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## SECURED LENDING ALERT

### 23 Defenses of the Guarantor

This article focuses on the various defenses which have arisen to the enforcement of a commercial loan guaranty. Many of these defenses can be thwarted with careful drafting of the guaranty. The drafting suggestions listed below are general in nature and are not intended as specific legal advice.

Guaranties are largely, but not exclusively, governed by the common law of the state whose law is applicable to the particular guaranty. Some states, including Illinois, have enacted statutes that address specific issues with respect to guaranties, but the states generally have not adopted a uniform set of laws governing guaranties (such as the Uniform Commercial Code as it pertains to secured transactions, sales of goods, letters of credit, etc.) A brief discussion of the Illinois statutes and a recent adverse case for lenders appear at the end of this article.

Some courts bend over backwards to protect a guarantor. Over the years a number of defenses have been successfully raised by guarantors when a lender tries to collect a loan. However, as indicated above, many of these defenses can be defeated by careful drafting of the guaranty agreement.

Let's examine some of the more frequently raised guaranty defenses:

**1. NO CONSIDERATION.** This defense is raised frequently by guarantors. Courts have consistently held that credit extended to the primary debtor (borrower) is sufficient legal consideration to support a contemporaneous guaranty. This legal consideration is a prerequisite to a binding contract.

Suggestions: Guaranties should be dated and executed at the same time the loan documents are dated and executed. If the guaranty is obtained after the loan was made, there must be some independent consideration to support it, such as a forbearance by the lender in pursuing default remedies against the borrower concurrently with the execution of such guaranty. The guaranty should also contain a statement of the consideration for the guaranty. If the guaranty is a forbearance guaranty, it should recite what the lender is giving up. If the guaranty is taken

after the loan is made, without consideration, the risk of a later challenge for "consideration" will remain.

The issue of whether there is legal "consideration" to support a guaranty is separate and distinct from the "fair consideration" issue raised in connection with a fraudulent conveyance analysis discussed in Item 2 below.

**2. INTERCORPORATE GUARANTY AS A FRAUDULENT CONVEYANCE.** Some lenders do not realize that fraudulent conveyances include both (i) "actual" fraudulent conveyances in which a fraud on creditors was intended, and (ii) "constructive" fraudulent conveyances in which the conveyance (without any requirement of intention) has the constructive effect of a fraudulent conveyance on creditors of the guarantor.

Generally, under Section 548 of the Bankruptcy Code and state fraudulent conveyance statutes, a guaranty may be set aside as a constructive fraudulent conveyance if (a) the guarantor was insolvent at the time the guaranty was executed or was rendered insolvent or nearly insolvent as a result of such guaranty\*, and (b) the guarantor did not receive "reasonably equivalent value" or "fair consideration" in exchange for the guaranty. Both of these elements must be present in order to avoid the intercorporate guaranty or stated another way, if one of these elements is not met, the guaranty will not be set aside as a constructive fraudulent conveyance. So for example, if the guarantor was clearly "solvent" after taking into account the liability guaranteed, the fact that the guarantor did not receive "reasonably equivalent value" for the guaranty will not cause the guaranty to be deemed a "constructive fraudulent conveyance".

In assessing the first element of whether the guarantor was insolvent or became insolvent or nearly insolvent as a result of the obligation guaranteed, unfortunately, there are many issues to evaluate and very little decisional law to provide guidance on these crucial issues. Some of these thorny issues include: (i) what is the correct method for valuing the guarantor's assets for purposes of determining solvency?; (ii) what value does one assign to the guarantor's rights of subrogation, contribution and/or reimbursement?; (iii) how are the guarantor's liabilities to be measured?; and (iv) when does insolvency get measured in the case of a continuing guaranty? Another handicap when dealing with solvency issues is that some courts employ a "hindsight" approach (also called "retrospection") in evaluating the solvency of a guarantor, and a court may lean toward a determination of "insolvency" based on the fact that the guarantor did become insolvent within a specified period after the guaranty was obtained.

In assessing the second element of whether the guarantor received "reasonably equivalent value" or "fair consideration", many courts require that the guarantor receive a significant tangible economic benefit from the loan being guaranteed. A few courts have concluded that the guarantor received "reasonably equivalent value" or "fair consideration" if the guarantor received an "indirect benefit" from the guaranteed loan (examples include: increased corporate synergies in the form of a substantial identity and commingling of affairs of affiliated entities, general strengthening of the corporate family and the guarantor's debts were paid off from the loan).

The amount of consideration required in evaluating whether a guarantor received "reasonably equivalent value" or "fair consideration" is higher than that which is generally sufficient under law to sustain a contract. It should be noted that the "indirect benefits" support for an intercorporate guaranty has only arisen in a small number of cases and therefore a lender's reliance on "indirect benefits" should only be used after carefully evaluating the facts of the transaction and recognizing that there is an inherent business risk in relying on such theory due

to the sparse case law and the unique set of factual circumstances in which such theory was previously applied. In a recent very large bankruptcy case (In re TOUSSA, Inc., Case No. 08-10928-JKO, Adv. Pro. 08-1435-JKO), the United States Bankruptcy Court for the Southern District of Florida avoided as constructive fraudulent transfers certain liens given and debt obligations incurred by several of TOUSSA's subsidiaries to a syndicate of lenders. The Court soundly rejected the lenders' claim that the conveying subsidiaries had received "reasonably equivalent value" in the form of "indirect benefits" as a result of certain corporate synergies received by the subsidiaries, such as access to a centralized cash management system, purchasing, payroll and benefits administration.

Some lenders mistakenly believe that common ownership of the borrower and guarantor constitutes "fair consideration" for the intercorporate guaranty, but that is not accurate. Remember that each entity is a separate legal entity and has its own distinct set of creditors and it would be unfair to the creditors of the guarantor to permit the guarantor to guarantee the debts of an affiliate merely due to common ownership (since the benefit of the loan would generally only inure to the common shareholders, and not to the guarantor itself).

Intercorporate guaranties should always raise a red flag for a lender, and evaluation of the risk of a constructive fraudulent conveyance challenge must always be considered. When applicable, the lender should take great care in documenting its files to support its determination that the guarantor was not insolvent\* at the time the guaranty was executed or rendered insolvent or nearly insolvent as a result of the guaranty and/or where applicable, that the guarantor received either a direct monetary benefit from the loan or sufficient "indirect benefits" from the loan. Although such steps will not assure insulation from a fraudulent conveyance challenge, it may lessen the lender's burden in defending such a challenge.

The issue of whether a corporate guarantor received a benefit from a loan is always present when dealing with an upstream guaranty (subsidiary guaranteeing the parent's debt) or a cross-stream guaranty (subsidiary or affiliate guaranteeing another subsidiary's or affiliate's debt). In a downstream guaranty (parent guaranteeing its subsidiary's debt), the parent is deemed to receive an indirect benefit because its investment in the subsidiary is presumed to be increased by the improved financial status of the subsidiary. However, where the parent owns less than a majority of the subsidiary's stock or the subsidiary is insolvent on the date of the loan, a question could be raised as to the amount of benefit actually received by the parent.

It should be noted that an entire chapter in a book could be devoted to the complicated topic of fraudulent conveyances, but that for purposes of brevity, the above will have to suffice as a very brief summary. In any case, the fraudulent conveyance defense is growing as a potent defense for the guarantor in an intercorporate setting.

Lenders should also be aware that an intercorporate pledge of collateral to a lender by an entity to support a loan to an affiliated entity is also subject to the same constructive fraudulent conveyance analysis as would be made for an intercorporate guaranty.

[\*the actual solvency test under Section 548(B) of the Bankruptcy Code was abbreviated for purposes of this article and also includes two other alternative elements for a constructive fraudulent transfer: (i) if the guarantor was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the guarantor was an unreasonably small capital, or (ii) if the guarantor intended to incur, or believed that the guarantor would incur, debts that would be beyond the guarantor's ability to pay as such debts matured]

**3. STATUTE OF LIMITATIONS.** Lenders must check the applicable state statute to determine the applicable statute of limitations for a suit on the guaranty.

Suggestion: Many guaranties contain a provision requiring the guarantor to waive the defense that the statute of limitations has expired with regard to enforcing the guaranty. It is not clear if such a waiver will be enforced, but it cannot hurt to include such a waiver in case such waiver can be enforced.

**4. CONDITIONS PRECEDENT TO LIABILITY.** Many guarantors routinely raise defenses alleging that certain oral agreements were made which condition the effectiveness of the guaranty. For example, a guarantor will argue that the lender told the guarantor that no suit would be brought on the guaranty until the lender had pursued the borrower or the collateral without success. The standard form of commercial guaranty is drafted as a guaranty of payment, rather than a guaranty of collection, and therefore the guarantor is primarily liable for the debt and can be sued first without resorting to the borrower or the collateral (see Items 5 and 17 below).

Suggestions: Since there is no limit to the number of "conditions" to a guarantor's liability which can be alleged by a guarantor, the guaranty should include a strong "merger clause" which clearly states that the entire agreement of the parties is set forth in the guaranty and that it supersedes all prior or contemporaneous oral or written agreements. The merger provision should also exclude any course of dealing, course of performance or trade usage that might otherwise be used to undercut the written agreement.

**5. EXPRESS LIMITS ON THE SCOPE OF THE GUARANTY.** If the terms of the guaranty are limited as to amount, duration, joint and several liability, or contain some other form of limitation, the lender may find itself with less than an "unconditional" guaranty.

Suggestions: The description of the guaranteed debt should be described as broadly as possible. If the guaranty is a continuing guaranty, it is crucial that all future guaranteed debt be described in a comprehensive fashion. In addition, the language should clearly provide that the guarantor is primarily liable for the debt (a "guaranty of payment") rather than secondarily liable after exhaustion of remedies against the borrower or the collateral (a "guaranty of collection"). Limited guaranties in which the liability of the guarantor is capped or limited in some fashion must be drafted with precision. In drafting such limitation, consideration must be given to whether the limitation (i.e., cap) includes such items as interest, lender's attorneys' fees and other costs of collection. There are also typically "bad boy acts" included in some limited guaranties, which if they occur would convert the limited guaranty to an unlimited guaranty. These "bad boy acts" often impose unlimited liability on the guarantor for one or more events, such as: (i) fraud or material misrepresentation on the part of the guarantor or the borrower in connection with the guaranteed debt, (ii) a disposition of the collateral or portion thereof in violation of the applicable loan and security agreement, mortgage or other principal loan document securing the loan, and (iii) all damages, costs and expenses incurred by the lender as a result of an event described in subsection (i) or (ii) above and/or in collecting the guaranteed debt from the guarantor. Such provision can also be expanded to cover collection costs incurred by a lender in suing the borrower and/or disposing of any collateral for the loan, in addition to other events.

**6. REVOCATION OF CONTINUING GUARANTY.** Under a typical continuing guaranty, the guarantor is bound with respect to all guaranteed debts incurred on the date of execution of

the guaranty and at all times thereafter, but if the guarantor revokes the guaranty or dies, the guarantor is not bound on debts incurred following the revocation or death of the guarantor. Many continuing guaranty forms contain a provision permitting a guarantor (or his executor following the death of the guarantor), upon giving prior written notice to the lender, to revoke a continuing guaranty as to future debt after such revocation. Such a provision would typically provide that the revocation (a) is effective only upon the lender's actual receipt of such notice, and (b) does not release the guarantor (or in the case of a death, his executors or administrators) from liability for all debt incurred prior to lender's actual receipt of said notice. Such pretermination debt should be defined broadly to include funding of pretermination commitments and all extensions, renewals and refinancings of pretermination debt. There is also typically a provision which accelerates the guaranteed debt following the death of a guarantor which would enable the lender to make a liquidated claim (as opposed to a contingent claim) against the guarantor's estate.

Suggestion: Since the lender is relying on the continuing guaranty in agreeing to make future advances to the borrower under a line of credit or multi-disbursement loan, it is essential that the applicable loan documents provide that termination of the guaranty by the guarantor or the death of a guarantor triggers a default under the loan documents which would allow the lender to stop funding and accelerate the debt, among other specified remedies.

**7. FAILURE TO CONVEY ADVERSE INFORMATION.** In view of Section 124 of the Restatement of Security which requires a creditor to notify the guarantor at the outset of any adverse facts that would materially increase the guarantor's risk beyond what was reasonably assumed, a strong guaranty will contain adequate language to address such issue: "The Guarantors assume all responsibility for being and keeping themselves informed of Borrower's present and future financial condition and assets, and of all other circumstances bearing upon the risk of nonpayment of the Guaranteed Debt and the nature, scope and extent of the risks which the Guarantors assume and incur hereunder, and the Guarantors agree that the Bank shall have no duty to advise the Guarantors of information now or hereafter known to it regarding such circumstances or risks."

**8. MATERIAL ALTERATION OF THE UNDERLYING DEBT.** To avoid a defense by the guarantor that the lender materially increased the scope of the guarantor's risk by varying the terms of the guaranteed debt, the guarantor should waive all material alterations of the guaranteed debt in the guaranty (examples include: renewals or extensions of time for payment of the guaranteed debt, any change in the terms of the guaranteed debt including interest rate adjustments or the amount of the installment payments, and any discharge of or change in the borrower or any other change in the guaranteed debt).

**9. IMPAIRMENT OF THE COLLATERAL.** This defense is used often by a guarantor when a lender fails to perfect its security interest in the collateral or otherwise releases collateral to a third person without the guarantor's consent. A guarantor should waive any release or impairment of the collateral in the guaranty, including, but not limited to, lender's failure to perfect a security interest or lien in the collateral.

**10. FAILURE TO NOTIFY THE GUARANTOR OF AN ARTICLE 9 FORECLOSURE SALE.** Code Section 9-611(c) requires that notice of a foreclosure sale be given to not only the debtor, but also "any secondary obligor" which includes a guarantor on a debt. Although there are some older cases under the old Code which upheld the waiver of such notice in a guaranty, Revised Article 9 forbids predefault waivers of this suretyship defense. The waiver is still included in some guaranties, but it should not be relied upon as enforceable. Whether or not the

guaranty contains such a waiver, the guarantor should always be given notice of the sale in accordance with Article 9 of the UCC. It should also be noted that Code Section 9-624 permits a guarantor to waive the right to notification of the disposition of collateral, provided the waiver is in writing and is given after the default.

**11. FAILURE TO HOLD A COMMERCIALLY REASONABLE FORECLOSURE SALE.** A waiver in a guaranty of the lender's failure to hold a commercially reasonable sale should be unenforceable because Article 9 precludes a waiver of commercial reasonableness as a matter of public policy under Code Section 9-602(7).

**12. RELEASE OF CO-GUARANTORS.** At common law, a release of one guarantor by the lender discharges any other guarantor(s) to the extent of the released guarantor's proportional share of the total liability. The basis for this rule was that the remaining guarantor's scope of risk was increased to the extent that his right of contribution from the released guarantor was impaired by the release. The guaranty should provide that the guarantor's obligations under the guaranty shall not be relieved in the event the lender releases any one or more persons liable for the guaranteed debt, including any other guarantor.

**13. NEGLIGENT ADMINISTRATION OF THE LOAN.** A guarantor can raise the defense that lender's negligent administration of the loan materially increased the scope of the guarantor's risk. Most guaranties contain a broad waiver as described in Section 14 below to cover this risk. To attempt to include a specific waiver in the guaranty of "the lender's negligent administration of the loan" may open up a can of worms with regard to the negotiation of the guaranty with borrower's counsel.

**14. OTHER INCREASES IN THE SCOPE-OF-THE-RISK.** There are countless potential "scope-of-the-risk" defenses, based on existing decisional law, some of which are discussed in this article (including, material alteration of the debt, impairment of collateral, and negligent administration of the loan). The guaranty should contain a "catch-all" provision to fully protect the lender. Sample Provision: "The Guarantor hereby waives any act or omission of the Lender (except Lender's acts or omissions in bad faith) that materially increases the scope of the Guarantor's risk."

**15. BORROWER'S DEFENSES ON THE UNDERLYING DEBT.** Since a guaranty is ancillary to the underlying debt, if a borrower has a valid defense on the underlying debt (such as failure of consideration, fraud, or lender liability), the guarantor, absent a valid waiver, may also raise such defense, unless the defense raised was a risk intended to be shifted from the creditor to guarantor (such as bankruptcy and lack of legal capacity). This means that each defense must be analyzed to determine whether the parties intended the guarantor to assume the particular risk. Since such an analysis is problematic, the only safe strategy for the lender is to include in the guaranty a broad provision addressing this problem. A sample provision reads: "This Guaranty remains fully enforceable irrespective of any defenses which the Borrower may assert on the underlying debt, including, but not limited to, failure of consideration, breach of warranty, fraud, payment, waiver, release, statute of frauds, discharge in bankruptcy, lack of legal capacity, statute of limitations, res judicata, antideficiency statute, lender liability, illegality, unenforceability, accord and satisfaction, minority and usury." At first blush, the waiver of the defense of "payment" appears to be overreaching. However, there are a number of reasons to justify this waiver, including (i) the typical reinstatement provision in a guaranty which provides that the guaranteed debt having been fully or partially paid, shall be deemed "reinstated" should the lender be required to disgorge or return any payments received on the guaranteed debt (see reinstatement provision in Section 16 below), and (ii) for a

revolving loan under which the debt is paid down to zero from time to time, and (iii) for any loan in which the final payment thereon (whether or not a balloon payment) for whatever reason fails to constitute "good funds".

**16. RECOVERY OF PREFERENCES.** Under Section 547 of the Bankruptcy Code, a last-minute payment on a guaranteed debt may be set aside as a voidable preference. In such a case, the guarantor may argue that the payment discharged its obligation under the guaranty, notwithstanding the subsequent recovery of the debt payment from the lender. To address this potential problem, the guaranty should always contain a reinstatement clause which contains "clawback" language.

Sample reinstatement or "claw-back" provision: "The Guarantors agree that, to the extent that the Borrower makes a payment or payments to the Lender or the Lender receives any proceeds of collateral, which payment or payments or proceeds or any part thereof are subsequently invalidated, declared to be fraudulent or preferential, set aside and/or required to be repaid to Borrower, its estate, trustee, receiver, or any other party, including, without limitation, any Guarantor, under any bankruptcy law, state or federal law, common law, judgment, decree, or order of any court or administrative body having jurisdiction over the Lender or any of its property, or equitable cause, or any settlement or compromise of any such repayment claim effected by the Lender with the claimant (including the Borrower), then to the extent of such payment or repayment, the Guaranteed Debt or part thereof which has been paid, reduced or satisfied by such amount shall be reinstated and continued in full force and effect as of the time immediately preceding such initial payment, reduction or satisfaction, and the Guarantors shall remain jointly and severally liable to the Lender for the amount so repaid to the same extent as if such amount had never originally been received by the Lender, notwithstanding any termination hereof or the cancellation of any note or other instrument evidencing any of the Guaranteed Debt."

**17. DUTY TO PURSUE THE BORROWER FIRST.** The guaranty should expressly clarify that it is a "guaranty of payment" and not a "guaranty of collection" so that the guarantor cannot assert the defense that the lender must pursue the borrower and/or the collateral first, before suing the guarantor.

Sample provision: "Guarantor agrees that this Guaranty is an absolute guaranty of payment and performance and is not a guaranty of collection. In order to proceed to enforce this Guaranty and hold the Guarantor liable hereunder, there shall be no obligation on the part of the Lender, at any time, to resort for payment to the Borrower or any other guarantor, or to any other person or entity, or to any collateral, security, property, liens or other rights or remedies whatsoever, all of which are hereby expressly waived by the Guarantor."

**18. ABSENCE OF DEFAULT BY THE BORROWER.** Obviously, the lender cannot proceed against the guarantor until the borrower has defaulted on the guaranteed debt. The lender must carefully document the circumstances of the default and make sure it has strictly complied with the provisions of the loan documents in declaring a default.

**19. FAILURE TO GIVE NOTICE OF THE BORROWER'S DEFAULT.** Another basic waiver which should be specifically set forth in the guaranty is clear language that the guarantor waives notice of the borrower's default. Notwithstanding such guaranty waiver, the guarantor should always be notified in writing by the lender concurrently with any notice of default sent to the borrower.

**20. LACK OF AN ENFORCEABLE GUARANTY AGREEMENT.** A guarantor can argue that he did not know what he was signing, or that he had no bargaining power or that he could not read the small print. All of these arguments raise the same basic contract defense - that there was no mutual assent ("meeting of the minds") necessary to form a contract. These arguments are more persuasive when the guarantor is an individual without counsel rather than with counsel or a corporation or other entity.

Suggestions: The guaranty should be drafted in a font size that is easily readable, If the guarantor is not represented by counsel in the transaction, the guarantor should be given a chance to read the guaranty and ask questions. The guarantor should be given a copy of the signed guaranty. In addition, notarization of the guarantor's signature is desirable generally.

**21. FAILURE TO GIVE NOTICE OF THE DEBT.** A guaranty should provide that the guarantor waives notice of when the underlying debt is incurred. This is a basic waiver found in all guaranties.

**22. REGULATION B VIOLATIONS.** Some lenders are not aware that requiring spousal guaranties for a loan can under certain circumstances violate Regulation B and the Equal Credit Opportunity Act and may subject the lender to actual and punitive damages (plus costs, including attorney's fees), as well as to a defense to enforcement of a spousal guaranty. This is another one of those subjects for which an entire article could be written instead of a short summary. Regulation B provides, in general, that a lender may not require the signature of a borrower's spouse on a loan as a co-maker or a cosignature of both spouses as guarantors on a loan to a third party (such as a corporation, etc.), if the borrower or guarantor (in the case of a third party loan) could meet the lender's standards of creditworthiness for the amount and terms of the loan requested. If the borrower alone (or the guarantor in the case of a third party loan) does not meet the lender's creditworthiness standards, the lender may require another party to the loan (i.e., a cosigner or a guarantor) to support the loan, but the lender cannot require the borrower's spouse (or in the case of a third party loan, guarantor's spouse) to serve as the additional party.

**In view of the fact that Regulation B is a highly technical area and poses a risk of liability to lenders, lenders should be extra cautious when obtaining spousal guarantees or requiring a spouse to cosign a loan. Notwithstanding the general discussion of Regulation B below, loan officers must be very careful to make sure they comply with their institution's internal policies and procedures regarding spousal guarantees and spousal co-makers. For example, some lending institutions require that personal financial statements do not include any jointly held assets.**

Regulation B does not strip lenders of all protection. Lenders may require spousal cosignatures on certain loan documents under certain circumstances, including, when granting secured credit to a married borrower or guarantor and the spouse's signature is necessary, or reasonably believed necessary by the lender, to make the property offered as security available to satisfy the loan in the event of default. The most likely scenario to fall within this safe harbor is the lender's requirement of a spouse's signature on a mortgage of jointly owned real estate.

a. Loans made directly to an individual borrower. In such a situation, a spouse may guarantee the loan to his spouse but only if such guaranty does not violate Regulation B:

If only one spouse applied for the loan, the lender should carefully document its consideration of that spouse's individual financial strength and assets. If the borrower's



individual financial statements and assets are not sufficient to support the loan, the lender then may request either additional collateral or a cosigner or guarantor. The lender can set forth objective nondiscriminatory standards for the additional collateral or additional party (such as limiting the state of residence of an eligible guarantor to the lender's geographical market), but the lender should be careful not to require marital assets as additional collateral or to specify the borrower's spouse as the required additional party.

The borrower should have the option of providing additional collateral or a cosigner or guarantor that does not involve his spouse. If however, the borrower in his application offers jointly held assets or relies on the separate assets or income of his spouse to support the loan, the nonborrower spouse can be required to sign any loan documents necessary to enable the lender to realize on those assets in the event of a default. If the borrower relies on the separate income of his spouse to support the loan, the lender can require the spouse to cosign or guarantee the loan. However, lenders must be cautious in this area. The offer of jointly held assets as security for the loan or the submission of joint financial statements does not automatically entitle the lender to require both spouses' signatures on all loan documents.

b. Loans made directly to a third party (typically a business entity). In such a situation, a spouse may guarantee the loan to the business entity but only if such guaranty does not violate Regulation B:

An important exception to Regulation B in which a spouse can coguarantee with his or her spouse a loan made to a third party is if the spouse is a principal in the borrowing entity (e.g., a shareholder, officer or director of a corporate borrower), although it is assumed that all such principals will be made guarantors (and that the spouse was not singled out from the other principals to be a guarantor as a result of such guarantor's marital status).

Another exception from Regulation B which applies to both loans to spouses and to loans to third parties, which is riskier for a lender, is although a spousal co-signature or guarantee may not automatically be required by a lender under Regulation B, there is no prohibition against the spouse from volunteering to cosign or guarantee a loan. The unofficial staff Interpretations of Regulation B provide that "where a spouse's offer to guarantee the loan is truly voluntary creditors should permit the spouse to undertake this obligation." Lenders must carefully document any offer by a spouse to cosign or guarantee a loan, as the risks of being sued for damages or setting aside the guaranty remain if the lender cannot provide that the spouse "truly volunteered" to cosign or guaranty the loan.

All loan files (including those subject to renewal or modification) containing spousal cosigners, guarantors or co-guarantors should be reviewed for compliance with Regulation B. If the lender cannot provide adequate documentation to support the cosignature, the spouse should be released from his or her loan obligations (with the written consent of the borrower and remaining guarantors).

**23. STATUTE OF FRAUDS.** Guaranties must be in writing.

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**REAFFIRMATIONS OF GUARANTY AND CONSENT:**

Regardless of the multitude of waivers contained in a guaranty, when a credit is being modified and the guaranty is to remain in place, it is recommended that a reaffirmation of guaranty and

consent be obtained from all remaining guarantors. Examples of such credit modifications include: (i) a renewal or extension of a loan, (ii) a substitution or release of any collateral, (iii) a substitution or release of one or more guarantors, (iv) a forbearance by lender of default remedies following an event of default, (v) a change in the borrower, or (vi) any other material modification in the terms of the loan.

In some limited cases, a lender may recognize that under the circumstances it cannot obtain a reaffirmation, and in such case, a business decision must be made by a lender to forego the reaffirmation and rely on the waivers in the guaranty. However, a reaffirmation of guaranty is preferred and provides more protection to the lender than reliance on waivers made in the guaranty itself.

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### **ILLINOIS STATUTES PERTAINING TO GUARANTORS:**

As indicated at the outset, although Illinois has not adopted a comprehensive set of laws governing guaranties, it has adopted certain laws which address specific issues with respect to guaranties, namely: (i) Section 3-605 of the Illinois Uniform Commercial Code (the "Code") governing negotiable instruments, and (ii) the Illinois Sureties Act.

Code Sections 3-605 and 3-419 address certain situations where a person who is a comaker, indorser or guarantor of a negotiable instrument (and who signs the negotiable instrument as an accommodation party, as described below) may be discharged from liability as a result of certain modifications to the debt transaction.

The 1990 revisions to Article 3 of the Code have been enacted in nearly all states, including Illinois. These revisions provide a restatement of the rules governing guarantors and other accommodation parties to negotiable instruments, including specifically promissory notes. However, since many promissory notes employed in the standard asset-based or commercial loan transaction today would likely not qualify as a "negotiable instrument" due to the very strict definition thereof contained in Code Section 3-104, this article will not include a detailed analysis of these revised Code Sections. It should also be noted that the Official Comment to Code Section 3-605 recites that the "importance of the suretyship defenses provided in Section 3-605 is greatly diminished by the fact that the right to discharge can be waived as provided in subsection (f). The waiver can be effectuated by a provision in the instrument or in a separate agreement."

In light of Section 3-605(f) described above, to the extent that a promissory note may be construed to be a negotiable instrument and there is an accommodation party (i.e., a comaker, indorser or guarantor who signs the negotiable note for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument), it would be useful to include a broad waiver in such note as follows:

"The undersigned waives (a) all defenses based on impairment of collateral or suretyship, and (b) any defenses that the borrower may assert on the underlying debt, including, but not limited to, failure of consideration, breach of warranty, fraud, payment, waiver, release, statute of frauds, discharge in bankruptcy, lack of legal capacity, statute of limitations, res judicata, antideficiency statute, lender liability, illegality, unenforceability, accord and satisfaction, minority and usury."

## THE ILLINOIS SURETIES ACT:

A copy of the Illinois Sureties Act (740 ILCS 155) is attached to this Bulletin. Under this little known Illinois statute, enacted in 1874, a guarantor can, if it qualifies under the statute, be released from liability under his guaranty.

Although the Illinois Sureties Act is antiquated, its provisions remain law in Illinois and lenders must be aware of the Act's provisions.

A recent Illinois Appellate Court decision was a stark reminder to lenders that the Illinois Sureties Act can be a potential nightmare for a lender under the proper circumstances. In JPMorgan Chase Bank, N.A. v. Earth Foods, Inc., 898 N.E. 2nd 718 (IL Ct. App. 2008), the Illinois Appellate Court held that a guarantor of a note was a "surety" for purposes of the Illinois Sureties Act. In 2001, JPMorgan extended a line of credit to Earth Foods, Inc. (the "Borrower"). All three of the co-owners of the Borrower personally guaranteed the loans. Borrower experienced financial difficulty in early 2004 and stopped making payments on its loans. JPMorgan sent a default notice and demand for payment in April 2004 and subsequently filed suit against the Borrower and the guarantors.

At trial, the guarantors argued that JPMorgan could not recover from the guarantors because they were protected by Section 155/1 of the Illinois Sureties Act which reads as follows:

**"155/1. Surety may compel diligence by creditor.**

When any person is bound, in writing, as surety for another for the payment of money, or the performance of any other contract, apprehends that his principal is likely to become insolvent or to remove himself from the state, without discharging the contract, if a right of action has accrued on the contract, he may, in writing, require the creditor to sue forthwith upon the same; and unless such creditor, within a reasonable time and with due diligence, commences an action thereon, and prosecutes the same to final judgment and proceeds with the enforcement thereof, the surety shall be discharged; but no such discharge shall not in any case affect the rights of the creditor against the principal debtor."

The three guarantors argued that they qualified as "sureties" under the Illinois Sureties Act. One of the guarantors, at trial, claimed that he had previously sent a letter to JPMorgan warning that the Borrower was depleting its inventory (which was collateral for the loans) and demanded that JPMorgan take action.

In view of the Court's holding that the guarantors did in fact qualify as "sureties" under the Illinois Sureties Act, the case was then remanded back to the trial court to determine whether the guarantors had satisfied the factual requirements of the Illinois Sureties Act entitling them to be discharged from their guaranty obligations.

This case sets a potentially explosive precedent for lenders with guaranties governed by Illinois law.

There have also been older cases which have held that a creditor cannot be compelled under the statute to sue a borrower who was already insolvent or had fled the state on the date of the notice given by the surety to the creditor.

Another potential landmine under the Illinois Sureties Act is Section 155/3 which deals with the death of a borrower. Section 155/3 of the Illinois Sureties Act provides that if the principal maker (borrower) dies, and the creditor (lender) fails within 6 months after entry of the original order directing issuance of letters of office, to file a claim with the representative or the court, the surety shall be released from liability to the extent that the claim may have been collected from such estate if it had been timely presented by the creditor.

It would make sense for lenders to press for a modernization or elimination of the Illinois Sureties Act as it is clearly outdated and potentially harmful to the finance industry in general.

This article is for informational purposes only and is not intended as legal advice to any member or recipient.

**Bennett L. Cohen, Esq.**

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#### **About the Author**

Bennett L. Cohen is a partner in the law firm of Cohen, Salk & Huvar, P.C. Bennett concentrates his practice in secured lending. He regularly represents banks, commercial finance companies, insurance companies and other institutional lenders in the structuring, documentation and closing of secured lending transactions, including asset-based loans, commercial loans, commercial real estate mortgage and construction loans, mezzanine loans, leveraged acquisitions, equipment lease loans and factoring transactions. He served for fifteen years as general counsel to the Midwest Association of Secured Lenders, a trade association of over eighty banks and finance companies located in Chicago and outlying areas. Bennett is a member of the American Bar Association and serves on the ABA Committee on Commercial Financial Services and the ABA Subcommittees on Secured Lending, Loan Documentation and the Uniform Commercial Code. He is a member of the ABA Joint Task Force on Deposit Account Control Agreements, the ABA Model Intercreditor Task Force, and the ABA Joint Task Force on Filing Operations and Search Logic.

## **CHAPTER 740-CIVIL LIABILITIES**

### **ACT 155-SURETIES ACT**

#### **155/1. Surety may compel diligence by creditor.**

When any person is bound, in writing, as surety for another for the payment of money, or the performance of any other contract, apprehends that his principal is likely to become insolvent or to remove himself from the state, without discharging the contract, if a right of action has accrued on the contract, he may, in writing, require the creditor to sue forthwith upon the same; and unless such creditor, within a reasonable time and with due diligence, commences an action thereon, and prosecutes the same to final judgment and proceeds with the enforcement thereof, the surety shall be discharged; but no such discharge shall not in any case affect the rights of the creditor against the principal debtor.

#### **155/2. Act extends to heirs, etc. - Not to official bonds.**

The provisions of this act shall extend as well to the heirs, executors and administrators of the surety as to the heirs, executors, administrators and assigns of the creditor, but shall not extend to the official bonds of public officers, executors, administrators, or guardians.

#### **155/3. When principal maker dies - Diligence against estate.**

Whenever the principal maker of any note, bond, bill or other written instrument dies, if the creditor does not, within 6 months after the entry of the original order directing issuance of letters of office, present the same to the representative or the proper court for allowance, the sureties thereon shall be released from the payment thereof to the extent that the same might have been collected of such estate if presented in proper time; but this Section shall not be construed to prevent the holder of any such instrument from proceeding against the sureties within such 6 months.

#### **155/4. Surety not to prejudice principal.**

No surety, his or her heir, executors or administrators, shall be allowed to confess judgment or allow judgment to be entered by default, so as to distress his or her principal, if the principal will enter his or her appearance as defendant to the action, and tender to the surety, his or her heirs, executors or administrators, sufficient counter security, to be approved by the court before which the action is pending.