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Dealing with Guaranties

Guarantors are often the primary source of repayment under credits to smaller business and startups. Capitalization issues arise as entrepreneurs look to future revenues as a source of repayment and future capitalization, leading to an overabundance of undercapitalized businesses, especially with startups. The owners of such businesses become wary of the risks of injecting personal savings into the venture, and the use of the guaranty has become commonplace. A secondary use of the secured guaranty, especially that of the guaranty secured by the business owner's personal residence was long a favorite device of the government guaranty programs. While the SBA seldom actually took a borrower's home away absent fraud or misapplication of funds, the threat always remained available means of maintaining the borrowers' attentions. This article will act as a refresher course in the provisions of a guaranty and some of the better practices with respect to realizing against a guaranty.

Important guaranty provisions

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Guaranty of payment versus guaranty of collection. Originally, guaranties were provided in two forms, that of payment and that of collection. The guaranty of collection, seldom used in today's business, provides that in the event that the principal obligor fails to make the guaranteed payments, then the holder of the guarantee may go against the Guarantor only after taking all steps necessary to collect against the principal, including the reduction of the claim to a final judgment in court. Given the time value of money, and the costs of litigation in today's courts, the guaranty of collection is of greatly reduced value. The guaranty of the payment on the other hand becomes actionable upon the default of the principally, with out the necessity of showing a reluctance or inability to pay on the principal's part.

Parties' Intent. Whether a guaranty will be deemed a guaranty of payment or of collection is a matter of the parties' intent and should be shown by the language of the document itself. Generally, where the term "payment" is included in the definition of the guaranty, the guaranty will be deemed a guaranty of payment, notwithstanding the inclusion of the term "collection". Where there is no use of the term "guaranty", and the undertaking is cast more in the language of an "" against ultimate losses and attorney fees incurred by the beneficiary of the agreement, it will be deemed a guaranty of payment. Where there is little evidence on the face of the document, the facts and circumstances of the undertaken might be taken into account. In general, however, if a document is titled as a guaranty, the courts are most likely to deem the undertaking as one of payment[1].

UCC Treatment. In both Mississippi and Tennessee, the Uniform Commercial Code provides that a guaranty made by an accommodation party (i.e. one who signs on the initial instrument) will, in the case of a clear intent, be enforced only as a guaranty of collection and not of payment:

> If the signature of a party to an instrument is accompanied by words indicating unambiguously that the party is guaranteeing collection rather than payment of the obligation of another party to the instrument, the signer is obliged to pay the amount due on the instrument to a person entitled to enforce the instrument only if (i) execution of judgment against the other party has been returned unsatisfied, (ii) the other party is insolvent or in an insolvency proceeding, (iii) the other party cannot be served with process, or (iv) it is otherwise apparent that payment cannot be obtained from the other party.

Mississippi Code (1972) Sec. 75-3-419 (d), TCA Sec. 47-3-419 (d). The negative implication is that where ambiguity exists, an accommodation party will be a guarantor of payment, and this statutory provision may well be used in the construction of separate guaranties in times to come.

Waivers -- Maintaining the Guaranty as a Principal Obligation. Even if a guaranty is of payment and not of collection, there arise certain questions as to the extent to which collection should be first sought of the primary obligor. This will generally arise in two scenarios, first in the case where the Lender prefers to go after the guarantor for political or expedience considerations, and secondly where the objective evaluation of the likelihood of actual recovery from the principal is low. Assuming that the guaranty document does not have any express provisions setting forth the prerequisites to demand for payment, both in Mississippi and in Tennessee, at the very least, such demand as may be required so as to create a default on the part of the principal should at least be made, at least where a default does not otherwise arise without demand. Beyond that, however, there is not a clear statement of the types of notices, presentations and demands required of the guarantor. A complete form guaranty may contain a block of waivers as follows:

> Waiver of Rights. The Guarantor expressly waives: (a) notice of acceptance of this Guaranty by the Bank and of all extensions of credit to the Borrower by the Bank; (b) presentment and demand for payment of any of the Borrower's Indebtedness; (c) protest and notice of dishonor or of default to the Guarantor or to any other party with respect to the Borrower's Indebtedness or with respect to any security therefor; (d) notice of the Bank obtaining, amending, substituting for, releasing, waiving or modifying any security interest, liens, or encumbrances now or hereafter securing the Borrower's Indebtedness, or the Bank's subordinating, compromising, discharging or releasing such security interests, liens or encumbrances; (e) all other notices to

[1] This is a deviation from the historical treatments of bonds and guaranties, especially in Mississippi. Early Mississippi case law required an affirmative guaranty of solvency to enforce a guaranty of unspecified nature beyond an amount the holder would have obtained in a judgment against the principal. Robinson v. Lane, 22 Miss. 161 (1850)

which the Guarantor might otherwise be entitled; (f) demand for payment under this Guaranty; and (g) any right to assert against the Bank, as a defense, counterclaim, set-off, or cross-claim any defense (legal or equitable) set-off, counterclaim, or claim which the Guarantor may now or hereafter have against the Bank or the Borrower, but such waiver shall not prevent the Guarantor from asserting against the Bank in a separate action, any claim, action, cause of action, or demand that the Guarantor might have, whether or not arising out of this Guaranty.

However, there is not a lot of case law addressing the efficacy of some of these common waivers, and the wise course therefore is to follow the general common law prerequisites to the presentation of a demand against the guarantor.

Notice of Default. It is advisable to give the Guarantor notice of the default of the principal. Of course, in the case where a shareholder officer is guaranteeing corporate debt, knowledge of the default may be inferred. In addition, where there is a failure to notify a guarantor of default, the result is generally an offset to the extent that the guarantor suffers actual damages as a result of the failure to provide the notice. The failure will not, in general, cause the guaranty to become unenforceable.

Notice of Amendments. Many modifications are made extending the time for payment of guaranteed loans or modifying the rate of interest. When such actions are taken, it is important not only to notify the guarantor of the changes being made but to also have the guarantor join into the modification agreement. While most guaranty forms will expressly waive the right to such notice (and presumably any right to join into the modification) and while it is true that more modern case law in Tennessee and Mississippi has enforced guaranties of modified debt, it should be noted that some states (not Tennessee or Mississippi) have statutory laws voiding the obligation of the guarantor in the event of such modifications, and an inventory of the modern cases will show them to be situations where the guarantor is a managing principal of the debtor, fully cognizant of and benefitted by the modification made. Should a similar issue arise in the case of a guaranty by a minority member or other more remote accommodation party, it is possible that a court may take a position more favorable to such a guarantor. It is therefore always advisable to make certain that all guarantors have joined into any modification or extension of the guaranteed indebtedness, including any release of collateral or other guarantors.

Notice of Dishonor. Notice of dishonor of a note has almost been waived out of existence. Under older law, prior to any demand on against the principal maker of a note payable from the principal's account with a third party, the creditor would first be required to present the note to the account holder third party and the same would have to be dishonored. There would thereupon be a requirement of notice of such dishonor to the principal maker. This concept migrated to the guaranty, and there was a similar common law doctrine that there had to be a dishonor of the obligation on the part of the principal and notice of the same prior to proceeding against the guarantor. This concept no longer exists, since in the case of promissory notes, where payment is to be made from an account debtor, the law of negotiable instruments (i.e. checks) has superseded the common law and in the case of guaranties, this notice is now synonymous with the notice of default by the principal.

Actions Directly Against Guarantor. Assuming the proper notices have been given the guarantor during the term of the loan and the period surrounding the principal's default, the creditor may wish to proceed directly against the guarantor without joinder of the principal. It seems clear that this may be done in both Tennessee and in Mississippi. If the principal is not joined in the suit for political (e.g. high profile principal) or expedient (e.g. out of state principal) reasons, most likely the principal will be brought in to the suit on a cross claim by the guarantor. However, where the principal is judgment proof, not only may the suit be brought against the guarantor alone, but in the case of bankrupt principals, the action will have to be against the guarantor alone.[2]

Unusual Statutory Provisions

In addition to the common and case law treatment of guaranties, there are statutory provisions in both Tennessee and in Mississippi which we have found ourselves explaining to out of state lenders from time to time. These provisions stem from the statutory law in both states with respect to suretyship, which is the predecessor to the modern guaranty, but which has some decidedly different considerations. Classically, a surety was paid to underwrite the debt of another, and professional sureties provided the bonds necessary for the protection of estate interests, in the case of executors, administrators and conservators, as well as the bail bonds, completion bonds, and lost instrument bonds necessary for security in legal transactions. It is not surprising that a large portion of the case law dealing with guaranties was founded in the surety transactions, and most of the statutory regulation of suretyship applied to the types of bonds mentioned above. But given that, the following two statues are still on the books in Tennessee and Mississippi:

Miss. Code (1973) § 87-5-1. Surety discharged if creditor fails to sue the principal debtor when notified.

Any person bound as surety or accommodation indorser for another, may, at any time after the debt has become due or liability been incurred, give notice in writing to the creditor to commence and prosecute legal proceedings against the principal debtor, if living and resident within this state, for the recovery of the debt; and if the creditor fails to commence legal proceedings by the next term of the court in which the same shall be instituted, to be held after the expiration of thirty days from the giving of the notice, and to prosecute the same to effect, the surety who shall have given the notice shall be discharged from liability. It shall not be lawful to plead or to give in evidence under this section a notice not in writing, and any act of the creditor shall not be a waiver of notice in writing as herein required.

Tenn. Code Ann. 47-12-101. Notice requiring creditor to sue — Creditor's inaction. —

(a) When any surety by bill, bond, covenant, or nonnegotiable note for the payment of money or note for specific articles, other than the surety of a guardian, executor, administrator, or public officer, or guarantor of negotiable paper, apprehends that the principal is likely to become insolvent, or to migrate from the state, without previously discharging the debt or obligation, the surety may, if the debt or security be due, by notice in writing, require the creditor forthwith to put it to suit.

(b) Unless, within thirty (30) days thereafter, the creditor commences an action, and proceeds with due diligence in the ordinary course of law to recover judgment for the debt or obligation, and by execution to make the amount due thereon, the creditor shall forfeit the right which the creditor would otherwise have to recover it from the surety.

We have been asked from time to time how these provisions affect a common loan guaranty. The answer is not as certain as we would wish. While it is apparent that these provision are contained within sections dealing with the law of suretyships, and specifically, the law applicable to surety companies, they do have broad language and might have some applicability to a common loan transaction. The better holding would be that they do not.

The Tennessee statute does not seem to have any annotation or case law construing the provisions of the statute. The insertion of "…guarantor of negotiable paper…" seems to mean that common loan transaction should be excluded. However, it could also be read as an addition to the "any surety by bill ,,," language, and most modern notes do not meet the (UCC.) definition of "negotiable", so it is difficult to give an unqualified answer.

[2] This situation has an interesting comparison to the earlier law (see fn. 1)

Common sense dictates that the statute should not apply to common guaranties, but lawyers and judges are not always ruled by common sense[3].

Mississippi has addressed its statute, though, and in a relatively modern case as well. In Brent v National Bank of Commerce of Columbus 258 So.2d 430 (Miss. 1972), the Mississippi court actually provided criteria for distinguishing a surety from a guaranty, and since the Mississippi statute clearly applies only to sureties (the word "guaranty" is not to be found), the court held that this statute would not be applied to garden variety loan guarantors. For reference, the court found the following to be the distinguishing characteristics of the guaranty and the surety:

> To paraphrase and set forth in substance, the distinguishable attributes of a contract of suretyship are as follows: (1) A surety is primarily and directly liable to the creditor on his contract from the beginning; (2) the undertaking of a surety is made at the same time and usually jointly with that of his principal, and binds him jointly to the performance of the very contract under which the liability of the principal accrues; (3) the contract of the surety is a direct original agreement with the obligee that the very thing contracted for shall be done, i.e., the surety is an insurer of the debt or obligation; and (4) a surety is held to know every default of his principal and is liable without notice. In contrast, a guaranty contract possesses the following characteristics: (1) A guarantor is secondarily liable to the creditor on his contract and his liability is fixed only by the happening of the prescribed conditions at a time after the contract itself is made; (2) the contract of a guarantor is separate and distinct from that of his principal, and his liability arises solely from his own contract, although its accrual depends on the breach or performance of a prior or collateral contract by the principal therein; (3) a guarantor enters into a cumulative collateral engagement, by which he agrees that the principal is able to and will perform a contract which he has made or is about to make, and that if he defaults the guarantor will, on being notified, pay the resulting damages, i.e., a guarantor is an insurer of the ability or solvency of the principal, although this characteristic is not present in an absolute guaranty or a guaranty of payment, but only in a conditional guaranty or a guaranty of collection; and (4) except where the guaranty is absolute, generally the guarantor is entitled to notice of the default of the principal.

These distinctions draw upon a 1923 case and the same Corpis Juram Secundus books that served as a backdrop for the closing credits in the "Perry Mason" series, but the court does sensibly determine that there is something about a paid surety bond which is different from a loan guaranty, and the statutory provision allowing the Indemnitor to force a suit will not be applied to loan guaranties.

Subrogation and the Deprizio Doctrine

Under general common law principals, a guarantor who makes a payment on behalf of the principal is subrogated to the rights of the creditor against the principal. In effect, the guarantor succeeded to the position of the

[3] Not to be facetious, often other precedent and the effect of the ruling as precedent itself force tribunals to strictly adhere to statutory language in spite of its intent to the contrary.

creditor under the loan[4]. In a 1989 bankruptcy case generally called "Deprizio", the Deprizio Doctrine was adopted which basically held that should the creditor have an inside guarantor (e.g. a shareholder or officer) the preference period for payment made on the debt would be extended from 90 days to one year. Since guarantors of bank debt are almost always "insiders" under the bankruptcy code, the result was to extend the preference period for almost all guaranteed debt. Congress sought to remedy this in the 1994 Bankruptcy Reform Act, but several circuits continued to pay lip service to the Doctrine leaving an issue as to whether Deprizio was truly dead. Since Deprizio hinged on the fact that an insider guarantor could become a creditor of the bankrupt estate, and was benefitted by the payment made by the principal to the creditor, the key to defeating the extended preference period was to make certain that the guarantor could never become a creditor and thus break the chain. As a result, post 1990 guaranties should have a provision under which the guarantor waives any right to subrogation for any payments made by the guarantor under the guaranty. The effect is to avoid the possibility of the guarantor becoming a creditor benefitted by the principal's payments, and while there may yet be a uniform statement of the continued applicability of Deprizio, the "boilerplate" waiver of subrogation necessary in all modern guaranties avoids one becoming the final test case for Deprizio. It is important, therefore, to review your standard documentation to make certain such a waiver is included.

Purchase of the Indebtedness by Guarantor

In many cases, one of the most mutually beneficial workout transactions between a creditor and a guarantor will be the purchase by the guarantor of the creditors note, and an assignment of all of the collateral associated with the loan. Much more potent that common law subrogation, such an act insures that the guarantor obtains the benefits of any collateral posted for the indebtedness, and also gives the guarantor some additional influence over the acts of his co-guarantors. The insider guarantor may face true Deprizio issues and may be further hindered by the collection efforts it may take against the principal to the disadvantage of unsecured creditors, but these issues are present in any situation in which the guarantor is attempting to recover his payment of the principal's debt. Also, the Deprizio clauses contained in the guaranties make the efforts at recovery by subrogation or contribution from other guarantors even more difficult. Where more than one guarantor is involved, the sale of the loan to the deep pocket guarantor preserves that guarantor's ability to realize against the principal's assets as well as to proceed against the remaining guarantors in an orderly fashion.

Application to Multiple Debts

The application by the lender of funds received by a principal between guaranteed and unguaranteed loans or portions of the same loan have steadily withstood challenge by guarantors over the years, although cases do continue to arise discussing the issue. Where there is a specific instruction as to the debt to be paid, the creditor will generally be obliged to comply. However, where there is no such direction, the creditor is free to apply the payment to an unguaranteed debt in preference to a guaranteed debt in both Mississippi and in Tennessee. Of course, this presupposes that the debts are mature in each case. At least in Mississippi, and most likely in Tennessee, a creditor cannot accelerate unmatured, unguaranteed debt in order to pay the same in preference to matured guaranteed debt.

[4] But see the section **Purchase by Guarantor** below. Many of the ancillary remedies of the creditor can be lost to the performing guarantor if the guarantor pays and the note is cancelled.

Other Miscellaneous Issues

Release of Collateral or Co-Guarantors. It would seem to be well settled law that in Tennessee and in Mississippi that a creditor may release collateral or the obligations of co-guarantors without affecting the recourse against a guarantor if the guaranty so states. In the case of "absolute" guaranties, this would almost certainly be the case. However, although Mississippi and Tennessee courts do seem to favor the ability of the creditor to go after any one of jointly and severally liable co-guarantors, there is an equitable doctrine of "impairment of collateral" which has been given some recognition in Tennessee and Mississippi cases and which may well be invoked in the event of collusion or if there appears to have been some particularly poor business judgment on the part of a creditor. It is, therefore, advisable to keep all the guarantors informed of any actions with respect to any collateral or any one guarantor, allowing the remaining guarantors to preserve recourse for the right of contribution which may arise as a result of a full release by any one guarantor.

Last Dollar/First Dollar. Although claims are often made by guarantors that recovery by the creditor should be applied to the guaranty, it is clear in Tennessee and in Mississippi that the guaranty is generally treated as a guaranty of deficiency. Guarantors will be held liable for the last dollar of the borrowers obligation, even if the amount is limited by dollar figure. This should be compared to guaranties of percentages of the outstanding amount, in which recoveries do, by their operation, result in a pro rata reduction of the guaranty amount. Note however, that in a percentage guaranty, because the payment by the guarantor results in a subrogation claim on the part of the performing guarantor (absent the language waiving such subrogation for Deprizio considerations above), while not satisfying the borrower's debt to the creditor, the creditor and the guarantor have now become competing creditors against the borrower. Most guaranty forms have a provision requiring that such claims be subordinated in full to the creditors claims.