
Guarantors Beware

Parties that signed loan guarantees in recent years, including loans secured by real property, are understandably nervous in today's difficult economy. With so many real estate projects in trouble, many lenders are breathing a sigh of relief when they find a loan guaranty in their file. Most often these are personal guarantees signed by individuals that are principal players in the real estate project. When the loan goes bad, how nervous should the guarantor be?

The answer depends upon a myriad of factors, many of which are outlined below, which might provide a defense against the lender. As an initial matter, however, it should be noted that the guaranty is legally separate and distinct from the loan obligation. The often-cited Anti-deficiency Rule and One Action Rule should have nothing directly to do with a secured loan guaranty (but those rules might play an indirect role). The lender is free to pursue the guaranty, pursue the collateral securing the loan, or both. When a loan turns bad, a typical lender will ask: How attractive is the guaranty versus the collateral? Non-judicial foreclosure is arguably an easier remedy than a guaranty lawsuit. So if the collateral is worth a major portion of the unpaid debt, the lender might view foreclosure as the primary remedy with the guaranty as secondary. If, however, the collateral's value is not strong or is rapidly declining, the lender might make pursuing the guaranty the top priority. High cost and effort might discourage the lender from simultaneously pursuing both avenues. If a guarantor is facing probable liability to a lender, the guarantor should consider the following:

Is the guaranty a sham? If the guarantor is merely an "alter ego" of the borrower, then that guaranty might be a sham, since the guarantor is really akin to a principal/borrower, and therefore entitled to the protections of the One Action Rule and Anti-deficiency Rule. For example, if a lender requires a general partner to guaranty the loan of a limited partnership, then this guaranty could be construed as an invalid sham guaranty since, by law, the general partner was already obligated for the debts of the partnership/borrower, and should have received the protections of a borrower. Similarly, sole shareholders of corporations, sole members of limited liability companies, and other closely related parties, might be able to bring an alter ego/sham guaranty defense. It is a very fact specific analysis. For example, if a lender's practices routinely attempt to circumvent the Anti-deficiency Rule and One Action Rule (these borrower protections are not waivable) by requiring a party, even financially strong party, to borrow using a special purpose entity and then backstop that loan with a guaranty from the principal party, then such practice might create an invalid sham guaranty.

Are traditional contract defenses available? A guaranty is like any other contract. It is susceptible to all contract defenses, such as allegations of unconscionability, incapacity, duress, fraud, forgery, mistake, waivers, failure of consideration and a breach of implied covenant of good faith and fair dealing. Many would deem these defenses to be "long

shots,” especially if the court will view the guarantor as a sophisticated party. Many of these defenses may have been expressly waived in a well-drafted guaranty agreement. These defenses depend on the individual facts and circumstances.

Was the underlying obligation increased in any way, without guarantor’s consent? If this occurred in the past, then this could be raised as a guarantor defense. The guarantor would arguably not be liable if the guarantor did not consent to changes in the underlying obligation. Again, this type of defense is fact driven and may have been waived when the guaranty was executed.

Did the lender fail to exhaust its remedies against the borrower or the collateral? Since a guaranty is akin to a suretyship, this classic surety defense might apply. Conceptually, this defense says that the guaranty was a “backstop,” and the guaranty should not be responsible unless and until the underlying remedies have been exhausted. With that said, this defense is commonly waived when a guarantor executes a standard form guaranty agreement.

Is there a right to collect from the other guarantor? Loans are commonly guaranteed by more than one guarantor. Through an express or implied right of “contribution” a guarantor who pays a lender might be able to recover some of those funds from the co-guarantor. The co-guarantor might be a partner and such rights might be addressed in the partnership agreement.

Is the guarantor heading for bankruptcy? If the lender is convinced that bankruptcy is likely, a guarantor might be able to negotiate a settlement with the lender. The legal implications of bankruptcy are complicated, but the potential for bankruptcy may play a large role in a guarantor’s negotiations with a lender.

Has the bidding at foreclosure affected the guaranty? In the event that the lender has non-judicially foreclosed on the property, and if the lender used a “full credit bid” at the foreclosure sale (as lenders often do), then the acquired property will be deemed worth the amount bid, and since the full credit bid was used, the debt will be deemed fully repaid. With the borrower’s debt reduced to zero dollars, the potential amount recoverable from the guarantor is reduced to zero dollars. On the other hand, if the lender low-bids in a judicial foreclosure, thus keeping some guaranteed debt “alive,” then a guarantor’s liability might depend on the application of the so-called “fair value” rule. If a fair value hearing occurs in a judicial foreclosure after a successful low bid, the loan deficiency, i.e., the guarantor’s legal exposure, might be reduced by the fair value of the property, not merely the amount of the low bid.

As a general rule, guarantees are enforceable and serious matters. When a loan goes bad, the negotiations between the lender and a guarantor can be complicated. It’s a minefield for both parties, and much depends upon the facts and the content of the documents. In addition, as with many contract disputes, attention must be given to contract provisions that permit the winning party to collect attorneys fees. Such fee provisions make it prudent to carefully analyze how to contest a loan guaranty.



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