ENFORCING THE COMMERCIAL GUARANTY AGREEMENT

By Anthony J. Jacob, Aric T. Stienessen and Jeremy D. Duffy, Hinshaw & Culbertson LLP

Over the past few years, there has been increased litigation over the enforcement of commercial guaranties by lenders. As more borrowers default on their loan obligations, lenders have more frequently taken action against guarantors to recover damages due to a borrower's default. In response, guarantors have raised a variety of defenses.

This article starts with a summary of the basic terms of a commercial guaranty and the purposes for which it is used. This article then examines the topics frequently encountered when enforcing a commercial guaranty agreement and sets forth recent noteworthy cases on each topic.

Terms And Purposes Of A Commercial Guaranty

A guaranty is an agreement made by a third party, whether a person, trust or a business entity, to pay and/or perform the obligations of a debtor for the satisfaction of a debt owed to a creditor upon the occurrence of an event, typically a default by the debtor, under the original loan agreement. A guaranty, like any contract, requires mutual assent, adequate consideration, definiteness and a meeting of the minds. Under most states' Statute of Frauds, a guaranty must be in writing, signed by the guarantor(s) and delivered to the creditor.

In the context of a loan transaction, a guaranty serves as a form of collateral to support the debt obligation between the debtor and the creditor. But, the guaranty and the loan agreement evidence separate obligations, and their independence is not affected by the fact that both agreements are written on the same instrument or are contemporaneously executed. The guaranty cannot exist without a primary debt obligation. Thus, if the primary debt obligation has been fully satisfied, is void or is illegal, a guaranty of the debt obligation can also be deemed unenforceable.

Types of Guaranties

By way of background, there are varying types of guaranties.

- An absolute guaranty provides that the guarantor promises to pay or perform the obligations of the debtor upon the occurrence of an event of default (typically debtor's default). If a guaranty does not contain words of limitation or conditions, it is typically construed as an absolute guaranty.

- A conditional guaranty requires the happening of some contingent event (other than the default of the debtor) or the performance of some act on the part of the creditor before the guarantor will be liable.

- A payment guaranty obligates the guarantor to pay the debt at maturity (which may arise due to an event of default). Upon the occurrence of a debtor's default, the guarantor's obligation becomes fixed and the creditor does not need to make a demand on the debtor.

- A collection guaranty is a guarantor's promise that if the creditor cannot collect the claim with due diligence, usually after suit (and exhaustion of remedies) against the debtor, the guarantor will pay the creditor.

- A performance guaranty obligates the guarantor to perform some obligation on behalf of the debtor for the benefit of the creditor.

- A continuing guaranty is a guaranty that is not limited to a single transaction but contemplates a future course of dealing which may encompass a series of transactions, may be for an indefinite period and/or may be intended to secure payment or performance of an overall debt of the debtor. As such, a continuing guaranty may include subsequent indebtedness without new consideration.

- A guaranty is a restricted guaranty when it is limited to a single or limited number of transactions, to a certain part of the debt obligation and/or to a certain period of time.

- A downstream guaranty is a guaranty by a parent corporation for the obligations of its subsidiary. In this scenario, a lender will look to the parent corporation to back up the debt of a subsidiary corporation due to the parent corporation's superior assets and financial condition.

- An upstream guaranty is a guaranty by a subsidiary corporation for the obligations of its parent corporation. Typically, a creditor will require an upstream guaranty when debtor's, *i.e.* the parent corporation's, only assets are the stock of a subsidiary, and the subsidiary owns assets used as collateral to secure the credit obligations.

- A cross-stream guaranty is a guaranty among affiliated corporations, whose stock are both owned by the same parent.

Commercial Guaranty: Topics And Cases

A party's enforcement of a commercial guaranty, like any other contract, requires the analysis of basic contract principles. What sets a commercial guaranty apart from other contracts is that a commercial guaranty may lie dormant and unattended to by the parties until the occurrence of some subsequent, triggering event. At that time, which may be months or years after the commercial guaranty and the underlying debt documents were originally executed, the party seeking to enforce the guaranty then has to examine the terms of the guaranty, the status and condition of the guarantor and other facts and circumstances existing at the time of enforcement.

Whether a party is seeking to enforce a commercial guaranty or defend against its enforcement, the party needs to start by identifying the particular type of guaranty, the lien placed on the guarantor, whether the guaranty is properly secured and perfected (if intending to do so), the existence and integrity of the guarantor's assets and collateral used to guaranty of debt, and how best to foreclose upon the guarantor and take possession of the guarantor's assets. The following sections summarize a few of the topics and current cases a party may need to consider when enforcing a commercial guaranty.

Consideration

A guaranty without consideration is merely an unenforceable gratuitous promise. While some guaranties are founded on separate consideration than the original credit transaction, the guarantor need not receive a direct benefit for consideration to exist. The consideration usually consists of a benefit to the debtor or a detriment to the creditor.

In the case of *In re Kraft, LLC*, 429 B.R. 637 (Bankr. N.D. Ind. 2010), a bank lent money to a debtor in return for a mortgage and subject to promissory notes signed by individuals, but not by the debtor. The bank sought to foreclose under the mortgage and to collect money under the promissory notes against the debtor. The debtor argued that because the mortgage was given by an entity which did not execute any of the underlying notes, the mortgage is essentially a guaranty. Under Indiana law, if the guaranty is executed after the underlying debt obligation is incurred, there must be additional consideration given. Because no further consideration was given at the time the mortgage was executed and delivered in debtor's case, the mortgage (again arguably akin to a guaranty) is voidable.

In its opinion, the court provided a detailed explanation of the laws of guaranties in Indiana. A guaranty is an independent contract to assume the liability for the payment of a debt if the primary obligor defaults in performance or payment. If the obligor subsequently defaults, the guarantor becomes primarily liable on the debt, subject to the terms of the guaranty. A mortgage is different than a guaranty in that a mortgage is a lien which secures an underlying debt, and when the obligation is discharged, the mortgage has no function and is legally extinguished. While additional consideration is necessary for a guaranty that is executed after the primary obligation, a pre-existing debt or liability is sufficient consideration to support a mortgage given as security, and no additional consideration is needed.

In another case, *Brown v. Lawrenceville Properties, LLC*, 710 S.E.2d 682 (Ga. Ct. App. 2011), a debtor argued that the parties' various corrections to a lease term, which lease included a guaranty, amounted to a novation and therefore invalidated the guaranty. The court disagreed. The court stated that a novation requires four essential elements: (1) a previous valid obligation, (2) the agreement of all the parties to the new contract, (3) the extinguishment of the old contract, and (4) the validity of the new contract. In this case, the amendment and assignment of the lease was executed by the guarantor. The guaranty then was continued and extended to the assigned obligations. Therefore, a default on the assigned obligation would require that the guarantor be responsible for such default pursuant to the guaranty agreement.

Joint and Several Liability

A guarantor of a debt obligation is liable upon a default, and the person to whom the guaranty is made is not required to first resort to recover from the primary obligor. A guarantor of a promissory note may be held jointly and severally liable with the primary obligor, although the extent of the guarantor's liability depends upon the terms of the guaranty agreement.

In *Wachovia Bank, National Ass'n v. Horizon Wholesale Foods, LLC*, No. 09-0072-KD-8, 2009 WL 3526662 (S.D. Ala. Oct. 23, 2009), the bank sought to enforce a loan default against the guarantors at the first instance. Three individuals executed unconditional guaranties. Each guaranty provided that it was a continuing and unconditional guaranty of the payment and performance and that the guarantor in each instance was jointly and severally liable with the debtor. The court enforced the guaranties against the guarantors finding the guarantors liable for the principal, interest, miscellaneous fees and attorneys' fees.

Release of Co-Guarantors

When two or more persons guarantee the debt of another, they simultaneously enter into an implied promise on the part of each to contribute his or her share if necessary to meet the common obligation between the co-guarantors. The discharge of one co-guarantor's direct liability to the creditor does not relieve him or her from liability to contribute to the other co-guarantors. In addition, the fact that a creditor sues only some of the co-guarantors, or recovers a judgment against fewer than all of them, does not excuse those not sued or not included in the judgment from paying their part of the joint debt. Accordingly, as a general rule, one or more of the co-guarantors against whom the judgment is recovered may, upon paying the creditor, compel contribution from all other co-guarantors. A creditor's release of one guarantor does not necessarily release the co-guarantors.

In *Lestorti v. DeLeo*, 4 A.3d 269 (Conn. Super. Ct. 2010), the case dealt with a guaranty agreement whereby the plaintiff, defendant, and Otto Paparazzo and OJP Development Corp. each agreed jointly and severally to guaranty the liability of Pond Place Development II to First Union National Bank under a note. The note was secured by a mortgage. Wachovia Bank, the successor to First Union National Bank, commenced a foreclosure action against Pond Place and the plaintiff and defendant under the terms of the guaranty agreement. The plaintiff and defendant were originally named defendants in the foreclosure action, but that action was dismissed as to the plaintiff for failure to make proper service upon him. The defendant was found liable for the deficiency judgment. The defendant later settled and paid the judgment with Wachovia Bank. Defendant then filed a counterclaim against the plaintiff for half of the judgment. The trial court granted the plaintiff's motion to strike the counterclaim. The defendant then appealed. The Appellate Court found that Wachovia Bank's failure to obtain personal jurisdiction over the plaintiff impaired the defendant's right to contribution from the plaintiff, and thus, the defendant was not entitled to reimbursement from the plaintiff for any amount.

The issue in the case was whether the defendant could recover any portion of the judgment from the plaintiff where the bank failed to properly assert personal jurisdiction over the plaintiff. Under Connecticut law, the right of contribution between co-guarantors is based on the theory of implied contract. A co-guarantor, however, is not entitled to contribution for any amount paid to the creditor toward the common debt. Rather, under Connecticut law, a guarantor's right of contribution from a co-guarantor arises only when the guarantor has paid in excess of his or her share of the entire obligation and the amount of contribution he or she is entitled to collect is limited to the amount paid in excess of his or her share of the entire obligation. The reason this principle of limitation exists in Connecticut is because a guarantor, as among co-guarantors, is a principal for the portion of the debt which he or she ought to pay and is a secondary obligor for the remainder of the debt. Therefore, when a co-guarantor makes a payment to the creditor in an amount that is less than his or her share of the whole outstanding obligation, the co-guarantor has no right to contribution from the other co-guarantors.

The court concluded that the defendant had a right of recourse and right of contribution from the plaintiff and that the bank's failure to obtain jurisdiction over the plaintiff did not impair the implied contract between the plaintiff and defendant as co-guarantors and the right of contribution between them. In addition, the bank's release of one guarantor did not impair or release the obligations of any other guarantor.

Impracticability/Frustration of Purpose

In *Twin Holdings of Delaware LLC v. CW Capital, LLC*, 906 N.Y.S.2d 784, 2010 WL 309022 (Sup. Ct. 2010) unpublished table decision, a guarantor claimed that the decline in the real estate market, a factor outside its control, made it more difficult to lease out space in its building. The guarantor also alleged that the financial crisis in the real estate market made it more difficult for the debtor and guarantor to refinance the loan. In another case, *Flathead-Michigan I, LLC v. Penninsula Development, L.L.C.*, No. 09-14043, 2011 WL 940048 (E.D. Mich. Mar. 16, 2011), a guarantor claimed that the economic fallout in 2008 frustrated the terms of the guaranteed obligations.

For similar reasons, the courts in both cases held that the guarantors were not excused from performance of the guaranteed obligations on the ground of impracticability or frustration of purpose. Both courts found that the guarantors were sophisticated entities with knowledge of the pertinent business industry and they were aware of the possibility of volatility in the financial markets.

Misrepresentation

A guarantor may make a claim of fraudulent inducement of an agreement in response to the enforcement of a guaranty agreement, but must show the following: (1) a misrepresentation of material fact by the creditor, (2) the creditor knew the statement was false at the time or made the assertion without regard to its falsity, (3) the creditor intended the guarantor to act, (4) that the guarantor reasonably relied upon the statement, (5) that the guarantor acted to its detriment, and (6) that the guarantor incurred actual damages.

Courts do not look favorably upon a guarantor's claim of misrepresentation, especially when the guaranty agreement is absolute and unconditional. *See 627 Acquisition Co. v. 627 Greenwich, LLC*, 927 N.Y.S.2d 23 (Sup. Ct. 2011); *Alerus Fin., N.A. v. Marcil Grp. Inc.*, No. 20110113, 2011 WL 4924152 (N.D. Oct. 18, 2011) to be published in N.W.2d; *Outsource Servs. Mgmt, LLC v. Ginsburg*, No. 08-5897 (DWF/FLN), 2010 WL 5088190 (D. Minn. Dec. 7 2010).

Lack of Notice to Guarantor

In certain instances, a creditor must provide the guarantor with notice of a default or triggering event under the primary debt obligation before seeking to enforce a guaranty agreement. However, the language of the guaranty is controlling in determining whether the creditor is under a duty to notify the guarantor of a default, and notice need not be given when the terms of the guaranty expressly dispense with the need for the notice.

In a Michigan Appellate Court case, *Comerica Bank v. Cohen*, 291 Mich. App. 40 (2010), the court found a guarantor to be liable for a portion of the guaranteed debt even though the creditor did not give timely notice of a default. The court held that a failure to give notice of the default or negligence in giving such notice, in a case where the guarantor is entitled to notice, does not of itself discharge the guarantor from liability and bar a recovery upon the guaranty. Essentially, there must be not only a want of notice within a reasonable time, but also some actual loss or damage thereby caused to the guarantor. If such loss or damage does not go to the whole amount of the guaranteed claim, but is only in part of the claim, the guarantor is discharged only *pro tanto*.

In another case, *Vision Bank v. 145, LLC.*, No. 10-00521-KD-B, 2011 WL 5289070 (S.D. Ala. Nov. 4, 2011), a debtor applied for a loan from a bank and an individual executed an unlimited continuing guaranty agreement in favor of the bank. In the guaranty, the individual expressly waived notices of every kind. The individual later executed a second unlimited individual guaranty and again, waived notices of every kind. The debtor failed to satisfy the promissory note by its maturity date. The bank mailed a notice of foreclosure and a copy of the foreclosure publication only to the debtor.

The guaranty agreement in this case did not require notice to the guarantor. In fact, the guaranty agreement stated that all notices were waived, including notice of presentment for payment, demand, default, and non-payment pertaining to the primary debt obligation and the guaranty. As such, the bank was able to enforce the guaranty.