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NOT TO BE PUBLISHED IN THE OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION ONE

BANK OF AMERICA, N.A., Plaintiff and Respondent, v. DANNY LAHAVE et al., Defendants and Appellants.	B237360 (Los Angeles County Super. Ct. No. BC415243)

APPEAL from a judgment of the Superior Court of Los Angeles County. Mary H. Strobel, Judge. Reversed.

Fisher & Wolfe, David R. Fisher, Jeffrey R. Klein; Greines, Martin, Stein & Richland, Robert A. Olson and Kent J. Bullard for Defendants and Appellants.

Jeffer Mangels Butler & Mitchell, Robert B. Kaplan and Neil C. Erickson for Plaintiff and Respondent.

Danny Lahave and Top Terraces, Inc. (Guarantors), appeal from a court trial on stipulated facts after the trial court entered a judgment in favor of "Bank of America, National Association, as successor by merger with LaSalle Bank National Association" (Noteholder) in the amount of $377,438.82. We are asked to determine whether a late fee consisting of 5 percent of the balance of a note constitutes a penalty unenforceable as a matter of public policy under New Mexico law against Guarantors, notwithstanding their purported waiver of any invalidity, illegality, or unenforceability of the note. We conclude the waiver is ineffective because the late fee constitutes a penalty in violation of New Mexico public policy and therefore is unenforceable. We reverse the judgment of the trial court.

BACKGROUND

A. The Note, Deed of Trust, and Guaranty

On April 9, 1999, MCE Associates, L.P. (Original Borrower), executed a "Deed of Trust Note" (Note) in favor of P.W. Real Estate Investments Inc. (Original Lender) in the sum of $9,175,000, with a maturity date of May 1, 2009. 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."

The Note provided that in the event of default, "[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 option of [Original Lender] if any payment required in this Note is not paid on or before the fifth (5th) day after the date when due . . . ." The Note also provided that in the event of default, default interest would be at 12.74 percent (5 percent higher than the normally applicable interest rate). In addition, the Note contained a late fee provision (Late Fee) that stated, "If any sum payable under this Note is not paid on or before the fifth (5th) day after the date on which it is due, Maker shall pay to [Original Lender] upon demand an amount equal to the lesser of five percent (5%) of such unpaid sum or the maximum amount permitted by applicable law to defray the expenses incurred by [Original Lender] in handling and processing such delinquent payment and to compensate [Original Lender] for the loss of

the use of such delinquent payment and such amount shall be secured by the Deed of Trust and Other Security Documents."

To secure payment of the Note, Original Borrower concurrently executed a "Deed of Trust, Security Agreement, Assignment of Leases and Rents and Financing Statement" (Deed of Trust) for shopping center property located in New Mexico in favor of Original Lender as beneficiary. The Deed of Trust provided, "If 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."

Delma Properties, Inc. (Original Guarantor), concurrently executed a "Guaranty of Recourse Obligations" (Guaranty) in favor of Original Lender. The Guaranty stated that the guarantor 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. Guarantor hereby irrevocably and unconditionally covenants and agrees that it is liable for the Guaranteed Obligations as a primary obligor." Under article 1, section 1.2, entitled, "Definition of Guaranteed Obligations," the guaranteed obligations were defined as "the obligations or liabilities of Borrower to Lender for any loss, damage, cost, expense, liability, claim or other obligation incurred by Lender . . . ." Section 1.2 stated that 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 is not paid when due" or Borrower filed for bankruptcy.

The Guaranty contains the following waiver provisions. Article 1, section 1.4 of the Guaranty provided that the guaranteed obligations of Guarantor to Noteholder "shall not be reduced, discharged or released because or by reason of any existing or future offset, claim or defense of Borrower . . . ." Article 2 of the Guaranty provided that "Guarantor's obligations under this Guaranty shall not be released, diminished, impaired, reduced or adversely affected by any of the following, and 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 any of the following:

[¶] . . . [¶] 2.4. The 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 . . . ." Under section 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, (vi) the creation, performance or repayment of the Guaranteed Obligations (or the execution, delivery and performance of any document or instrument representing part of the Guaranteed Obligations or executed in connection with the Guaranteed Obligations, or given to secure the repayment of the Guaranteed Obligations) is illegal, uncollectible or unenforceable, or (vii) . . . it being agreed that Guarantor shall remain liable hereon regardless of whether Borrower or any other person be found not liable on the Guaranteed Obligations or any part thereof for any reason."

The Guaranty'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."

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 and the applicable laws of the United States of America."

B. The Assignment and Assumption

In November 2002, Market Center East Albuquerque, LLC, assumed the obligations of Original Borrower, and Market Center East Management Corporation, Chivas Retail Partners, LLC, and Abitare Realty Corporation (Substitute Guarantors) assumed the obligations of Original Guarantor by executing a consent and assumption agreement. Effective January 10, 2003, the Note, Deed of Trust, Guaranty, and other loan documents were assigned from Original Lender to Noteholder through a series of assignments. In January 2006, Market Center East Retail Property, Inc. (Borrower),

assumed the obligations of Market Center East Albuquerque, LLC, and Guarantors Lahave and Top Terraces, Inc., assumed the obligations of Substitute Guarantors by executing a consent and assumption agreement.

C. Default and Bankruptcy Court Action

Borrower did not pay the January 2009 monthly payment. On April 22, 2009, Borrower filed a voluntary chapter 11 bankruptcy petition (see 11 U.S.C. §§ 1101–1174) in New Mexico (case No. 09-11696). In that action, Borrower filed a "Motion to Sell Real Estate," namely the New Mexico shopping center. On November 6, 2009, the United States Bankruptcy Court for the District of New Mexico (the Bankruptcy Court) entered an order granting Borrower's motion and the New Mexico shopping center was sold. The Bankruptcy Court entered "an order authorizing the disbursement to [Noteholder] of $7,948,574.00, representing the unpaid principal balance of $7,548,776.47, and unpaid interest at the non-default contract rate of $399,797.53 . . . ." On December 29, 2009, Noteholder filed a "Motion to Allow Secured Claim" which included, among other things, a "request for a late fee equal to 5% of the principal balance due and owing to the Noteholder pursuant to the loan documents on the maturity date of the Note of May 1, 2009 in the amount of $377,438.82."

Addressing the late fee in its decision published on August 3, 2010, *In re Market Center East Retail Property, Inc*. (Bankr. D.N.M. 2010) 433 B.R. 335 (*Market Center*), the Bankruptcy Court stated that New Mexico "has not yet formulated a specific 'test' regarding whether a liquidated damages clause is enforceable," but follows the "Restatement (Second) of Contracts." (*Market Center*, *supra*, 433 B.R. at p. 360.) The court noted "Restatement § 356(1) provides: [¶] 'Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.' [¶] Comment a to Restatement § 356 provides, in part: [¶] 'The parties to a contract may effectively provide in advance the damages that are to be payable in the event of breach as long as the provision does not disregard the principle of

compensation. The enforcement of such provisions for liquidated damages saves the time of courts, juries, parties and witnesses and reduces the expense of litigation. This is especially important if the amount in controversy is small. However, the 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.'" (*Market Center*, *supra*, 433 B.R. at p. 361.)

The Bankruptcy Court "assume[d]" that in order to determine whether a contract term was unenforceable, New Mexico would follow other jurisdictions in framing the following three-part test, namely, whether: (1) the anticipated injury is difficult or incapable of accurate estimation; (2) the stipulated damages are extravagant or disproportionate to the injury anticipated; and (3) the stipulated damages have the effect of punishing debtor for breaching the contract. (*Market Center*, *supra*, 433 B.R. at pp. 362–363.) The Bankruptcy Court concluded that damages were not difficult to estimate because "[t]he damages were accruing interest (at the default rate), attorneys fees and costs (which are provided for), and minimal administrative costs." (*Id*. at p. 364.) The Bankruptcy Court also determined that the damages were "extravagant and disproportionate to the injury anticipated from a failure to pay the balloon when due" because the Late Fee, which is 5 percent of the entire balloon payment, "serves as a windfall for the creditor"; "a creditor should not get both an above market default interest rate and late fees on the same debt"; "it is unreasonable to interpret a late fee provision as applying to a balloon payment"; "creditors are usually denied late fees after acceleration or maturity"; and "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." (*Id*. at pp. 364–366.) The Bankruptcy Court noted that "[t]he late fee is 5% no matter whether a payment is one day late, one year late, or never paid at all." (*Id.* at p. 366.) Finally, the Bankruptcy Court held that the Late Fee has the effect of punishing Borrower for breaching the contract and concluded that the Late Fee was an unenforceable penalty.

(*Id*. at p. 367.) The Bankruptcy Court determined that as to Borrower the 5 percent Late Fee was an "unenforceable penalty" because "[t]he anticipated injury is not difficult or incapable of accurate estimation. The stipulated damages are extravagant and disproportionate to the injury anticipated. The stipulated damages have the effect of punishing Debtor for breaching the contract." (*Ibid.*)

D. Breach of Guaranty Action

Meanwhile, Noteholder treated the bankruptcy by Borrower as a triggering event obligating Guarantors for all payments due under the Note. On June 5, 2009, Noteholder filed a complaint for breach of guaranty against Guarantors in the Los Angeles Superior Court. Subsequently, Noteholder and Guarantors stipulated that the amount of the Late Fee was $377,438.82 and that copies of 10 attached loan and guarantee documents were genuine and authentic.

The parties stipulated that "[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 . . . to be unenforceable by . . . Noteholder against the [Borrower], is enforceable against . . . Guarantors and whether the Late Fee can be collected by . . . Noteholder from . . . Guarantors."

Guarantors' trial brief argued that the doctrines of res judicata and collateral estoppel barred Noteholder's action; the Late Fee did not constitute part of the guaranteed obligations and therefore was not collectible against Guarantors; and the Guaranty's waiver provisions were unenforceable because they were ambiguous and violated New Mexico public policy. Noteholder's trial brief argued that claim preclusion did not bar Noteholder's claim; the waivers contained in the Guaranty must be enforced strictly; and the "New Mexico Commercial Code" did not apply to the Guaranty.

E. Statement of Decision

Later, the trial court filed and served a proposed statement of decision. Guarantors filed objections to the statement of decision, including a request that the court address "[w]hether the provisions of section 2.4 of the Guaranty providing that Guarantor remains liable to [Noteholder] even if 'the Guaranteed Obligations, or any part thereof,

exceeds the amount permitted by law, . . . [or] violate[s] applicable usury laws . . . [or] 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 . . . [or] the creation, performance or repayment of the Guaranteed Obligations . . . is illegal, uncollectible or unenforceable' are unconscionable under New Mexico law, California law, or either or both." Guarantors also requested the court address "[w]hether the Guaranty's purported waivers, or any of them, violate New Mexico public policy" and whether the Late Fee constitutes punitive damages and thus imposes tort liability on Noteholder.

In its statement of decision filed October 25, 2011, the court overruled these objections, referring to the discussion in section III.E. of the statement of decision, which stated, among other things, that under New Mexico law Guarantors "have not shown that the defense that the Late Fee was an unenforceable penalty could not be waived in advance via the Guaranty" and "the Guaranty explicitly provides that the obligation of the [G]uarantors are not reduced or discharged if a guaranteed obligation is found illegal or unenforceable against the [B]orrower." According to the statement of decision, "[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." 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." And "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." The court rejected the argument that Noteholder was seeking to recover tort damages, concluding "[t]he Late Fee is a contractual provision that appears in the Note which is part of the Guaranteed Obligations . . . ." And the court determined that the Late Fee was not an unenforceable penalty as to Guarantors "for failure to timely fulfill an obligation to make payment." The court stated, "Rather it is a contractual provision under which

[Guarantors] agreed to pay sums which became due by virtue of their contractual obligations under the Guaranty."

The court found in favor of Noteholder in the amount of $377,438.82. Judgment was entered on November 9, 2011. Guarantors appealed.

DISCUSSION

A. Standard of review

We apply California law where the parties cite no conflicting authority from the law of the foreign jurisdiction. (*Garamendi v. Mission Ins. Co.* (2005) 131 Cal.App.4th 30, 41.) Because both parties rely on California law regarding the standard of review, collateral estoppel, and raising new legal arguments on appeal, we shall apply California law in analyzing those issues.

"When the decisive facts are undisputed, we are confronted with a question of law and are not bound by the findings of the trial court." (*Ghirardo v. Antonioli* (1994) 8 Cal.4th 791, 799–800 [the question of whether a transaction is usurious is a question of law].)

B. The Late Fee constitutes an unenforceable penalty in violation of New Mexico public policy

The sole issue on appeal is whether a Late Fee consisting of 5 percent of the balance of a note constitutes a penalty unenforceable as a matter of public policy under New Mexico law against Guarantors, notwithstanding their purported waiver of any invalidity, illegality, or unenforceability of the note. We conclude the waiver is ineffective because the Late Fee constitutes a penalty in violation of New Mexico public policy and therefore is unenforceable.

Initially, we reject Guarantors' argument that the Bankruptcy Court's decision—that the Late Fee was not recoverable against Borrower because it was an unenforceable penalty—has a preclusive effect on the issue of whether the Late Fee contained in the Guaranty was unenforceable against Guarantors. Neither the parties nor the issues to be litigated are identical because Guarantors were not parties to the bankruptcy proceeding and the waiver language contained in the Guaranty was not at issue. (*Hernandez v. City*

of Pomona (2009) 46 Cal.4th 501, 511 [doctrine of collateral estoppel applies when issue to be relitigated is identical to issue actually and necessarily decided in final decision on the merits in former proceeding and party against whom preclusion is sought is same or in privity with party to former proceeding].)

We also reject Noteholder's argument that because certain authorities cited by Guarantors in support of their arguments concerning the illegality of the Late Fee and the unconscionable nature of the waiver provisions were never raised in the trial court below, Guarantors should be barred from raising a number of claims of error. Guarantors raised the issue of unconscionability before the trial court. And "[w]e are aware of no prohibition against citation of new *authority* in support of an *issue* that was in fact raised below." (*Giraldo v. California Department of Corrections & Rehabilitation* (2008) 168 Cal.App.4th 231, 251.)

Next, we examine the law of New Mexico with respect to guaranties. "A guaranty is a contract and we apply all of the general rules regarding the application and construction of contracts." (*WXI/Z Southwest Malls v. Mueller* (Ct.App. 2005) 137 N.M. 343, 346 [110 P.3d 1080, 1083].) A guaranty is a separate, distinct contract. (110 P.3d at p. 1083.) In general, "'[t]he language of the written guaranty agreement governs the rights of the [g]uarantors' and '[t]he parties . . . are free to determine for themselves by contract . . . the duties and obligations which follow.' [Citations.]" (110 P.3d at p. 1084.) Thus, "'[i]n the absence of fraud, unconscionability, or other grossly inequitable conduct,'" "'[c]ourts may not rewrite obligations that the parties have freely bargained for themselves.'" (*Ibid*.)

Under New Mexico law, the Restatement provides guidance. The "two principal sources of law governing the rights and duties of the parties with respect to a guarantee of a promissory note" are the New Mexico Uniform Commercial Code and the common law. (*Venaglia v. Kropinak* (Ct.App. 1998) 125 N.M. 25, 29–30 [956 P.2d 824, 828–829].) "For authoritative guidance on the common law we look to the Restatement." (956 P.2d at p. 829.) The Restatement Third of Suretyship and Guaranty 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" and refers to Restatement Third of Suretyship and Guaranty, section 6. (Rest.3d Suretyship and Guaranty, § 34, com. a, p. 144.) The Restatement Third of Suretyship and Guaranty, section 6, comment a, page 29, provides that "[a]greements between the secondary obligor and the obligee as to the availability and scope of suretyship defenses are typically incorporated into the contract creating the secondary obligation," but comment b notes 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.)

In addition, a guarantor may agree upon the terms of the guaranty and waive the defense of impossibility or illegality. According to the Restatement of Security, section 117, pages 311–312, "Where the principal has a defense of impossibility or illegality, this defense is available to the surety against the creditor unless the surety has otherwise contracted with the creditor." The Restatement of Security, section 117, comment b, page 312, states, "Illegality is treated at length in the Restatement of Contracts, §§ 512–609 (Chapter 18). A bargain is illegal if either its formation or its performance is criminal, tortious, or otherwise opposed to public policy. (Restatement of Contracts, § 512.) In general there is no remedy on an illegal bargain. (Ibid., § 398.)" Comment d to the Restatement of Security, section 117, pages 312–313, states, "The surety, if he desires, may assume a risk greater than that which would be implied from a mere guaranteeing of the principal's performance. The surety may contract not only as a surety but also as an insurer, that is, that he will indemnify the creditor against loss, irrespective of the continuance or even of the existence of a duty on the part of the principal. Such a contract may be stated in specific terms or it may be implied from terms used, interpreted in the light of the circumstances."

But an illegal promise is against public policy and cannot be enforced against the principal or the surety. Comment d to the Restatement of Security, section 117, page 313, further states, "If the surety's promise is itself illegal, it cannot be enforced against him, not because of any merit in the surety's position but because it is against public

policy to give effect to the surety's promise. 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. Where, however, the principal's promise is legal where made, and there is no illegality in the surety's promise, the surety's obligation may be enforced unless it has itself become illegal of performance."

New Mexico courts have held that a contract provision that is "illegal, contrary to public policy, or grossly unfair" is substantively unconscionable under New Mexico law and is void. (*Fiser v. Dell Computer Corporation* (2008) 144 N.M. 464, 470 [188 P.3d 1215, 1221].) A penalty, which is "a term fixing unreasonably large liquidated damages . . . 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, 532 [943 P.2d 560, 566] (*Nearburg*).) "The substantive analysis focuses on such issues as whether the contract terms are commercially reasonable and fair, the purpose and effect of the terms, the one-sidedness of the terms, and other similar public policy concerns." (*Cordova v. World Finance Corp. of NM* (2009) 146 N.M. 256, 259, 262–263 [208 P.3d 901, 904, 907– 908]; accord, *Padilla v. State Farm Mut. Auto. Ins. Co*. (2003) 133 N.M. 661, 665 [68 P.3d 901, 906–907] (*Padilla*).)

We conclude that the Late Fee is a penalty—unenforceable as a matter of public policy. *Nearburg* explained that a penalty is a term fixing unreasonably large liquidated damages and ordinarily is unenforceable on grounds of public policy because it is punitive rather than compensatory. (*Nearburg*, *supra*, 943 P.2d at p. 566.) Also, according to the Restatement of Security, section 117, comment d, page 313, "[I]t is against public policy to give effect to the surety's promise" "[i]f the surety's promise is itself illegal." Although we cannot rely on the Bankruptcy Court's opinion in *Market Center* for purposes of collateral estoppel, we adopt the Bankruptcy Court's analysis of the penal nature of the Late Fee in its published decision, *Market Center*, *supra*, 433 B.R. 335. (*Bowen v. Ziasun Technologies, Inc.* (2004) 116 Cal.App.4th 777, 786 [federal and out-of-state cases can be persuasive authority].) *Market Center* concluded that the Late

Fee was a penalty because "[t]he anticipated injury is not difficult or incapable of accurate estimation. The stipulated damages are extravagant and disproportionate to the injury anticipated. And, the stipulated damages have the effect of punishing Debtor for breaching the contract." (*Market Center*, *supra*, 433 B.R. at p. 363.)

Guarantors state that they have found no New Mexico cases on point regarding whether a Late Fee unenforceable as to the borrower is unconscionable with respect to a guarantor. Nevertheless, Guarantors persuasively argue "[t]hat 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." In the absence of New Mexico authority, a New Mexico court will look to other jurisdictions that follow the Restatement. (*Market Center*, *supra*, 433 B.R. at p. 362 ["The Court assumes that New Mexico would frame a test similar to" tests applied by out-of-state courts that follow the Restatement].)

Accordingly, we rely on *WRI Opportunity Loans II, LLC v. Cooper* (2007) 154 Cal.App.4th 525, which held that a guarantor cannot waive the unenforceability of an illegal principal obligation. In that case, a written guaranty waived the guarantors' defenses arising out of the "'limitation of the liability of Borrower to Lender'" and waived the rights of the guarantors under Civil Code section 2809 (guarantor not obligated in amounts larger than that of the principal) and Civil Code section 2810 (guarantor not liable if there is no liability upon the part of the principal at the time of the execution of the contract unless guarantor has assumed liability with knowledge of the existence of the defense). (154 Cal.App.4th at p. 542.) The Court of Appeal reasoned that "[t]he usurious provisions of a loan are void on the grounds of illegality or unlawfulness because they violate express provisions of law." (*Ibid*.) It noted that an illegal contract is void and cannot be ratified by a subsequent act and the defense of illegality cannot be waived by stipulation in the contract. (*Ibid*.) Citing *Wells v. Comstock* (1956) 46 Cal.2d 528, the Court of Appeal held that the guarantors' waiver of

their defenses was ineffective regarding the usury. (154 Cal.App.4th at pp. 543–544.) The Court of Appeal noted that in *Wells v. Comstock*, *supra*, 46 Cal.2d 528, our Supreme Court relied on section 117 of the Restatement of Security to hold that where the plaintiff entered into an unlawful contract to sell corporate stock to the defendant, "'[s]ince the principal obligation of the contract is unenforceable because of illegality, the guaranty too is unenforceable.'" (154 Cal.App.4th at p. 543.)

Noteholder makes much of the general rule that a guarantor may waive legal defenses to liability under the terms of the guaranty, citing the Restatement Third of Suretyship and Guaranty, section 48, comment a, and numerous New Mexico cases. But that part of the Restatement merely states that a guaranty provision waiving standard suretyship defenses is not ordinarily unconscionable. (Rest.3d Suretyship and Guaranty, § 48, com. a, p. 209.) Further, *Bowlin's Inc. v. Ramsey Oil Co., Inc*. (Ct.App. 1983) 99 N.M. 660 [662 P.2d 661] and *Rivera v. Rivera* (Ct.App. 2010) 149 N.M. 66 [243 P.3d 1148], cited by Noteholder for the proposition that "the test of whether the Guaranty provisions were unconscionable must be applied at the time that Guaranty was signed," are inapplicable because those cases concerned procedural rather than substantive unconscionability as at issue here. And in none of the other cases cited by Noteholder did the creditors collect a penalty as Noteholder would here, if the Late Fee were enforced. (*Ward v. First Nat. Bank in Albuquerque* (1980) 94 N.M. 701, 703 [616 P.2d 414, 416] [guarantors waived right to borrowers' discharge in bankruptcy as defense to creditor's attempt to collect on debts of borrowers]; *First State Bank v. Muzio* (1983) 100 N.M. 98, 99 [666 P.2d 777, 778] [guarantor waived right to claim statutory homestead exemption and priority for collection of debts]; *Sunwest Bank of Clovis, N.A. v. Garrett* (1992) 113 N.M. 112, 117 [823 P.2d 912, 917] [creditors' release of some guarantors did not reduce liability of remaining guarantors under guaranty]; *Levenson v. Haynes* (Ct.App. 1997) 123 N.M. 106, 110 [934 P.2d 300, 304] [where guaranty specifically stated underlying lease could not be modified without express written consent of guarantor, stricter restraints on modification than established under general suretyship law governed rights of guarantors]; *Western Bank v. Aqua Leisure, Ltd*. (1987) 105 N.M.

756, 759 [737 P.2d 537, 540] [creditor's alleged obligation to dispose of collateral in "commercially reasonable manner" was overridden by terms of guaranty that stated creditor may sell collateral on terms as it may deem reasonable].)

None of the cases cited by Noteholder provides authority for the enforcement of a penalty. In sum, we conclude that the Late Fee is unenforceable because it violates New Mexico's public policy of not enforcing a penalty because it goes beyond compensation into punishment. "'If a contract or term thereof is unconscionable at the time the contract is made a 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.'" (*Padilla*, *supra*, 68 P.3d at p. 907.) In light of our conclusion, we need not address Guarantors' further arguments that "even were the guaranty's illegality waiver somehow enforceable under New Mexico law, it cannot be enforced by California courts" and the trial court erred in "reading the Late Fee as contractually applicable here."

DISPOSITION

The judgment is reversed. Lahave and Top Terraces, Inc., are entitled to costs on appeal.

NOT TO BE PUBLISHED.

MALLANO, P. J.

We concur:

CHANEY, J.

JOHNSON, J.