIX does not and cannot contest that "[u]nder 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.) An "inherently one-sided agreement" or one that is "grossly unreasonable" or "that unreasonably benefit[s] one party over another" is against public policy and unenforceably unconscionable. (*Cordova v. World Finance Corp. of N.M.* (2009) 146 N.M. 256, 259, 263, 264 [208 P.3d 901, 904, 908, 909]; see *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"].) Such substantive unconscionability inheres in provisions that are simple penalty, windfall grabs with no economic justification, as here. (See *Carboni v. Arrospide* (1991) 2 Cal.App.4th 76, 80 [no legitimate business interest in 200% interest rate, which was ten times the prevailing rate].)

Thus, the penalty is unconscionable under the chosen New Mexico law and ORIX has not demonstrated otherwise.[3/]

C. The "Waiver of Illegality" Provision Is Unenforceable; Refusing To Enforce That Provision Does Not Lessen The Rule That A Guarantor Can Agree To Be Liable When The Borrower Is Not.

That brings us to what is really ORIX's fulcrum, indeed, essentially only, argument: that a guarantor, unlike other contracting parties, is free to have contractually imposed on it a waiver of illegality and public policy. ORIX cites *no* case in New Mexico, California, or anywhere else, so holding. It does not do so because there is none. That simply is not the law anywhere.

[3/] California may require at least a modicum of both substantive *and* procedural unconscionability. (See *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, 114 [noting that "prevailing view" requires both].) Even so, "the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa." (*Ibid.*) Certainly, California has no strong public policy for the possible additional procedural unconscionability requirement, especially where the language is boilerplate and rather than being directly negotiated was assumed by Guarantors, who replaced the prior guarantor on a pre-existing guaranty. (1 AA 4; 2 AA 288, 296; see 2 Madison et al., Law of Real Estate Financing (2011) § 17:26, fn. 1 [noting that "most lenders will entertain few if any comments to the guaranty waiver language" and that it "has essentially become boilerplate not open for discussion"].) In any event, unconscionability under California law is redundant. The provision is undeniably illegal and unenforceable under California law. The *result*—unenforceability—is consistent under both New Mexico and California law.

Rather, the consistent law is that a contract—any contract, including a guaranty contract—cannot waive illegality. (*Wells v. Comstock* (1956) 46 Cal.2d 528, 533 [refusing to enforce illegal provision *as against a guarantor*]; *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]; *WRI Opportunity Loans, supra*, 154 Cal.App.4th at p. 544 [guaranty; illegal usury provision].) This is not some special California rule, this is the general law across the country, as our Supreme Court recognized in *Wells, supra*, in which it relied on the Restatement of Security, section 117. (*Wells, supra*, 46 Cal.2d at p. 533.) Indeed, the "general rule" distilled from jurisdictions throughout the country is that "an illegal contract cannot be validated by a waiver of its illegality, . . . and the defense of illegality available to a party cannot be waived . . . by agreement." (17A Am.Jur.2d (2004) Contracts, § 309 [collecting cases], footnotes containing citations omitted.)

Even in litigation, public policy cannot be waived. (*Nyhus v. Travel Management Corp.* (D.C. Cir. 1972) 466 F.2d 440, 447, 448 ["Invalidity of a contract offensive to public policy cannot be waived by the parties"; issue could not be waived by failure to plead].) It would be remarkable if parties could do by contract what they cannot do in open court. Indeed, as demonstrated in the opening brief, and unrebutted by ORIX, the Guaranty's *own terms* constrain its enforcement according to "laws of general

application relating to the enforcement of creditors' rights." (1 AA 174, ¶ 3.5; see AOB 50-51.)[4/]

Rather, ORIX attempts to piece together from cases that allow waiver of certain purely *procedural* protections (see RB 20-21) a syllogism that because procedural steps can be waived, *substantive* public policy constraints and substantive illegality can be waived. But the attempt to extrapolate is entirely unfounded. Guarantors do not dispute that a guarantor in certain circumstances can be held liable when the borrower *no longer* is, e.g., when the borrower has been discharged in bankruptcy. As explained in the opening brief, the opinion in *Ward v. First Nat. Bank in Albuquerque* (1980) 94 N.M. 701, 703 [616 P.2d 414, 416]—cited by the trial court (3 AA 686) and ORIX (RB 21, 34)—merely illustrates this accepted proposition. And as also explained in the opening brief and unrebutted by ORIX, there was no such relief or discharge in bankruptcy here; instead, in the bankruptcy action, ORIX collected everything that it was owed and was denied only the same illegal late penalty at issue in this case. (See AOB 37-38.)

Likewise, there is no dispute that a guarantor—whether under New Mexico or California law or under the general rules set forth in the Restatement—can waive certain *procedural* protections, e.g., statutorily

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[4/] In the opening brief, Guarantors demonstrated that the trial court's refusal to apply this provision contravened principles of illegality, public policy, unconscionability, and strict construction so as not to expand the liability of guarantors. (AOB 50-51.) ORIX responds only that "[t]he Trial Court's analysis of Section 3.5 needs no further elucidation." (RB 44.) We agree. The analysis is simply wrong.

specified notice or the conditions on the sale of collateral, or requirements to proceed against collateral. (See Civ. Code, § 2856 [specifically allowing guarantors to waive anti-deficiency protections].) To this end, ORIX points out a portion of the Restatement that merely confirms that a guaranty provision waiving standard suretyship defenses (*not* public policy) is not ordinarily unconscionable. (RB 25, citing Rest.3d Suretyship & Guaranty, § 48.)

But that is as far as waiver goes. Just because a contract can waive procedural protections does not mean that it can waive illegality or public policy. The law does not go that far. As the Restatement maintains in multiple places, freedom of contract in guaranties "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 & Guaranty § 6, com. b, p. 29; see also *id.*, § 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"].) Thus, as held in *WRI Opportunity Loans*, a guarantor may contractually waive certain defenses but cannot waive the unenforceability of the principal obligation because of illegality. (154 Cal.App.4th at p. 544 [usury].)

And a "waiver" of illegality or public policy is by definition unconscionable. (*Cordova, supra*, 208 P.3d at 909 ["grossly unreasonable and against [New Mexico] public policy under the circumstances"]; *Fiser v. Dell Computer Corp.* (2008) 144 N.M. 464, 470 [188 P.3d 1215, 1221]

["Substantive unconscionability relates to the content of the contract terms and whether they are illegal, contrary to public policy, or grossly unfair"].) Unconscionability is all the more clear here, where the waiver of illegality is completely one sided. (*Cordova, supra*, 208 P.3d at p. 904 ["inherently one-sided agreement is against New Mexico public policy and is therefore void as unconscionable"].)

ORIX nowhere explains why its theory would not justify a provision that a guarantor would have to pay three times what the borrower owed in the event of borrower default, or would have to agree to become an indentured servant for a set number of years, or would have to pay a penalty amount if the borrower rented or sold to a person of Hispanic or African descent. (Cf. *Bassidji, supra*, 413 F.3d at p. 930, 938-939 [holding California law bars enforcing guaranty of illegal contract to sell goods to Iran and citing *Kashani v. Tsann Kuen China Enterprise Co.* (2004) 118 Cal.App.4th 531, 536-537 (plaintiffs could not legally establish claim based on contract that was illegal and against public policy, as established by executive orders and implementing regulations precluding trade with Iran)].) ORIX argues just that such is not this case, but it provides no principled basis why its anything-in-a-contract-provision-goes theory applies here but not in such other instances. Public policy is public policy. The public policy against penal contract provisions does not have some special disfavored status. Rather, it is strong, longstanding, and virtually universally recognized.

The law—in New Mexico, California, across the country—is that illegality and public policy are not negotiable. They may not be waived.

III.

TO THE EXTENT THAT THERE MIGHT BE A CONFLICT OF LAW, STRONG CALIFORNIA PUBLIC POLICY DOES NOT ALLOW CALIFORNIA COURTS TO ENFORCE CONTRACTUAL PENALTY PROVISIONS.

Even where there is a true conflict in the law between California as forum state and the law of another jurisdiction chosen in the contract, the other jurisdiction's law does not automatically apply. "If . . . there is a fundamental conflict with California law, [and] . . . . California has a materially greater interest than the chosen state, the choice of law shall not be enforced, for the obvious reason that in such circumstance [California courts] will decline to enforce a law contrary to this state's fundamental policy." (*Nedlloyd Lines B.V. v. Superior Court* (1992) 3 Cal.4th 459, 466, footnotes and citation omitted.)

ORIX does not, cannot, dispute that its penal late fee provision violates fundamental California public policy. ORIX points to no New Mexico public policy *favoring* untoward and unfair penalty provisions. That's because there is none. At most, ORIX argues that freedom of contract (or more properly freedom for a lender to impose onerous and unfair terms) is favored in New Mexico—but not to the extent of unconscionability or oppression. In any event, California has a strong interest in enforcing its public policy here.

Defendant Lahave is a California citizen and defendant Top Terraces is a California corporation, and they were at the time of assuming the

Guaranty. The contract was entered into in California. (See 1 AA 234, 238 [Guarantors signed agreement assuming Guaranty as "Substitute Guarantor" on January 12 in California]; 1 AA 233, 236 [plaintiff's predecessor LaSalle Bank signed as "Noteholder," i.e., lender, on January 10 in Texas].) ORIX chose California as the forum state and chose to bring suit here, making California the asserted place of performance. (See Civ. Code, § 1646 [contract to be interpreted according to the law of the place of performance or if none specified according to law of place of contracting].)[5/] Certainly plaintiff Bank of America, for which ORIX services the loan, has extensive business operations in California, making it fair to subject the plaintiff to California norms.

Although the property in the underlying loan is in New Mexico, ORIX is not suing on that loan. It is suing on the Guaranty. And even though a guaranty has to be read in conjunction with the underlying loan agreement, the Guaranty is a separate contract (see Rest.3d Suretyship & Guaranty, § 50, com. a, p. 218 [generally lender may pursue enforcement of guaranty independently of underlying obligation]; *Coppola v. Superior Court* (1989) 211 Cal.App.3d 848, 865-866), as ORIX argues (RB 23; see also ARA 3, fn. 3 [ORIX noting that Guarantors are California citizens under a guaranty that is independent of the note securing payment on the

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[5/] Although the Guaranty stated that it 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]" (1 AA 176 ¶ 5.3), it did not contain any provision identifying a place of performance. (See Appellants' Reply Appendix ("ARA") 5 [in support of writ of attachment, ORIX arguing that Guarantors' contacts are in California as are the assets from which ORIX sought enforcement].)

New Mexico property]). *None* of the parties to the assumed Guaranty—defendant Guarantors as "Substitute Guarantor" or plaintiff's predecessor LaSalle Bank as "Noteholder," i.e., lender—was a New Mexico citizen. (See 1 AA 221-223, 233-234.) New Mexico has little interest in the assumed Guaranty entered into outside of New Mexico between parties none of whom are New Mexico citizens and one of whom has chosen to bring suit in California. Between California and New Mexico, California has the far stronger public policy interest here.

ORIX does not dispute that California's public policy bars the result it seeks but attempts to sidestep California's clear public policy by arguing that "this is a case which cries out for the application of the doctrine of judicial estoppel." (RB 37.) Hardly. In fact, judicial estoppel fails here for multiple reasons:

- Guarantors did not achieve any success attributable to arguing that New Mexico law applied. (See AOB 45; *New Hampshire v. Maine* (2001) 532 U.S. 742, 750-751 [121 S.Ct. 1808, 1815, 149 L.Ed.2d 968] [successful assertion needed for judicial estoppel].) ORIX cites papers in which Guarantors "took [that] position" and lists trial court rulings that, ORIX contends, were "based upon that position" (RB 37-39), but the latter contention is just ipse dixit. ORIX doesn't demonstrate that any ruling hinged on applying uniquely New Mexico law.
- ORIX was allowed to and did fully brief the California public policy issue (3 AA 662, 664-74), which was placed squarely before the trial court on stipulated facts and documents. (See *ABF Capital Corp. v.*

Berglass (2005) 130 Cal.App.4th 825, 832-833 [no judicial estoppel based on "inconsistent *legal* positions asserted in the *same* action"; "The trial court had ample opportunity to examine both positions closely, taking into consideration the opposing party's objection and both parties' argument, which was extensive, and to determine whether defendant had been deceitful in asserting the latter position or, as appears to be the case here, merely had been ignorant when asserting the former position. . . . It consequently was unnecessary to invoke judicial estoppel," internal citation omitted].)

- Judicial estoppel applies to fact issues, *not* questions of law as presented in this appeal. (*Swift & Co. v. Hocking Valley Ry. Co.* (1917) 243 U.S. 281, 289 [37 S.Ct. 287, 289-290, 61 L.Ed. 722 Brandeis, J.] ["If the stipulation is to be treated as an agreement concerning the legal effect of admitted facts, it is obviously inoperative; since the court cannot be controlled by agreement of counsel on a subsidiary question of law"]; *Desny v. Wilder* (1956) 46 Cal.2d 715, 729 ["This court, of course, is not bound to accept concessions of parties as establishing the law applicable to a case"].)
- The positions taken were not "totally inconsistent," as required for judicial estoppel. (See *MW Erectors, Inc. v. Niederhauser Ornamental & Metal Works Co.* (2005) 36 Cal.4th 412, 422.) Guarantors' position—their whole position—was that the late fee provision was illegal and unenforceable against guarantors under New Mexico law. (See, e.g., 1 Respondent's Appendix 236 [Guarantors arguing that under New Mexico law late fee provision

was unenforceable penalty and Guarantors could not waive illegality].) That is entirely consistent with their position on appeal that the late fee provision is illegal and unenforceable against Guarantors under New Mexico law, just as it is under California law and the law across the country and if not illegal under New Mexico law, California public policy *separately* bars enforcement.

- Judicial estoppel is an equitable doctrine that should be rejected when its application contravenes a strong California public policy. (See *MW Erectors, supra*, 36 Cal.4th at p. 422.) Here, the public policy at issue is so strong that illegality of penalty provisions "'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, first emphasis added.)

Equally meritless is ORIX's claim that the trial court supposedly found that Guarantors "had previously *admitted* on a number of occasions that California law did not apply." (RB 37, emphasis in ORIX brief, citing 3 AA 684-686.) Nowhere does the trial court's decision refer to "admissions" by Guarantors. (See 3 AA 684-686.) Rather, the trial court refers to arguments and assertions regarding the choice-of-law issue, not whether California has an overriding public policy. (3 AA 684-685.)

California's public policy is strong and preeminent. California does not allow enforcement of illegal contractual penalty provisions, regardless whether in a guaranty or in some other contract. Period. That policy cannot be defeated by contract language, nor can a party be judicially estopped from relying on it.

IV.

DEFENDANTS NEVER GUARANTEED THE ILLEGAL AMOUNT IN THE FIRST PLACE.

And there is another problem with ORIX's argument. Guarantors only promised to pay amounts that were at least at one time owed by the borrower under the loan: "the term 'Guaranteed Obligations' means the obligations or liabilities of Borrower to Lender." (1 AA 167.) But the late fee penalty was *never* owed by the borrower. That's true for two reasons.

First, an illegal contract term—such as the penalty late fee provision—is void ab initio. (E.g., *Marathon Entertainment, Inc. v. Blasi* (2008) 42 Cal.4th 974, 992 ["'Where a contract has several distinct objects, of which one at least is lawful, and one at least is unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest,'" citation omitted].) ORIX cannot contest that, as to the borrower, the penal late fee was always illegal. Under the loan agreement, "[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.) The penalty late fee provision, thus, by the loan documents' own terms, was excised from and never a part of the "obligations or liabilities of Borrower to Lender." It was never, under the Guaranty's express terms, an amount owed by Guarantors because it was never an obligation or liability of the borrower. (See AOB 48-49.)

Second, the late fee never applied to balloon payments owed. Guaranties are construed strictly to *not* expand guarantors' liability. (*Levenson, supra*, 934 P.2d at p. 306; see also *Airlines Reporting Corp. v. United States Fidelity & Guaranty Co.* (1995) 31 Cal.App.4th 1458, 1464.) It is unreasonable to construe late fees as applying to balloon payments. (*Poseidon Development, supra*, 152 Cal.App.4th at pp. 1115-1116; see also *Montoya v. Villa Linda Mall Ltd.* (1990) 110 N.M. 128, 130 [793 P.2d 258, 260] ["the law favors a reasonable construction of contract language"]; Civ. Code, § 1643 [requiring reasonable interpretation of contract language].) The $377,438.82 sought and obtained by ORIX against Guarantors, thus, was never part of the "obligations or liabilities of Borrower to Lender" and as such was never, under the Guaranty's express terms, an amount owed by Guarantors.

Contrary to ORIX's suggestion, this is not an argument that Guarantors do not owe the penal late fee because it was *no longer owed* by the borrower, i.e., that the borrower was "discharged" or "released" from the obligation. Rather, the argument is that Guarantors do not owe the penal late fee because it was *never* owed by the borrower. In the former situation, under appropriate circumstances (e.g., when the borrower no longer owes an amount due to a bankruptcy discharge), the guarantor might be liable. In the latter situation, however, the guarantor, under the Guaranty's express terms, has no liability because the claimed fee was never an "obligation[] or liabilit[y] of Borrower to Lender."

Nor can ORIX rely on the "definition of Guaranteed Obligations" as including "'obligations or liabilities of Borrower to Lender for any loss,

damage, cost, expense, liability, claim or other obligation . . . .'" (RB 43.) Here, ORIX suffered no such loss. As the bankruptcy court found, due to the sale of the property to Lowe's for $9.75 million, ORIX got paid in full on the loan, *plus* the bankruptcy court awarded default-rate interest and costs and attorneys' fees. (See 2 AA 353, 361.) The late fee here is a complete and unadulterated windfall. The stated purpose of the late fee was "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), but, as the bankruptcy court determined, those were completely provided for elsewhere. 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." (2 AA 334; see also 2 AA 361 [allowing $3,600 postpetition travel expenses].) ORIX continues to ignore the bankruptcy court's express determination that "once the closing contemplated by the settlement took place, *the guaranty collection action should have ceased altogether*." (2 AA 354, emphasis added.)

For these reasons, too, the judgment must be reversed and the trial court directed to enter judgment for Guarantors.

V.

TO THE EXTENT THAT ATTORNEY'S FEES ARE TO BE AWARDED, THEY SHOULD BE AWARDED TO GUARANTORS.

In apparent hope of a self-fulfilling prophesy, ORIX asks for its attorney's fees on appeal in the event of affirmance. (RB 45-46.) The simple answer to that request is that there is no basis to affirm the judgment.

But—ORIX having raised the issue—if a determination as to an entitlement to attorney's fees is to be made, it should be in favor of Guarantors. Guarantors have at all times been a California resident and California corporation. (2 AA 288, 296, 510-511 ¶ 2.) Guarantors executed the contract assuming the Guaranty in California. (See 1 AA 238.) *ORIX* chose California as the forum in which to bring this action. There is no New Mexico party to the assumed Guaranty; as an ostensibly separate obligation, the place of performance would appear to be California as that is where ORIX has demanded payment. (See Civ. Code § 1646; see also ARA 3, fn. 3 [ORIX arguing Guarantors are California citizens and that Guaranty is independent obligation].) Thus, regardless of any choice of law provision, the strong California public policy requiring mutuality of attorney's fees embodied in Civil Code section 1717 applies.

ABF Capital Corp. v. Grove Properties Co. (2005) 126 Cal.App.4th 204 ("*Grove Properties*"), is on point. In *Grove Properties*, a California resident executed a contract in California to be performed outside of California with a New York entity and calling for application of New York law. The New York-based plaintiff chose to bring suit in California. (*Id.* at

pp. 209-211.) The Court of Appeal held that Civil Code section 1717's attorney fee mutuality requirement applied. (*Id.* at p. 222.) *Grove Properties* held that section 1717 embodied *fundamental* public policy. (*Id.* at pp. 214, 217.)

As there, here "[t]he place of contracting appears to be California, where defendants [here, Guarantors] signed and accepted the [guaranty assumption] agreement, and where they mailed their acceptance of that agreement; this was the 'last act' needed to give the . . . contract a binding effect . . . ." (*Grove Properties, supra*, 126 Cal.App.4th at p. 222; compare 1 AA 238 [Guarantors signed on January 12 in California] with 1 AA 236 [lender signed on January 10 in Texas].) (As in *Grove Properties*, here there was no place of performance designated and, if one had to be ascertained, it would be California where plaintiff filed suit demanding performance.)

Here, as in *Grove Properties*, "the 'particular issue' does not deal with the substance of the [investment] or its operations, or with the substance of the 'Assumption of Liabilities' agreement, but with the procedural question of attorney fees and the reciprocity of attorney fees provisions." (126 Cal.App.4th at p. 222.) And, here, as in *Grove Properties*, "[p]laintiff has purposely resorted to California as the forum for this litigation; the attorney fees are attributable to California litigation and, as we have seen, California has a fundamental policy interest in protecting its citizens from unfair litigation tactics or procedures, and in ensuring fairness in litigation before its courts." (*Ibid.*; see also *Ribbens Internat., S.A. de C.V. v. Transport Internat. Pool, Inc.* (C.D.Cal. 1999) 47 F.Supp.2d 1117, 1126 [Civil Code section 1717's fundamental public policy controls

over contract clause selecting Pennsylvania law]; but cf. *ABF Capital Corp. v. Berglass*, *supra*, at pp. 834, 837 [applying New York choice of law clause where no record as to where contract was signed or that defendant was even a California resident at the time of entering the contract].)

Attorney's fees are an element of costs. (Code Civ. Proc., § 1033.5, subd. (a)(10).) As such, they are part of the litigation process as to which the forum state's law controls. The bottom line is that "[t]he interest of California in seeing its residents receive fair play with respect to attorneys fees, when resort is made to the California courts, is a fundamental equitable policy of this state. Because resort is made to the California courts, and implicates the equitable treatment of California citizens, California has a great material interest in the attorneys' fees issue—fees which are attributable to litigation in California." (*Grove Properties*, *supra*, 126 Cal.App.4th at p. 220.)

Thus, attorneys' fees on appeal (and throughout the litigation) should awarded to Guarantors, not to ORIX.

CONCLUSION

The judgment should be reversed with directions to enter judgment for defendants and to award the defendants their reasonable attorney's fees.

DATED: July 6, 2012

Respectfully submitted,

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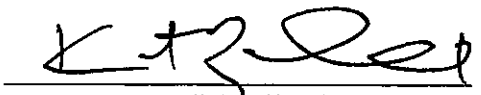
CERTIFICATION

Pursuant to California Rules of Court, Rule 8.204(c)(1), I certify that this **APPELLANTS' REPLY BRIEF** contains 8,205 words, not including the tables of contents and authorities, the caption page, signature blocks, or this Certification page.

DATED: July 6, 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 **July 6, 2012,** I served the foregoing document described as **APPELLANTS' REPLY 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 **July 6, 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