

# Guaranties 201 – Why We Get Them and How to Make Them Stick!

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# Overview

- **Guaranties, generally**
- **Enforcement and defenses**
- **Bankruptcy implications**

# The Basics of Guaranties

# What is a Guaranty and How Does a Guaranty Differ from Suretyship?

- **A guaranty is a contractual obligation that acts as an additional source of recovery and answers the debt of another**
- **A guaranty is executed separately from a principal debt contract with separate consideration**
- **A guaranty is a type of suretyship which is a more general term describing various financial relationships; a surety may be primarily or secondarily liable for the underlying obligation**

# What are the Different Kinds of Guaranties?

- Conditional guaranty requires the occurrence of some contingent event (other than the primary obligor's default) prior to triggering the guarantor's obligation
- Absolute guaranty is triggered upon primary obligor's default

# What are the Different Kinds of Guaranties?

- **Guaranty of payment requires guarantor's payment at maturity in the event the debtor fails to pay (an absolute guaranty)**
  - Exhaustion of remedies against primary obligor not required
  - No obligation to perform other than payment
- **Guaranty of collection requires guarantor's payment if the creditor cannot collect payment from the primary obligor, usually through litigation (a conditional guaranty)**
- **Guaranty of performance would require guarantor to undertake delivery or purchase of goods (assuming underlying agreement is something other than financial arrangement and where guarantor has ability to perform)**

# What are the Different Kinds of Guaranties?

- **Special guaranty specifies who may enforce the guaranty whereas a general guaranty may be enforced by anyone (successors and assigns)**
- **Non-recourse guaranty is the pledge of collateral without personal obligation**
- **Guaranty can be restricted to a specific underlying transaction or continuing if intended to cover a series of forthcoming transactions**
- **Guaranty may also be secured by the guarantor's assets (See UCC Arts. 3 and 9)**



# Scope of Guaranty

- **Guaranty agreement can provide for limited “cap” on amount owed**
  - Cap amount can include or exclude enforcement expenses and costs
- **Guarantee agreement can limit the time period in which guaranty remains in effect and/or can terminate upon the primary obligor satisfying certain financial benchmarks**

# “Bad Boy” Conversion

- **“Bad boy acts” can convert limited to unlimited liability on the guarantor if the following occurs:**
  - fraud or material misrepresentation on the part of the guarantor or the borrower in connection with the guaranteed debt, or
  - a disposition of the collateral in violation of the applicable loan and security agreement

# Regulatory and State Law Compliance Issues with Guaranties

- **Equal Credit Opportunity Act (Regulation B) makes it illegal to require a credit applicant's spouse (who is not involved in the business) to sign a guaranty (spousal guaranty may be necessary where there are joint assets)**
- **State law may permit issuance of guaranty only where guaranty is in furtherance of the guarantor's own corporate purposes**
  - Close relationship between guarantor and primary obligor may satisfy this requirement

# Compliance with Corporate Documents

- **Guarantor's formation documents (by-laws, articles of incorporation) or third party contractual obligations (covenants therein) may require board authorization for guaranty issuance, may provide other limitations or may prohibit guaranties altogether**
- **Seek opinion letter from guarantor's counsel and obtain resolution authorizing guaranty**

# Enforcement and Defenses

## Who can Enforce the Guaranty?

- Guaranty provided that guarantor “unconditionally guarantees the punctual payment when due . . . of any and all indebtedness . . . to Creditor now or hereafter existing.” Guaranty defined “Creditor” as “[PFS] . . . and all affiliates of PFS.”
- Subsequent purchaser of PFS’ assets was not an affiliate of PFS, and therefore was not a “Creditor” whose accounts were secured by the Guaranty. Accordingly, there simply was no basis for holding the guarantor personally liable under the Guaranty.

## Enforcement with Foreign Guarantor

- Foreign service of process is typically expensive and confusing
- Foreign guarantor can appoint process agent in the US and can consent to this service of process

# Waivers as to Enforcement

- **Guarantor typically waives notice of:**
  - creditor's acceptance of the guaranty and of existence of the guaranteed obligation
  - amendments or modifications made to the underlying agreement
  - changes to the guaranteed obligation amount



# Getting Out of the Guaranty – Potential Defenses

- **Contractual defenses**
- **Disclosure defenses**
- **Risk factor defenses (“suretyship defenses”)**
- **Primary obligation defenses**

# Getting Out of the Guaranty – Contractual Defenses

- **Meeting of the minds**
- **Lack of consideration**
- **Statute of limitations begins running when underlying debt is payable (or upon default in the case of continuing guaranty)**
  - Running of statute of limitations against the principal obligor is no defense to guarantor's liability
- **Statute of frauds**
- **Conditions precedent to guaranty liability (guaranty of collection)**
- **Limitations on scope of guaranty**
- **Guarantor can revoke offer for future debt incurred pursuant to continuing guaranty**
- **Lack of proper corporate authorization**

## Getting Out of the Guaranty – Disclosure Defenses

- **Lack of notification of an advance related to continuing guaranty may discharge guarantor's obligation (waiver usually enforceable)**
- **Lack of notification of primary obligor's default (waiver usually enforceable)**
- **Lack of notification (at the outset) of adverse facts that would increase guarantor's risk or of material changes to the underlying credit that would change guarantor's risk**

## Getting Out of the Guaranty - Risk Factor/Suretyship Defenses

- **Material change to underlying debt terms including interest rate adjustments or changes to the amount of installment payments (unless guarantor consents or waives)**
- **Impairment of security interest in collateral (discharge to the extent of impairment)**
- **Release of co-guarantor (discharge to the extent of released guarantor's proportional share of total liability)**
- **Suretyship defenses asserted by parent guarantor seem unviable (because parent guarantor likely has control over its subsidiary and the benefits realized by subsidiary will flow to parent as well)**

# Getting Out of the Guaranty - Primary Obligation Defenses

- **Primary obligor released from underlying debt**
- **Extension of time to perform primary obligation**
- **Failure to first pursue debtor discharges guarantor to the extent of damage caused by such failure (under guaranty of collection)**
- **Contractual defenses that primary obligor could assert**
  - Except for primary obligor's incapacity and bankruptcy discharge

# Reservation of Rights

- **Guarantor typically reserves all rights that the primary obligor holds under the underlying agreement**
- **Beneficiary of the guaranty may want to exclude from the reservation of rights clause primary obligor's bankruptcy and primary obligor's lack of capacity as defenses**

- **Where a creditor seeks to collect under a guaranty and the guarantor raises defenses of fraudulent inducement, ambiguity, undue influence, misrepresentation and breach of good faith dealing, and the like, the guaranty's unambiguous representations and warranties will control and defenses will be rejected**

# Potential Bankruptcy Implications



## Getting Out of the Guaranty - Bankruptcy Defenses

- **Guaranty and/or the payments made pursuant to the guarantee were fraudulent transfers**
- **Enforcement of guaranty against debtor-guarantor stayed by the automatic stay or through bankruptcy court's equitable powers where actions against the non-debtor-guarantor may harm successful reorganization**

# What Happens When a Guarantor Files for Bankruptcy?

- **Guaranty may be avoidable as a fraudulent transfer if made within two years prior to the petition per the Bankruptcy Code or within a longer time period depending on applicable state fraudulent transfer law**
- **Avoidable if guaranty lacked reasonably equivalent value in exchange and guarantor was insolvent at the time when the guaranty was executed**
- **Payments made under a guaranty that is determined to be a fraudulent transfer may also be avoided**

# Was the Guarantor Insolvent?

- **Insolvent if guarantor**
  - was left with “unreasonably small capital with which to conduct its business,” or
  - “intended to incur or believed it would incur debts beyond its ability to repay”

# What is Reasonably Equivalent Value?

- **Downstream guaranty (parent guarantees subsidiary's obligation) provides economic value except when subsidiary is insolvent**
- **Upstream guaranty (subsidiary guarantees parent's obligation) and cross stream guarantee (affiliate guaranties another's obligation) provide challenges when identifying “reasonably equivalent value”**
  - Better financing arrangement? Synergistic gains?

## Drafting Tips to Avoid Fraudulent Transfer Challenges

- **Agreement should evidence direct and/or indirect benefits conferred to the guarantor**
- **Contribution agreement providing guarantor with right to reimbursement/contribution from primary obligor after guarantor makes payment on the guaranty (a tangible benefit)**

## Drafting Tips to Avoid Fraudulent Transfer Challenges

- **Guarantor to warrant that it isn't insolvent and won't be rendered insolvent as a result of the guaranty**
- **Limit the guarantor's liability to an amount slightly less than its net worth**
- **TOUSA: savings clauses (limiting the amount recoverable under the guarantee to an amount that would not render the guarantee constructively fraudulent) may not be enforceable (issue not addressed on appeal)**

## What Happens When Primary Obligor's Payments Are Avoided?

- **Guaranty expires upon the primary obligation being paid in full**
- **Creditor may end up having to return payments received to the primary obligor's bankruptcy estate**
- **In such an event, a “spring-back” clause can reinstate the guaranty which allows creditor to seek payment from the guarantor**

## Is Creditor's Guaranty Claim Reduced by the Primary Obligor's Payment Amounts?

- Traditionally, a creditor need not deduct from its claim an amount received from a non-debtor third party in partial satisfaction of an obligation except to the extent payment from the debtor would produce a double recovery (Supreme Court in Ivanhoe)
- Ivanhoe has been interpreted to allow creditor to assert claim's full value against one obligor even after receiving collateral from a co-obligor, subject again to the rule that the claimant not retain more than 100 percent of the amount it was owed



## What About When the Primary Obligor Files for Bankruptcy?

- **Bankruptcy discharge of principal obligor does not release guarantor**
- **Debtor may propose reorganization plan providing for release of nondebtor guarantor and is confirmable subject to creditor's timely objections**
- **Guarantor holds contingent claim against debtor that becomes fixed when guarantor pays the creditor whose claim was guaranteed**

# Questions & Answers