



presents

Commercial Loan Guarantees Under Heightened Scrutiny

Strategies for Lenders and Guarantors in Drafting, Negotiating and Enforcing Guaranty Agreements

A Live 90-Minute Audio Conference with Interactive Q&A

Today's panel features:

Charles (C.J.) Schoenwetter, Partner, **Bowman and Brooke**, Minneapolis

Tony Toranto, Special Counsel, **Luce Forward**, San Diego, Calif.

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COMMERCIAL LOAN GUARANTIES UNDER HEIGHTENED SCRUTINY:

Strategies for Lenders and Guarantors in
Drafting, Negotiating and Enforcing Guaranties

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ROADMAP



- I. What is a Guaranty?
- II. When are Guaranties Used?
- III. How are Personal Guaranties Interpreted?
- IV. Common Enforcement Issues.
- V. Best Drafting Practices for Lenders/Creditors.
- VI. Examples.

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I. What is a Guaranty?

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What is a Guaranty?

A guaranty is an independent contract between a guarantor and a creditor by which the guarantor promises to make payment if the principal debtor defaults. It is collateral to the contractual obligation between the creditor and debtor.¹

An absolute and unconditional guaranty is an unconditional undertaking on the part of the guarantor that he will pay a debt immediately upon the default of the debtor.

¹ See, e.g., *Angelo Iafrate Co v M & K Development Co*, 80 Mich. App. 508, 514, 264 NW2d 45 (1978).

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What is a Guaranty? (cont'd)

- Contracts of Indemnification differ because under a contract of indemnity the promissory undertakes to protect the promisee against a loss or liability to a third person, whereas under a contract of guaranty the undertaking is to protect the promisee from the acts of a third person.
- Traditionally a guaranty was distinguished from a surety in that the surety's liability was joint and primary with the principal, whereas the guaranty's liability was collateral and derivative. Moreover, a surety contract is between the debtor and the surety.²

² 38 Am. Jur. 2d §§ 11-12 at 880-81 (West 1999).

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II. When are Guaranties Used?

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When are Guaranties Used? (cont'd)

Personal guaranties are used to secure:

- A. Repayment of loans.
- B. Payment on leases.
- C. Payment for goods and services.
- D. Damages for non-performance of contractual obligations.

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III. How are Personal Guaranties Interpreted?

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How are Personal Guaranties Interpreted? (cont'd)

The rules governing the interpretation and construction of contracts generally apply to contracts of guaranty.

- In the absence of ambiguity, fraud or misrepresentation, the parties' intent is defined by the written terms of the guaranty, considered as a whole.
- Ambiguities will be construed against the drafter—especially when dealing with form contracts.

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How are Personal Guaranties Interpreted? (Cont'd)

NOTE: Guarantors defending against an enforcement action will often argue that the guaranty agreement was procured through fraud and/or contains ambiguities in order to avoid liability.

- Include a “no reliance clause.”
- Include an integration clause in the guaranty.

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How are Personal Guaranties Interpreted? (Cont'd)

In some jurisdictions, however, guaranties are strictly construed in favor of the guarantor and against the lender/creditor.

- A guarantor has the right to prescribe the exact terms upon which he will enter into the obligation, and to insist on a termination of the guaranty if those terms are not strictly observed.³

³ *Schmidt v. McKenzie*, 215 Minn. 1, 9, 9 N.W.2d 1, 5 (1943) (“Such a contract of guaranty is *strictissimi juris*. The plaintiff must perform strictly, or it cannot hold the guarantors.”) (italics in original) and (“*** the guarantor has the right to prescribe the exact terms upon which he will enter into the obligation, and to insist on his discharge if those terms are not observed. It is not a question of whether he is harmed by a deviation to which he has not assented. He may plant himself on the technical obligation; ‘This is not my contract.’ Since a guarantor is ‘* * * bound by his agreement.’ * * * it is eminently just and proper that he should be a favorite of the law, and have a right to stand on the strict terms of his obligation. To charge him beyond its terms, or to permit it to be altered without his consent would be, not to enforce the contract made by him, but to make another for him.”) (quotations omitted) (citing numerous cases); *Bandit Industries v. Hobbs Int'l*, 620 N.W.2d 531 (Mich., 2001).

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How are Personal Guaranties Interpreted? (Cont'd)

Interpreting Guaranties Under Michigan Law:

“The undertaking of a [guarantor] is to receive a strict interpretation. The [guarantor] has a right to stand on the very terms of the contract. To the extent and in the manner and under the circumstances pointed out in his obligation, the [guarantor] is bound, and no further. The liability of a [guarantor] is not to be extended by implication beyond the terms of his contract. * * * A [guarantor] cannot be held beyond the precise terms of his agreement. * * * ‘The claim against a surety is *strictissimi juris*.’”⁴

⁴ *Bandit Industries v. Hobbs Int'l*, 620 N.W.2d 531 (Mich., 2001).

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IV. Common Enforcement Issues.

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Common Enforcement Issues (Cont'd)

Enforcing a guaranty is easy—so long as:

- It was well drafted.
- You enforce promptly and with vigor.

Typical guaranty language facilitates enforcement:

- Waiver of all defenses.
- Absolute, unconditional and continuing guaranties.
- Waiver of acceptance, notice of breach, etc.

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Common Enforcement Issues (Cont'd)

The best defenses to an action seeking to enforce a personal guaranty are those that go straight to the heart of the guaranty and whether it was formed. For example:

- **Fraud In The Execution/Fraudulent Inducement;**
- **No Acceptance of the Offer; and**
- **Inadequate Consideration.**

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 Common Enforcement Issues. (Cont'd)

The next best defenses are those that challenge the terms of the contract of guaranty (i.e., whether the guaranty is ambiguous), or whether the other party is the first party to breach the guaranty contract.

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 Common Enforcement Issues. (Cont'd)

Often, a “WIN” for a party defending an enforcement action is obtaining additional and adequate time to:

1. Negotiate a settlement;
2. Obtain funds to pay-off the Plaintiff; and/or
3. Create a comprehensive strategy, engage in asset protection planning and retain bankruptcy counsel.

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 Common Enforcement Issues. (Cont'd)

Fraud vitiates a contract and makes it voidable at the discretion of the party who was defrauded.⁵

There are 2 types of fraud guarantors commonly use to avoid liability under a contract of guaranty:

1. Fraudulent Inducement; and
2. Fraud in the Execution.

⁵ Horn v. Cooke, 118 Mich. App. 740, 745; 325 N.W.2d 558 (1982).

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 Common Enforcement Issues – Acceptance. (Cont'd)

Until the requested acceptance has been made, the promise of the guarantor is nothing but an offer and creates no binding obligation on the guarantor even though the promise was in writing and signed by the promisor; nor does the mere signing of what is in fact an offer for a contract of guaranty create a contractual obligation, and in this respect the name which the parties attach to the instrument is immaterial.⁹

- But notice of acceptance can be waived if it does not require performance of some affirmative act.

⁹ 38 Am. Jur. 2d, Guaranty § 35 at 898 (West 1999) (citing numerous cases). 22

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 Common Enforcement Issues. (Cont'd)

Inadequate Consideration —

Like other contracts, guaranties must be supported by consideration and a guaranty cannot be enforced unless the promise is supported by consideration.¹⁰

Although funding a loan at the same time as a guaranty is signed is adequate consideration, **a pre-existing debt is not sufficient consideration for a third-party guaranty.**¹¹

¹⁰ 38 Am. Jur. 2d, Guaranty § 40 at 902 (West 1999).
¹¹ Baker v. Citizen State Bank of St. Louis Park, 349 N.W.2d 552, 557 (Minn. 1984). 23

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 Common Enforcement Issues — Inadequate Consideration. (Cont'd)

In some circumstances, **a promise to forbear from exercising a legal right of the creditor's equals sufficient consideration to make any return promise of guaranty enforceable, 'provided the promise is coupled with actual forbearance.**¹²

If a "creditor does not forbear for a reasonable time, there is a failure of consideration and the guarantor is discharged from liability."¹³

¹² Baker, 349 N.W.2d at 558, quoting 38 Am. Jur. 2d Guaranty § 46, at 1049 (1968).
¹³ Baker v. Citizen State Bank of St. Louis Park, 349 N.W.2d 552, 559 (Minn. 1984). 24

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Common Enforcement Issues — Inadequate Consideration, (Cont'd)

In *Brooksbank*, the amount allegedly guaranteed was less than \$200,000. The court concluded forbearance of less than 80 days was unreasonable.

"[T]here is no question that the shareholders were some significant period of time away from realizing any revenues. Yet here we are asked to believe that forbearance of less than eighty days is reasonable consideration in exchange for the renewed guarantee. Such a position is unreasonable and we decline to adopt it."¹⁴

¹⁴ Compare *Baker*, 349 N.W.2d at 559 (finding forbearance from calling outstanding debt for seven days was unreasonably short and, therefore, not consideration for mortgage guarantee) with *Westbrooke State Bank v. Anderson Land & Cattle Co.*, 364 N.W.2d 416, 419 (Minn. App. 1985) (finding forbearance for nearly two years was more than adequate for mortgages given to secure preexisting debt).

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Common Enforcement Issues, (Cont'd)

First Party to Breach—

Typically, a first breaching party cannot raise to its advantage a subsequent breach of contract against another party when it has first breached the contract itself.¹⁵

"A guarantor may be discharged or released from liability by a breach of the contract of guaranty."¹⁶

¹⁵ *Ehlinger v. Bodi Lake Lumber Co.*, 36 N.W.2d 311 (Mich. 1949); *MTS Co. v. Taiga Corp.*, 365 N.W.2d 321, 327 (Minn. Ct. App. 1985), *rev. denied* (Minn. June 14, 1985); 17A C.J.S. *Contracts* § 458 (1963).

¹⁶ 18 Michigan Pleading and Practice, § 13, p. 44.

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Common Enforcement Issues — First Party to Breach, (Cont'd)

Often this defense is coupled with a claim that the contract of guaranty is ambiguous or the underlying loan agreement was orally amended or modified by the parties' course of performance to include new or different terms regarding, for example, payment, ability to cure, and/or terms of default.

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NOTE: Ordinarily, a provision purporting to prohibit modification of a contract except by a specified method does not prevent the parties to a contract from modifying it by some other methods.¹⁷

¹⁷ Zurich Ins. Co. v. CCR and Co., 576 N.W.2d 392 (Mich. App. 1997) (clause specifying contract may only be amended by a further written contract is wholly nugatory); Larson v. Hill's Heating & Refrig. of Bemidji, 400 N.W.2d 777, 781, (Minn. Ct. App. 1987) ("The general common law rule is that a written contract can be varied or rescinded by oral agreement of the parties, even if the contract provides that it shall not be orally varied or rescinded.") citing 6 Corbin on Contracts § 1295, at 206 (1962); see also In re Estate of Giguenet, 366 N.W.2d 345, 347 (Minn. Ct. App. 1985) (parties may orally agree to waive or modify a contractual term requiring the debt to be paid by a certain date) (oral agreement to delay enforcement of past-due promissory note).

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In addition to a formal written amendment to a contract, a written contract may also be modified by oral agreement of the parties and by the conduct of the parties, and the conduct of the parties may be evidence of a subsequent modification of their contract.¹⁸

¹⁸ Larson v. Hill's Heating & Refrig. of Bemidji, 400 N.W.2d 777, 781, (Minn. Ct. App. 1987) (a written contract can be varied or rescinded by oral agreement of the parties), citing 6 Corbin on Contracts § 1295, at 206 (1962); Williston on Contracts § 623, at 815-16 (3 ed. 1961).

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Impairment of Collateral

If the guaranty is secured by collateral and the party benefitted by the guaranty unjustifiably impairs the value of the collateral, then the liability of the guarantor is discharged to the extent of the impairment.*

1. Failure to obtain or maintain perfection.
2. Release of collateral.
3. Improper disposition of collateral.

*Restatement (Third) of Suretyship and Guaranty, § 34 (1995).

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Cannot Waive Impairment of Collateral Defense

Even absolute, unconditional and continuing guaranties have been interpreted as not waiving the impairment of collateral defense.

Courts reason that such defenses are not waivable because the Uniform Commercial Code § 9-602 prohibits debtors from waiving the commercial reasonableness standards relating to the sale of collateral securing debts.

*AAR Aircraft & Engine Group, Inc. v. Edwards, 272 F.3d 468 (7th Cir. 2001); but see Chem. Bank v. Paul, 614 N.E.2d 436 (Ill. Ct. App. 1993).

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OTHER ENFORCEMENT ISSUES

- Right to a Jury Trial.
- Loan Modifications and Workouts.
- Foreclosures.
- Bankruptcy.

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V. Best Drafting Practices for Lenders/Creditors.

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 Best Drafting Practices for Lenders/Creditors. (Cont'd)

1. Have each page of the guaranty initialed by the guarantor. And have the guaranty notarized.
 - Helps to prevent claims of fraud in the execution and/or aids in the defense of such claims.
2. Expressly state a specific expiration date of the guaranty and provide for an irrevocable and continuing guaranty.¹⁹
 - Prevents courts from finding an ambiguity about duration of guaranty and reading into the guaranty a "reasonable" length shorter than the lender requires to enforce the guaranty.

¹⁹ "A guaranty that covers transactions arising in the future within the contemplation of the agreement will be considered a continuing guaranty." 18 Michigan Pleading and Practice, § 24, p 41, citing *Furtz v. Larsen*, 252 Mich. 201, 233 N.W.2d 320 (1930) and *Mat'l Bldg. Supply Co. v. Spencer*, 211 Mich. 228, 178 N.W. 655 (1920).

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3. If there is a cure period for the underlying loan or other obligation, and/or for the guaranty, then expressly state the length of the cure period. If there is no cure period for the guaranty, then state that expressly.
 - Prevents claim that the cure period has not yet passed based upon the past course of dealing, course of performance, and/or waivers of the bank/creditor/lender.

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4. Expressly state that adequate consideration has been provided and received by the guarantor. And then separately provide specifics of the consideration.
 - If forbearance is part of the consideration, then state the length of time you will forbear from initiating litigation based upon past/current defaults and preserve the right to sue earlier for new defaults by the underlying debtor.

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5. Expressly state that Guarantor generally waives any and all claims and defenses of the underlying debtor and of the Guarantor and that the guaranty is absolute and unconditional. Then separately list, by way of example, specific claims and defenses the Guarantor is waiving. Make sure this list includes claims/defenses for fraud, fraudulent inducement, statutes of limitation and setoff, etc.

- Prevents guarantor from arguing that such waivers were not done knowingly, and provides specific factual basis for dismissing affirmative defenses and counterclaims as soon as they are filed.

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6. Negotiate a contra proferentum clause.

- Provides a strong basis for arguing a pre-printed guaranty supplied by the lender should not be construed in favor of the guarantor.

7. Add an acknowledgment the guarantor is represented by legal counsel and had adequate time to confer with legal counsel regarding the guaranty.

- Helps prevent claims of duress, coercion and/or fraud or other bad faith allegations made by the guarantor against the lender.

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8. Add confession of judgment provisions allowing the lender to avoid the lawsuit and directly receive a judgment.

- Provides a more efficient and timely resolution.
- If the guarantor seeks to have the judgment vacated, then the guarantor must act promptly and demonstrate meritorious defenses allowing the judgment to be vacated.
- If a confession cannot be negotiated then obtain a waiver of the guarantor's right to a jury trial.

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9. Negotiate a secured guaranty and require the guarantor to provide an annual certified personal financial statement and copies of income tax returns.

- Make sure your judgment on a personal guaranty means something by locking in the ability to collect by obtaining a security interest in collateral.
- If you cannot obtain a security interest in collateral, then make sure you know where the guarantor maintains its assets.

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10. Negotiate a waiver of all notice requirements.

- Notice of acceptance;
- Notice of default;
- Notice of changes in the terms of the underlying loan agreement;
- Notice of seeking/obtaining remedies against the debtor; and
- Notice of filing a confession of judgment; etc.

NOTE: Notice of default is not a prerequisite to an absolute guaranty, unless lack of notice causes loss or damages to the guarantor.²⁰

²⁰ Michigan Pleading and Practice, § 25, p. 43. 41
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11. Include a clause expressly stating that the guarantor has not relied on any prior statements or representations by the lender/creditor and that the only information relied on by the guarantor is contained in the guaranty agreement.

- Limits the ability of guarantors to assert claims of fraud, fraudulent inducement and/or misrepresentation as the guarantor cannot establish the critical element of "reasonable reliance."

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VI. Examples.

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Examples (Cont'd).

Example No. 1

The guaranty states: "**REMEDIES.** After the Borrower or [Guarantor] default, and after you give any legally required notice and opportunity to cure the default, you may at your option . . . make all or any part of the amount owing by the terms of this Guaranty immediately due."

- What is the cure period? Is it ambiguous?
- What if the borrower defaulted previously and used 11 months to cure after the loan expired?
- Does this create an ambiguity regarding the cure period?

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Examples (Cont'd).

Example No. 2

The Guaranty states, directly above the signature line: "This guaranty is unsecured; secured by a mortgage or security agreement dated _____; secured by _____."

- After a payment default, the bank seized \$90,000 from the guarantor's personal bank account without notice.
- The deposit agreement signed 7 years previously contained a "setoff" clause in fine print.
- Was the guaranty fraudulently induced?

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Examples (Cont'd).

Example No. 3

1. The Guaranty contains clauses stating:

“WHEREAS Borrower has requested that Lender suspend the requirement of monthly interest, and Lender has agreed to do so provided Guarantor provides Lender with this Guaranty; and

WHEREAS, guarantor will derive a personal benefit from the agreement of Lender to suspend the requirement of paying interest on a monthly basis and accordingly, is willing to execute this Guaranty.”

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Example No. 3 (Cont'd).

2. The Guaranty states: “The entire agreement of Guarantor is set forth herein and there are no other agreements affecting the provisions herein.”

3. The Amended Loan Agreement signed contemporaneously with the guaranty, but by different corporate officer of the debtor states that “half-monthly” interest payments are waived for 12 months AND requires the debtor to provide a first mortgage on a specified property.

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Example No. 3 (Cont'd).

4. The Bank required payment of half-monthly interest and declares a default 43-days after the guaranty is signed.

5. No additional first mortgage on the additional specified property was ever provided by the debtor.

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Example No. 3 (Cont'd).

Is the Guaranty in Example No. 3 Enforceable?

- Was the offer of guaranty accepted by the Bank?
- Did the Bank breach the guaranty's requirements?
- Did the bank fraudulently induce the guaranty?
- Was there consideration?

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QUESTIONS?

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Thank you!

THE END

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Ask the Lawyer: Enforcing Personal Guaranties

By Charles (CJ) Schoenwetter and Michael A. Montgomery

Enforcing personal guaranties is not always a slam dunk. Although lenders draft these documents to be air-tight, there are many valid defenses that may allow an individual to escape personal liability under a contract of guaranty.

Lenders Seeking To Enforce Personal Guaranties at an Alarming Rate

With the residential construction industry in distress, many lenders are content to foreclose on property serving as collateral for loans, but some are not. In the last 12 months, an ever increasing number of lenders have filed suit against personal guarantors of non-performing loans. A paramount issue these individuals face is whether personal liability exists for the debts of their companies based on personal guaranties they signed years ago.

Are Personal Guaranties Different Than Other Contracts?

Personal guaranties are a special type of contract with unique defenses and rules of interpretation.

For example, courts generally construe the terms of a contract against the drafter — typically the lender in cases involving a personal guaranty. Case law specifically addressing the interpretation and applicability of guaranties goes further. Contracts for guaranty must be strictly construed in favor of the guarantor.

Courts addressing whether personal guaranties are enforceable extend this principle to explain that guarantors have the right to prescribe the exact terms upon which they will enter into the guaranty obligation and to insist on a termination of the guaranty if those terms are not strictly observed.

This case law precedent may allow a guarantor to avoid personal liability for even minor variations between the operative facts and the terms of the guaranty. In other words, guarantors possess the right to insist that they be bound only to the extent, in the manner and under the circumstances specified in their guaranties, and no further.

Typical Defenses in an Action to Enforce a Guaranty

Typical defenses that can be raised in an action seeking to

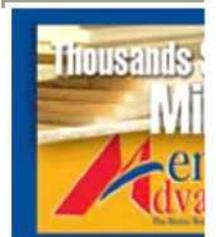
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enforce a personal guaranty include:

Failure of the lender to accept the personal guaranty — by providing notice of acceptance, for example

Failure of consideration

A material increase in the risk to the guarantor without the guarantor's consent

The lender's impairment of collateral securing the underlying loan

The lender's material alteration of the underlying loan agreement without consent of the guarantor

These defenses — two of which are discussed in greater depth below — are based on specific facts and may not be applicable to all, or even most, cases.

The Offer of a Personal Guaranty Must Be Accepted

A guaranty itself is typically just an offer — that must be accepted by the lender.

The terms of a personal guaranty may often require the offer of guaranty to be accepted in a particular manner, such as by extending the time period for paying off an existing loan. In such cases, failure to comply strictly with the manner of acceptance stated in the guaranty will result in no contract being formed. Thus, the personal guaranty cannot effectively be enforced against the would-be guarantor.

As one leading commentator has explained: "Until the requested acceptance has been made, the promise of the guarantor is nothing but an offer and creates no binding obligation on the guarantor even though the promise was in writing and signed by the promisor; nor does the mere signing of what is in fact an offer for a contract of guaranty create a contractual obligation, and in this respect the name which the parties attach to the instrument is immaterial."

Additionally, when the manner of acceptance does not otherwise require the lender to act, failure to give notice of acceptance may also be a valid defense to an enforcement action.

Something of Value Must Support the Guarantee

A personal guaranty also must be supported by consideration or something of value to be enforceable. A guaranty given for no consideration is merely an unenforceable gratuitous promise.

Personal guaranties are often form documents. Many times they contain a pro forma recitation that consideration (i.e., something of value) has been provided in exchange for the guaranty. However, such language is not determinative and individuals have successfully challenged the consideration recited in loan guaranties.

Consideration flowing to the borrower, however, does not need to result in a personal benefit to the guarantor in order to render the guaranty enforceable. Generally, consideration supporting the underlying obligation is sufficient to support the guaranty, if the promise of the guarantor is part of the transaction that created the original debt.

However, where the guaranty agreement is entered into independently or after the underlying debt obligation has been entered into, new consideration becomes necessary to support it.

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Failure of consideration and/or lack of adequate consideration can provide grounds to

avoid liability under a personal guaranty, especially when the guaranty was obtained as part of a work-out with a lender. Under such circumstances, courts have repeatedly dismissed claims against third-party guarantors when no additional funds have been extended.

A pre-existing debt is not sufficient consideration for a third-party guaranty. As expressed by one court, "consideration is not found in a mere naked promise to pay the existing debt of another." However, something as simple and small as "an extension of credit is ample consideration for execution of a guaranty."

Guarantors are often willing to sign personal guaranties in exchange for promises by the lender that there will be forbearance. There is no requirement to specify a definite period in an extension of the time for payment of an obligation. However, a lender's promise not to sue for the underlying overdue debt is not sufficient consideration unless the forbearance lasts for a reasonable period of time. If a lender does not forbear for a reasonable time, there is a failure of consideration and the guarantor is discharged from liability.

In one case involving a debt of \$200,000, a bank's forbearance of less than 80 days was held unreasonable, and the personal guarantor was released from his personal liability under the guaranty.

Whether a reasonable length of time for forbearance has been provided to adequately support the consideration required for a personal guaranty is always a question of fact.

Accordingly, this issue may be used to avoid summary judgment against the guarantor and force a trial, and may add three to six months (or longer) to the length of a case.

This additional time can often be used effectively by a guarantor and the underlying debtor to restructure or refinance the loan in order to avoid liability altogether.

Additional Factors on Enforceability

Documents drafted by lenders can be onerous and one-sided, with a lender at times providing representations and assurances as an inducement. At other times, lenders may enter into oral modifications of the underlying written loan agreement, or engage in unfair practices or bad faith relating to aspects of the lending relationship. It is possible for these circumstances to provide additional grounds for a defense.

For example, if a guaranty agreement does not state that it is the exclusive agreement between the parties regarding the issues addressed in the guaranty, then evidence of oral agreements made prior to, or contemporaneously with, the written guaranty may be used in determining the scope and terms of the guaranty contract.

Additionally, although many guaranties contain language stating that they may only be modified in writing signed by both parties, most courts recognize that contracts nonetheless may be modified orally or in the course of dealing between the parties. Those changes, though, typically must be demonstrated by clear and convincing evidence rather than a mere preponderance of the evidence — making them difficult to prove at trial.

If a lender has induced a material breach of the underlying loan

agreement, then that may serve as a defense as well as the basis for an affirmative claim against the lender.

Lenders are required by law to exercise good faith and fair dealing in their contractual dealings with borrowers and guarantors. If a lender engages in unjustified actions hindering another party's performance, then that is, in itself, a breach that may excuse performance.

Similarly, if the principal purpose of entering into a guaranty is frustrated, through no fault of the guarantor, by the occurrence (or non-occurrence) of an event that was a basic assumption on which the guaranty was made, then a guarantor's performance (i.e., payment of the underlying debt) may be excused.

Under this scenario, if a guaranty was procured with everyone's understanding that the lender would "work with" the borrower through a tough housing market — but then the lender immediately declares the borrower in default and sues on the personal guaranty — there may be a very strong "frustration of purpose" argument to assert against such a claim.

Determining When Guarantees Are Enforceable

Whether a personal guaranty is enforceable must be determined on a case-by-case basis.

In an overwhelming number of circumstances, a personal guaranty is typically enforceable. However, when the stakes are large and the transaction supporting the personal guaranty involves circumstances that are not standard, then the odds of a personal guaranty being vulnerable to a legal challenge substantially increase.

Personal liability under a guaranty can impose significant economic hardship for individuals while providing a quick and easy recovery for lenders. But recovery is not always certain. To determine whether a personal guaranty is enforceable, you should speak with an experienced attorney.

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The information in this article is intended to familiarize you with the law in this area. It is not intended to be an exhaustive presentation of legal information on this particular subject, and in no way constitutes an opinion of law. Your own attorney must review this information to determine how it may apply to your particular situation.

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**NATION'S
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Commercial Loan Guaranties under Heightened Scrutiny

Strategies for Lenders and Guarantors in Drafting,
Negotiating and Enforcing Guaranty Agreements

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Agenda

- Introduction
- Types of guaranties
- Drafting/ negotiating guaranties
- Questions

Introduction

- Definition of guarantor:
 - One who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor (CC §2787)

- Characterization of parties not controlling
 - Explicit guaranty
 - Co-obligor
 - Third party security
 - Take-out agreement
 - Master lease
 - Other

Introduction

- Consequence for real estate secured obligations:
 - One-action and anti-deficiency rules are not applicable directly to guarantors, or are waivable to the extent applicable (CC §2856)

Types of Guaranties

- Guaranty of payment or performance vs. collection
- Full or limited payment/ duration guaranty
- Recourse carve-out/ “bad boy” guaranty
- Continuing guaranty
- Springing guaranty
- Completion guaranty
- Related party corporate guaranties

Types of Guaranties

- Guaranty of payment or performance vs. collection

- Payment or performance:

A surety who has assumed liability for payment or performance is liable to the creditor immediately upon the default of the principal, and without demand or notice (CC §2807)

- Collection:

A guaranty to the effect that an obligation is good, or is collectible, imports that the debtor is solvent, and that the demand is collectible by the usual legal proceedings, if taken with reasonable diligence (CC §2800)

Types of Guaranties

- Full or limited payment/ duration guaranty
 - Liability limited by:
 - Amount or percentage
 - First dollar vs. last dollar
 - Duration (build-out, lease-up, DSCR hurdles, pay-downs, time without default, etc.)
 - Other

Types of Guaranties

- Recourse carve-out/ “bad boy” guaranty
 - Non-recourse or limited recourse
 - “Above the line” liability
 - Misapplication of rents or security deposits
 - Misapplication of insurance/ condemnation awards
 - Waste
 - “Below the line” or “full recourse flip” liability
 - Due on transfer violation
 - Fraud
 - Etc.

Types of Guaranties

■ Continuing guaranty

- A guaranty relating to a future liability of the principal, under successive transactions, which either continue his liability or from time to time renew it after it has been satisfied (CC §2814)
- May be revoked at any time by the guarantor, in respect to future transactions, unless there is a continuing consideration as to such transactions which he does not renounce (CC §2815)
 - But note ostensible ability to waive right to revoke (CC §2856(a)(1))

Types of Guaranties

- Springing guaranty
 - Liability springs to life upon creditor-unfriendly behavior
 - Example: voluntary bankruptcy

- Completion guaranty
 - Obligates the guarantor to complete the construction project, or provide funds for the lender to do so, if the borrower defaults on construction obligations
 - Measure of damages is (i) value which the improvements would have added to the security, had they been completed, less (ii) undisbursed loan proceeds¹

¹ *Glendale Federal Sav. & Loan Assn v Marina View Hieghts Development Co., Inc. (1977) 66 CA3d 101, 135 CR 802.*

Types of Guaranties

- Related party corporate guaranties
 - Upstream
 - Parent is primary obligor; Sub is guarantor
 - Downstream
 - Sub is primary obligor; and Parent is guarantor
 - Cross-stream
 - Sub A is primary obligor; and Sub B is guarantor

Drafting/ Negotiating Guaranties

- Purported guarantor problem
- Fraudulent transfer issues
- Waiver of suretyship rights and defenses
- Notice provisions
- Right to revoke
- Environmental indemnities
- Financial and other covenants

Drafting/ Negotiating Guaranties

- Purported guarantor problem
 - Arises anytime a person purports to incur liability as a guarantor for an obligation under which that person or its property is already liable
 - Examples

Borrower	Guarantor	Consequence
General partnership	General partner	Not a good guarantor
Limited partnership	General partner	Not a good guarantor
Revocable trust	Settlor/ trustee of borrower	Maybe not a good guarantor
Individual	Revocable trust of which borrower is the settlor or trustee	Not a good guarantor

Drafting/ Negotiating Guaranties

- Fraudulent transfer issues
 - “Actual” fraudulent transfer requires the actual intent to hinder, delay or defraud a creditor (Bankruptcy Code §548(a)(1)(A))
 - “Constructive” fraudulent transfer involves two elements:
 - Transferor/ obligor received less than reasonably equivalent value (Bankruptcy Code §548(a)(1)(B)(i), and
 - Transferor/ obligor was, or was rendered, insolvent (at fair valuation, not book valuation), had unreasonably small remaining capital, or intended to incur or believed it would incur debts beyond its ability to pay (Bankruptcy Code §548(a)(1)(B)(ii))
 - Lookback period of 2 years (federal) or 4 years (state)
 - Transfer/ obligation is avoidable

Drafting/ Negotiating Guaranties

- Waiver of suretyship rights and defenses
 - Three sets of rights under the Civil Code:
 - Rights of recourse against principal
 - Rights of contribution against co-sureties
 - Rights and defenses against the creditor
 - All three are waivable (CC §2856)
 - Other rights and defenses
 - Illegal transactions (e.g. – usury)
 - Duty to disclose
 - Rights under the UCC regarding enforcement against personal property collateral

Drafting/ Negotiating Guaranties

- Notice provisions
 - Typically not negotiable with traditional payment or performance guaranty
 - Consider in the take-out agreement or third-party security context

- Right to revoke
 - Typically applies to continuing guaranties
 - Include procedure for revocation
 - Clarify applicability of waiver to right to revoke (CC §2856(a)(1))

Drafting/ Negotiating Guaranties

- Environmental indemnities
 - Types of hazardous materials
 - Legal uses and quantities
 - Events arising after lender possession/ foreclosure

- Financial and other covenants
 - Careful attention to drafting
 - Include in guaranty
 - Include in other documents as borrower obligation

Questions

- Thank you for your time and attention

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