

# Revisiting The 24 Defenses Of The Guarantor — 24 Years Later

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## Joshua Stein and Elaine Wang

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### **Guaranties still raise plenty of issues and concerns for lenders.**

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#### **MANY COMMERCIAL REAL ESTATE LOANS**

rely on personal guaranties. Those guaranties usually cover only certain obligations of the borrower. Sometimes, they cover all loan obligations or at least a meaningful part of the principal indebtedness. (Partial principal guaranties merit an article, or perhaps a book, of their own. They raise a panoply of issues about the interaction between paydowns (voluntary or involuntary) and the scope of a guarantor's exposure. The outcomes of those legal issues often do not conform to the parties' business expectations, and those expectations are often murky in any case.) Regardless of what guaranties cover, however, lenders want to know the courts will enforce them and that lenders won't face unpleasant surprises in court.

Guaranties have played a significant role yet again in some of the loan enforcement litigation spawned by the recent financial meltdown. Lenders and sometimes guarantors have (re)learned about pitfalls in enforcing guaranties. And when lenders work out troubled loans instead of enforcing them, lenders sometimes have a chance to improve the language of their guaranties, and borrowers may be called upon to provide new or improved guaranties.

Whether for new loans or for enforcement or workouts of old loans, lenders and their counsel approach guaranties knowing that for decades the courts have protected any guarantor (sometimes called the “fool with a pen”) by upholding defenses that allow the guarantor to disclaim liability.

In the late 1980s, articles in three issues of the Secured Lending Alert newsletter highlighted 24 defenses that guarantors often raise when a lender tries to enforce a guaranty. *The 24 Defenses of the Guarantor* (pts. 1-3), Secured Lending Alert (Nov.-Jan. 1987-88). Those common defenses fell into five general groups:

- Basic contract law;
- Disclosure;
- Scope-of-risk;
- Primary obligation; and
- Bankruptcy.

Each defense can potentially derail or delay enforcement of the guaranty, thus producing counterintuitive results for the lender.

Careful drafting can protect a lender from many of these defenses. This article seeks to revisit each of the 24 defenses highlighted 24 years ago; update some drafting strategies to respond to each defense; analyze which defenses remain particularly important, given case law since 1987; and augment the discussion with further suggestions about how to negotiate, draft, and administer any guaranty.

As with any other drafting or legal suggestions, the suggestions offered here must always be adjusted to take into account the circumstances of each specific transaction. All sample language offered in this article assumes the guaranty has already defined the terms “Borrower,” “Guarantor,” “Guaranty,” “Insolvency Proceeding,” “Lender,” “Loan,” “Loan Documents,” and “Obligations.” Anyone using sample language, from this article or anywhere else, always must confirm such assumptions and edit accordingly — just one obvious example of why and how one cannot merely shovel words from one wordpile to another when using someone else’s sample language. The suggestions in this article look at the world from a lender’s perspective and do not consider how a guarantor or borrower might seek to push back against, or fine-tune, the language offered here. As a final caveat, the outcome of any particular dispute will depend on the facts of that case and the discretion of the particular court. Thus, nothing is assured.

### **Defense 1: Lack Of An Enforceable Guaranty**

A guarantor’s first defense consists of a general “meeting of the minds” defense, grounded in basic contract law. It is the guarantor’s most fundamental defense, based on the theory that the transaction lacked enough mutual assent and agreement to form an enforceable contract. This defense rarely succeeds for sophisticated corporate (or other business entity) guarantors. For an individual guarantor, particularly if “unsophisticated,” it can carry more weight. If the individual does not engage separate counsel — whether by strategy or happenstance — that may also support the argument for lack of sophistication.

***Drafting tip:*** Write the guaranty in plain English. Make sure the guarantor receives a copy of the guaranty, and acknowledges that. Finally, give the guarantor an opportunity to review the agreement and ask ques-

tions, as the language in many guaranties is often archaic and incomprehensible to mere mortals. Consider having the guarantor acknowledge representation by counsel.

**Sample Language:** “Guarantor acknowledges that before executing this Guaranty: (a) Guarantor has had the opportunity to review it with counsel of Guarantor’s choice; (b) Lender has recommended that Guarantor obtain separate counsel, independent of Borrower’s counsel, for this Guaranty; and (c) Guarantor has carefully read this Guaranty and understood the meaning and effect of its terms.”

## **Defense 2: No Consideration**

Any guaranty, almost by definition, invites the guarantor to claim lack of consideration as a defense. That’s because the guarantor does not receive loan proceeds directly — i.e., the guarantor receives no direct benefit for signing the guaranty. Or at least it looks that way, to anyone who just looks at the surface of the transaction and tries not to think too hard.

Courts have, however, long held that a lender’s extension of credit to the primary obligor provides enough consideration for a guaranty signed at the same time. *See Jenista v. Burlington N.*, 388 N.W.2d 770, 773 (Minn. Ct. App. 1986) (guaranty supported by consideration because lender suffered detriment by extending credit to debtor). In the case of a forbearance guaranty — where a guarantor signs a guaranty of an existing loan to persuade the lender to forbear from enforcement — the “failure of consideration” defense may carry a bit more weight.

**Drafting tip:** The recitals to the guaranty should recite and substantiate delivery of consideration for the guaranty.

**Example:** “Guarantor executes and delivers this Guaranty in consideration of, and to induce, Lender’s extension of credit to Borrower. Guarantor acknowledges that Lender would not have extended such credit but for this Guaranty.”

In the usual case, in which the guarantor will in fact very much benefit from the credit to the borrower, because the guarantor owns a substantial interest in the borrower, also say:

“Guarantor will derive substantial benefits from the Loan, because Guarantor owns a substantial equity interest in Borrower.”

In the case of a forbearance guaranty, add a statement like this:

“Guarantor delivers this Guaranty to induce Lender to forbear from enforcing its rights and remedies against Borrower. That forbearance will benefit Guarantor, as a substantial equity owner of Borrower.”

At the end of the recitals, perhaps say it again:

“NOW, THEREFORE, in consideration of the foregoing recitals, and for good, adequate, and valuable consideration, receipt of which Guarantor acknowledges, Guarantor agrees....”

### **Defense 3: Statute Of Frauds**

Ever since at least the original English Statute of Frauds, enacted in 1677, contracts of guaranty have needed to be in writing. Oral guaranties give guarantors a free ticket to unenforceability. Thus, no sane lender should (or would) rely on a phone call or a memorandum that is not signed by the guarantor. The validity of an email as a “writing” represents a still-developing area of the law, and no lender wants to contribute to that developmental process. If a guaranty comes from an entity, counsel should also think about issues of authority and execution, just as if the guaranty were a loan document executed by a primary borrower.

### **Defense No. 4: Statute Of Limitations**

Depending on state law, the same statute of limitations that governs written agreements in general will also usually govern guaranties. But when does the clock start to tick? Usually, as soon as the underlying debt is “payable.” For a promissory note, that means the maturity date. If the lender accelerates the note, then this could accelerate commencement of the limitations period. This is one of many good reasons that lenders should act in an absolutely unambiguous and intentional way in dealing with any acceleration or rescission of acceleration.

In the rare case of a note payable on demand, the clock starts ticking as soon as the primary borrower executes the note, as if the lender were deemed to have immediately called the loan. *See* J.A. Bock, Annotation, *When Statute of Limitations Begins to Run Against Note Payable on Demand*, 71 A.L.R.2d 284 (1960). Thus, for demand notes, the lender may need to have the guaranty re-executed or at least reaffirmed periodically — well before the statute of limitations runs — so the lender can call the loan and enforce the note and guaranty if the guarantor decides not to cooperate.

If murky events or circumstances might give the borrower or guarantor an argument that the loan matured, the lender should “do something” before the limitations period passes — either commence enforcement, or unambiguously and bindingly extend the maturity date, or take other steps to protect its position.

Guaranties sometimes include a waiver of the statute of limitations, but nobody has much confidence in these waivers. Hence this article does not offer sample language for such a waiver. As a creative variation, a guaranty could require the guarantor, as a separate obligation, to give the lender a warning notice if the guarantor thinks the limitations period has started to run — or is about to run — as a way to perhaps bootstrap a new limitations period. Such provisions are, however, not common and probably add no more value than an outright waiver. They’re creative, though.

**Drafting tip:** Any guaranty should require that the guarantor, promptly upon request, deliver an estoppel certificate to confirm the guarantor’s continuing liability. For example, the guaranty could say:

“Guarantor shall, within ten days after Lender’s request, deliver to Lender a certificate, in form and substance reasonably satisfactory to Lender, confirming that: (a) this Guaranty remains in full force and effect

and has not been waived, discharged, or released; and (b) Guarantor has no defenses or offsets against its obligations under this Guaranty.”

The loan documents should say that failure to deliver such a certificate constitutes a default. It may also make sense to have the guarantor (within the guaranty) consent to and acknowledge such a default. Guaranties often contain consents and acknowledgments of this type. Do they add anything? After the guarantor signed the guaranty, would a court really allow a guarantor to wiggle out of the guaranty, in whole or in part, because the guarantor didn’t like something in the loan documents? Some people apparently think so. Here is sample language: “Guarantor acknowledges and consents that the Loan Documents entitle Lender to accelerate the Loan (or place Borrower in default) upon the occurrence of certain events relating to Guarantor.” Those events might include failure to deliver an estoppel certificate or to maintain a specified level of creditworthiness.

A requirement for an estoppel certificate at least gives the lender a mechanism to enforce the loan if questions exist about continued enforceability of the guaranty. A lender’s main strategy to prevent “statute of limitations” problems should, however, focus on administering the loan and not waiting too long if the loan goes into default, or has even arguably matured on any other basis. The lender should not rely too heavily on the words of the document.

### **Defense 5: Conditions Precedent To Liability**

As another basic contract defense, a guarantor might assert that the guarantor does not become obligated under the guaranty unless certain conditions have been satisfied — and this hasn’t yet occurred. For example, a guarantor may argue that the lender agreed orally that the lender wouldn’t sue on the guaranty until the lender had fully pursued the primary debtor. Courts typically reject any such defense if a guaranty includes a good merger clause. *See, e.g., Centerre Bank of Kansas City, N.A. v. Distributors, Inc.*, 705 S.W.2d 42 (Mo. Ct. App. 1985). *See also, First New York Bank for Business v. DeMarco*, 130 B.R. 650 (S.D.N.Y. 1991).

**Drafting tip:** Include a strong merger clause, making it clear that the entire agreement of the parties appears within the four corners of the written guaranty. A merger provision seeks to exclude parol evidence and any course of dealing or trade usage that might otherwise undercut the written agreement. Language like this should help:

“This Guaranty and the documents to which this Guaranty refers contain the entire agreement among the parties about the matters this Guaranty covers. This Guaranty supersedes all prior agreements among the parties about such matters. No course of dealings among the parties, usage of trade, or parol or extrinsic evidence shall supplement, modify, or vary any term of this Guaranty. This Guaranty is unconditional. No unsatisfied condition exists to the full effectiveness and enforceability of this Guaranty. Nothing in this Guaranty may be changed, waived, revoked, or amended without Lender’s prior written agreement. If any provision of this Guaranty is unenforceable, then all other provisions shall remain fully effective.”

This sample language does, of course, go a bit beyond just “merger,” but similar language should appear in any guaranty. Avoid writing the merger clause so broadly, though, that it might extinguish other particular written agreements that the lender believes should remain in force. Even better, avoid having side letters or ancillary agreements, and instead include them in the main deal documents, where they won’t get lost, forgotten, or drafted out of existence by future merger clauses.

### **Defense 6: Express Limits On Scope Of Guaranty**

The words of a guaranty may limit its scope, making it something much less than an absolute or unconditional guaranty. As one example, a “guaranty of collection,” by definition, requires the lender to exhaust all remedies against the primary debtor before proceeding against the guarantor. *See* Uniform Commercial Code (U.C.C.) §3-416. A lender can avoid that trap by calling the document a “guaranty of payment,” and confirming that status within the text of the guaranty. If the guaranty covers attorneys’ fees and other costs of collection, it needs to say so. If that concept appears only in the loan documents, and not the guaranty, then the lender may find itself left with only a claim against the borrower. Outside real estate, a lender might obtain a “continuing guaranty” — one that covers all future extensions of credit to the same borrower. Any such guaranty must include broad language to capture all future debt. *See Bowyer v. Clark Equip. Co.*, 357 N.E.2d 290 (Ind. Ct. App. 1976) (guaranty not absolute because it did not waive notice of incurring all liabilities; hence, failure to give notice of default on an open account discharged guarantor).

**Drafting tip:** For a guaranty of payment (the usual case), say:

“This Guaranty is a guaranty of payment, not a guaranty of collection. Lender need not pursue Borrower or anyone else before enforcing this Guaranty against Guarantor.”

To assure the guaranty covers attorneys’ fees and costs of collection, include broad language, such as:

“Guarantor shall pay or reimburse all reasonable attorneys’ fees and costs of collection that Lender incurs in enforcing this Guaranty against Guarantor and the Loan Documents against Borrower.”

A careful guarantor may balk at the last six words. They ultimately raise a business issue about the scope of the guaranty. Any careful lender will often want to start by including them, to try to: (a) achieve as broad a guaranty as reasonably possible; and (b) prevent complex factual issues about which attorneys’ fees the guaranty covers and which attorneys’ fees it doesn’t cover.

For a dragnet clause in a continuing guaranty (uncommon in real estate), the lender might use language like this:

“The guaranteed debt includes all liability of Borrower to Lender, whether now or later incurred; for personal or business purposes; direct, indirect, or contingent; incurred as primary debtor, co-maker, or guarantor; otherwise guaranteed or secured; or on open account, evidenced by an instrument, Lender’s books and records, or otherwise.”

A well-drafted guaranty (or any other document) should say, once, that “include” means “without limitation.” The authors would welcome receiving any legal authority for the proposition that, in a sophisticated modern commercial transaction, “include” might actually mean anything other than “include without limitation.”

### **Defense 7: Revocation Of Continuing Guaranty**

The last basic contract defense arises from the notion that a continuing guaranty represents a standing offer, which the lender accepts every time it extends credit to the borrower. If the guarantor revokes the standing offer, the theory goes, then the guaranty does not cover any debt incurred after the revocation. A guarantor could try to assert this defense for any loan that contemplates future advances, such as a construction loan or one that will fund future property acquisitions.

**Drafting tip:** Aside from having the guarantor waive any right to terminate or revoke, a lender may want to limit the effectiveness of any revocation. As a starting point, a revocation can’t be effective unless the lender actually receives written notice of it. And the guaranty should define pre-termination debt broadly, to include the subsequent funding of pre-termination commitments and the modification or refinancing of any pre-termination debt. Some sample language:

“Guarantor waives any right to terminate or revoke this Guaranty. To the extent that such waiver is unenforceable or ineffective, any termination of this Guaranty shall take effect only for any debt that Borrower first incurs after Lender receives actual written notice of termination (a “Termination Date”). This Guaranty shall remain in full force and effect for all debt incurred before the Termination Date, including subsequent fundings under a commitment (conditional or unconditional) that Lender issued before the Termination Date. Regardless of when any renewal, extension, or modification of pre-Termination-Date debt occurs (with or without adjustment of interest rate or other terms), such debt shall be deemed to have been incurred before the Termination Date. This Guaranty shall continue to apply to that debt, even if a Termination Date occurs.”

If the guarantor does purport to revoke, terminate, or limit the guaranty in any way, that should constitute an immediate and incurable event of default under the loan documents.

### **Defense No. 8: Failure To Notify Guarantor Of Debt**

Any guarantor’s first disclosure-related defense arises from the lender’s failing to notify the guarantor of the incurrence of any guaranteed debt — whether in the first instance or at the time of any future advance. Language in the guaranty that waives notice of new indebtedness should prevent this defense. Therefore, any guaranty should contain such a waiver.

**Drafting tip:** Language for a waiver of notice could look like this:

“Guarantor waives diligence and all demands, protests, presentments, and notices of every kind or nature, including notices of protest, dishonor, nonpayment, default, and/or acceptance of this Guaranty, and the creation, renewal, extension, modification, or accrual of any Obligations.”

A guarantor will sometimes negotiate a right to receive certain notices, although the lender will resist mightily. If that resistance proves futile, then:

- The guaranty should narrowly and specifically define the guarantor’s right to notices;
- That right should go away to the extent that the lender cannot legally give such notices (e.g., because of the guarantor’s bankruptcy);
- The guaranty should if possible define an agent to receive notices, and limit the guarantor’s ability to change that agent’s address in a way that would frustrate delivery of notices; and
- The lender must remember to administer the loan accordingly.

Any requirement to deliver separate notices to the guarantor will rarely make sense, because it is counterintuitive and the guarantor will usually know everything it needs to know anyway. Whether or not the guaranty requires notices to the guarantor, a careful lender will usually give the guarantor copies of all material notices anyway, while formally disclaiming any obligation to continue to do so.

The definition of “Obligations” in any guaranty will depend on the scope of the guaranty. If the guaranty covers the entire loan, then define “Obligations” very broadly, to include such things as attorneys’ fees, other costs of collection, damages (including any recovery for breach of a representation or warranty), and default interest.

### **Defense 9: Failure To Notify Guarantor Of Borrower’s Default**

If a guaranteed loan goes into default, then this changes the guarantor’s liability from “contingent” to “imminent.” The guaranty is no longer hypothetical. If failure to give notice of default can imperil the lender, and the lender fails to give notice, then any such requirement for notice strikes at the time when it can do the most harm. Again, any guarantor should unambiguously waive notice of the borrower’s default. The language in the drafting tips immediately above should do the job.

### **Defense 10: Failure To Notify Guarantor Of Adverse Matters**

General legal principles require a lender to notify a guarantor of any adverse facts at the outset of the transaction that would materially increase the guarantor’s risk beyond that which the guarantor reasonably assumes — whatever all of that means. *See* Restatement of Security, §124(1) (1941) (“Where before the surety has undertaken his obligation the creditor knows facts unknown to the surety that materially increase the risk beyond that which the creditor has reason to believe the surety intends to assume, and the creditor also has reason to believe that these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety, failure of the creditor to notify the surety of such facts is a defense to the surety.”). Going forward, the lender has a similar obligation to notify the guarantor of any material adverse changes in the underlying credit that might increase the scope of the guarantor’s risk. *See American Nat’l Bank*

*v. Donnellan*, 170 Cal. 9, 148 P. 188 (Cal. 1915) (guaranty cancelled because bank president failed to disclose a material circumstance affecting the contract); *see also Sumitomo Bank of California v. Iwasaki*, 447 P.2d 956, 962 (Cal. 1968) (*Donnellan* imposes duty of voluntary disclosure of material unknown facts particularly when lender — not borrower — requests the guaranty; as would normally be the case); *Produce Clearings v. Butler*, 42 Cal. Rptr. 114 (Cal. Ct. App. 1964) (invalidating guaranty because beneficiary failed to inform guarantor that principal obligor had previously sold fictitious accounts). Rather than deal with these undefined burdens and any claims and defenses they might spawn, a careful lender will insist that the guarantor excuse the lender from any obligation to inform the guarantor of anything.

**Drafting tip:** To respond to this defense, the lender can include language like this in the guaranty:

“Guarantor has had a full and adequate opportunity to review the Loan Documents, the transaction that such documents contemplate, Borrower’s financial condition, Borrower’s ability to pay and perform the Obligations, and all related facts. Guarantor shall at all times keep itself fully informed on all such matters. Lender has no duty, at any time, to disclose to Guarantor any information about any such matters. If Lender in its discretion provides any such information, this does not obligate Lender to provide any further information.”

### **Defense 11: Special Disclosures To Consumer Guarantors**

For guaranties of consumer debt, both the Federal Trade Commission and the Federal Reserve Board require special written disclosures before a consumer guarantor (co-signer) becomes obligated under a guaranty. Failure to give the guarantor the right disclosure form constitutes a deceptive trade practice that relieves the guarantor of liability. 16 C.F.R. §444.3; 12 C.F.R. §227.14. Any consumer lender must fully familiarize itself with such regulations, of which this one is only the tip of the iceberg. If the original loan is “commercial,” but the guaranty includes a “dragnet clause” that could pick up any later consumer debt, or if the guarantor can somehow argue that the loan isn’t really “commercial,” then the lender may find that the federal consumer credit rules apply. State laws and regulations may further complicate the picture. And the “financial crisis” has triggered vast increases and further complexification of this entire area.

### **Defense 12: Material Alteration Of Underlying Debt**

Several common guarantor defenses start by looking at the scope of the risk that the guarantor assumed, or thought the guarantor assumed, when the guarantor signed the guaranty. To the extent that the lender materially increases the scope of that risk — by varying the terms of the guaranteed debt, this changes the risk that the guarantor expected to bear. The court then concludes that because of such change — because the lender changed the guarantor’s scope of risk — the guarantor should be discharged, either entirely or at least to the extent of damage the guarantor suffered.

The most basic scope-of-risk defense arises from a claim that the lender materially and unilaterally changed the underlying debt. If a guarantor guaranteed a loan and the borrower and the lender refinanced that loan, this could discharge the guarantor completely, absent a suitable waiver or confirmation. *See* N.Y. U.C.C. §3-606(1)(a) (“The holder discharges any party to the instrument to the extent that without such

party's consent the holder without express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person the instrument or collateral or otherwise discharges such person, except that failure or delay in effecting any required presentment, protest or notice of dishonor with respect to any such person does not discharge any party as to whom presentment, protest or notice of dishonor is effective or unnecessary.”).

Other material alterations of the underlying debt, with similar effect, include:

- A change in the price of goods financed by the guaranteed debt (where a guaranty covers an account payable for the sale of goods). See *Lawndale Steel Co. v. Appel*, 423 N.E.2d 957 (Ill. App. Ct. 1981);
- An extension of credit beyond the amount stated in the underlying agreement. See *King Korn Stamp Co. v. Guaranty Bank & Trust Co.*, 252 N.E.2d 734 (Ill. App. Ct. 1969);
- A novation of the original debt (replacement of the “old” debt with a “new” debt, a characterization that is not always entirely obvious). See *Steel City Nat'l Bank v. J.J. Wright Oldsmobile, Inc.*, 549 N.E.2d 726 (Ill. App. Ct. 1989); *Aluminum Co. of Am. v. Home Can Mfg.*, 480 N.E.2d 1243 (Ill. App. Ct. 1985); or
- A change in the primary borrower. See *Wheeling Steel Corp. v. Neu*, 90 F.2d 139 (8th Cir. 1937). But see *Pennsylvania House, Inc. v. Barrett*, 760 F. Supp. 439, 446 (M.D. Pa. 1991) (changes in corporate ownership of primary borrower did not materially alter guarantor's risk); *Massey-Ferguson, Inc. v. Finocchiaro Equipment Co.*, 496 F. Supp. 655, 662 (E.D. Pa. 1980), *aff'd without opinion*, 649 F.2d 859 (3d Cir. 1981) (declining to follow *Wheeling*, because Eighth Circuit in that case “failed to look beyond the formal change in the principal debtor as effecting a release of the guarantor” and such change was not a material alteration that should release guarantor).

**Drafting tip:** Any guaranty should allow the lender to alter the guaranteed debt without notice to, or consent by, the guarantor. For example, the guaranty could say:

“Without notice to, or consent by Guarantor, and in Lender's sole and absolute discretion and without prejudice to Lender or in any way limiting or reducing Guarantor's liability under this Guaranty, Lender may: (1) grant extensions of time, renewals, or other indulgences to Borrower or any other party liable under any Loan Document; (2) agree with Borrower to change the terms of the Obligations, including any increase or decrease in interest rates, amortization, or maturity; (3) agree with Borrower to change, amend, or modify any Loan Document, (4) make other or additional loans to Borrower in such amount(s) and at such time(s) as Lender and Borrower agree; (5) credit payments in such manner and order of priority as Lender may determine in its discretion, subject to the terms of the Loan Documents; and (6) otherwise deal with Borrower and any other party related to the Obligations as Lender determines in its sole and absolute discretion. Guarantor waives notice of any change in the guaranteed debt or any related circumstance, including a change in the business structure of Borrower.”

If, as is typical, the guarantor controls the borrower, the guaranty might address that fact:

“Guarantor acknowledges that because Guarantor controls or wholly owns Borrower, Guarantor can at all times control or direct any actions described in the previous sentence, and cause Borrower to agree or not agree to any such actions.”

This language could backfire on a mortgage lender, if the guaranty is limited to “bad boy” actions by the borrower and the deal structure also includes a mezzanine loan. Such structures have recently spawned litigation when the mezzanine lender takes over control of the mortgage borrower after a mezzanine loan foreclosure and subsequently causes the mortgage borrower to commit “bad acts,” triggering recourse liability for the guarantor, such as putting the mortgage borrower into bankruptcy. *See ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition LLC*, 2010 WL 653972 (N.Y. Sup. Ct. Feb. 24, 2010); *CSFB 2001-CP-4 Princeton Park Corporate Center LLC v. SB Rental I, LLC*, 980 A.2d 1 (N.J. Super. Ct. App. Div. 2009). A guarantor seeking to avoid liability can argue — sometimes with success — that the parties did not really intend to make the guarantor liable for the “bad acts” of a wholly independent third party (i.e., the mezzanine lender after foreclosure). Any language in a guaranty that confirms the guarantor’s control over the mortgage borrower might support the guarantor’s argument. The issue is better dealt with by expressly addressing the consequences of a mezzanine loan foreclosure.

### **Defense 13: Impairment Of Collateral**

If the lender impairs any collateral that secures (or was intended to secure) the obligations covered by the guaranty, but doesn’t obtain the guarantor’s consent to the impairment, this can discharge the guarantor, at least to the extent of the impairment, or the value of the collateral. N.Y. U.C.C. §3-606(1)(b) (“The holder discharges any party to the instrument to the extent that without such party’s consent the holder unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse.”).

This defense starts from the theory that when the guarantor signed the guaranty, the guarantor assessed the scope of its risk on the assumption that the lender would obtain and keep certain collateral. The existence of collateral not only reduces the likelihood of default, but also gives the guarantor a second benefit: if the guarantor pays the guaranteed obligation, the guarantor may inherit the collateral through principles of subrogation. If the lender somehow did something to undercut the guarantor’s assumption that the lender would hold collateral for the obligations, then the lender changed the guarantor’s risk profile, and should be punished accordingly.

The “impairment of collateral” defense represents one of the most popular guarantor defenses. Guarantors often assert it against secured lenders that fail to perfect their security or that release collateral without the guarantor’s consent. *See, e.g., Port Distrib. Corp. v. Pflaumer*, 880 F. Supp. 204 (S.D.N.Y. 1995), *aff’d per curiam*, 70 F.3d 8 (2d Cir. 1995); *Langeveld v. L.R.Z.H. Corp.*, 376 A.2d 931 (N.J. 1977); *State v. Clayton*, 825 A.2d 1155, 1159 (N.J. Super. Ct. App. Div. 2003); *Shaffer v. Davidson*, 445 P.2d 13 (Wyo. 1968).

**Drafting tip:** To deny a guarantor this defense, a secured lender should perfect its security interests (not a bad idea on general principles, either). Because lenders sometimes aren’t perfect, the guaranty should also include a waiver like this one:

“Without notice to, or consent by, Guarantor, and in Lender’s sole and absolute discretion and without prejudice to Lender or in any way limiting or reducing Guarantor’s liability under this Guaranty, Lender may: (1) authorize the sale, exchange, release, or subordination of any collateral; (2) accept or reject additional collateral; (3) discharge or release Borrower or any other obligor or any collateral; (4) foreclose or otherwise realize on any collateral, or attempt to foreclose or otherwise realize on any collateral, whether successfully or unsuccessfully; (5) accept a conveyance of any collateral; or (6) otherwise impair Lender’s collateral including, but not limited to, failing to perfect a security interest in the collateral. Guarantor waives any defense that might otherwise arise from any of the foregoing.”

### **Defense 14: Failure To Notify Guarantor Of Foreclosure Sale**

Lenders may assume that notice to the borrower will suffice for any foreclosure sale. To the extent that the U.C.C. governs, though, that might not be true, or at least some case law suggests a need to give the guarantor separate notice. The U.C.C. defines “debtor” broadly, in language that might include guarantors. U.C.C. §9-102(a)(28) (assuming a broad reading of the definition, in that a guarantor may be construed as a person having an interest in the collateral given its relationship with an obligor). Before any public or private sale of collateral, the U.C.C. requires the lender to notify the debtor, U.C.C. §9-611 — and depending on how one interprets the U.C.C.’s definition of “debtor,” this could also mean a guarantor.

Courts have generally confirmed that guarantors are debtors who must receive notice of sale. *See, e.g., AAR Aircraft & Engine Group, Inc. v. Edwards*, 272 F.3d 468, 473 (7th Cir. 2001) (holding guaranty absolute, prohibiting waivers of notice and of commercial reasonableness); *Commercial Discount Corp. v. King*, 515 F. Supp. 988, 990 (N.D. Ill. 1981) (U.C.C. prohibits guarantors from waiving notice of sale of collateral); *Shawmut Bank, N.A. v. Chase*, 624 N.E.2d 541 (Mass. 1993); *Branan v. Equico Lessors, Inc.* 342 S.E.2d 671 (Ga. 1986); *Shawmut Worcester County Bank, N.A. v. Miller*, 496 N.E.2d 625 (Mass. 1986). Some courts have upheld waivers of the right to notice in the guaranty. *See, e.g., Mendelson v. Maplewood Poultry Co.*, 684 F.2d 180, 182-83 (1st Cir. 1982); *First Nat’l Park Bank v. Johnson*, 553 F.2d 599 (9th Cir. 1977); *U.S. v. Lowy*, 703 F. Supp. 1040, 1044 (E.D.N.Y. 1989). Most courts have held that because a guarantor is a debtor for purposes of receiving the notice, the guarantor is also a debtor under U.C.C. §9-602(7), which prohibits any waiver of notice. U.C.C. §9-602(7) (prohibiting waiver of debtor rights and secured party duties under U.C.C. §9-611 on disposition of collateral and notice to “debtor” or any “secondary obligor”); *Bexar County Nat’l Bank of San Antonio v. Hernandez*, 716 S.W.2d 938 (Tex. 1986); *Prescott v. Thompson Tractor Co. Inc.*, 495 So.2d 513 (Ala. 1986).

Given these legal principles, a guarantor probably cannot effectively waive notice of a foreclosure sale in the guaranty. Thus, regardless of what the guaranty says, the lender should give the guarantor notice of the sale. As an alternative, the secured lender could collect from the guarantor first, and then let the guarantor succeed to the collateral and handle any foreclosure sale.

Some states, such as New York, require a mortgage lender to give any guarantor notice of certain enforcement activities. Failure to do so can release the guarantor, as a matter of statute.

### **Defense 15: Failure To Hold Commercially Reasonable Foreclosure Sale**

As a closely related defense, the guarantor might assert that the lender failed to hold a commercially reasonable foreclosure sale after default. If a secured lender fails to solicit a reasonable number of bids, inadequately publicizes the sale, or holds a public auction when (in hindsight) a privately negotiated sale could have produced a higher selling price for the collateral, the shortcomings of the sale process can produce a larger deficiency claim against the guarantor. Thus, each such action would materially increase the guarantor's scope of risk, and potentially give the guarantor a defense. *See U.S. v. Terrey*, 554 F.2d 685 (5th Cir. 1977); *In re LaPointe*, 253 B.R. 496, 498 (B.A.P. 1st Cir. 2000).

As in the case of the previous defense, the U.C.C. — if it applies — would likely prohibit a waiver of commercial reasonableness. U.C.C. §9-602(7) (prohibiting waiver of U.C.C. §9-610(b) regarding commercially reasonable disposition of collateral after default). Some cases involving the federal Small Business Administration do, however, allow sales to proceed in the “uncontrolled discretion” of the lender, even if that injures the guarantor. *See, e.g., U.S. v. Lattauzio*, 748 F.2d 559 (10th Cir. 1984); *U.S. v. McAllister*, 661 F. Supp. 1175 (E.D.N.Y. 1987). These cases may conceivably only apply to governmental lenders.

A careful lender may hesitate to include a “waiver of commercial reasonableness” in the guaranty, under the theory that it won't do any good and might do harm by inviting sloppiness. Instead, such a lender will focus on holding a proper foreclosure sale. Again, the lender might decide to enforce the guaranty first and then let the guarantor manage the foreclosure sale process later.

### **Defense 16: Release Of Co-Guarantors**

A lender's release of one of several guarantors can discharge any other guarantor to the extent of the released guarantor's proportional share of the total liability. This “release pro tanto” reflects the common law notion that any such partial release changes the “scope of risk” assumed by the remaining guarantors, to the extent that the release impairs their rights of contribution from the rest of the group of guarantors. *See U.S. v. Hub City Volkswagen, Inc.*, 625 F.2d 213 (9th Cir. 1980).

**Drafting tip:** To avoid this defense, a guaranty should include language like this:

“Each Guarantor has unconditionally delivered this Guaranty to Lender. Any other person's failure to sign (or remain obligated under) this Guaranty does not diminish or discharge any Guarantor's liability. Each Guarantor's liability is not conditioned on the liability or performance of any other person. Such liability exists, regardless of any other person's liability, whether a Guarantor is jointly and severally liable for the entire debt, or for only part. Lender's release of any Guarantor does not diminish or impair any other Guarantor's liability.”

### **Defense 17: Negligent Loan Administration**

If a lender administers the loan in a way that a court somehow decides was “negligent,” this could materially increase the likelihood that the lender will call upon the guaranty — another increase in the scope of the guarantor's risk beyond the risk that the guarantor originally intended to assume. Courts have in fact

recognized negligent loan administration as a tort. *See, e.g., Jacques v. First Nat'l Bank of Maryland*, 515 A.2d 756 (Md. 1986). Lenders should expect to see this defense raised more often, given recent controversy over the underwriting and administration of real estate loans.

**Drafting tip:** As with most other scope-of-risk defenses, solid waivers such as this one should prevent trouble for lenders:

“Guarantor waives any defense that Guarantor might otherwise assert based on any error, omission, action, or inaction by Lender in administering the Loan, or the manner in which Lender administers or fails to administer the Loan.”

### **Defense 18: Other Increases In Scope Of Risk**

Though the six scope-of-risk defenses listed above seem to be the most common, any guarantor’s counsel could, with some creative thinking, raise a variety of similar defenses, based on the facts of any particular case. Typical guaranty boilerplate seeks to prevent the most common such defenses, but a careful lender may want to go a step further.

**Drafting tip:** Any guaranty should probably include “catch all” language to try to prevent “scope of risk” defenses. For example:

“Without in any way limiting the generality of any waivers in this Guaranty, Guarantor waives any defense that Guarantor could otherwise assert based on any act or omission of Lender that alters the scope of Guarantor’s risk. Guarantor’s liability under this Guaranty shall continue even if Lender alters any obligations in any way or if Lender’s remedies or Guarantor’s remedies or rights against Borrower are in any way impaired or suspended without Guarantor’s consent. If Lender performs any action described in this paragraph, then Guarantor’s liability shall continue in full force and effect even if Lender’s actions adversely affect Guarantor, alter the scope of Guarantor’s risk, or expand Guarantor’s liability.”

### **Defense 19: Duty To Pursue Borrower First**

At common law, a lender may need to pursue the borrower before the lender can collect on a guaranty, particularly if the guarantor timely demands that the lender do so. *See, e.g., Pain v. Packard*, 13 Johns. 174 (N.Y. Sup. Ct. 1816). If the lender receives such a demand and doesn’t comply with it, this may excuse the guarantor to the extent of any damage caused.

Some courts have, however, held that a lender may sue an “absolute” guarantor without first trying to collect from the borrower. Courts will allow this because an absolute guarantor undertakes its guaranty unconditionally and is therefore “liable immediately upon default of the principal [borrower], without notice.” *See Lawndale Steel*, supra, 423 N.E.2d at 960 (Ill. App. Ct. 1981); *see also Allied Van Lines v. Aaron Transfer & Storage, Inc.*, 2003 U.S. Dist. LEXIS 15197 (D. Tex. Sept. 3, 2003).

**Drafting tip:** Any guaranty should require the guarantor to expressly waive the old common law rule. For example:

“Guarantor waives any right to require Lender to (a) proceed against Borrower or any other person obligated on the Obligations; (b) proceed against or exhaust any collateral; or (c) pursue any other right or remedy for Guarantor’s benefit or otherwise. Lender may proceed against Guarantor to enforce the Obligations without proceeding against Borrower, any other obligor, or any collateral. Lender may unqualifiedly exercise (or not exercise) in its sole discretion any or all of Lender’s remedies against Borrower or any other person without impairing Lender’s rights and remedies in enforcing this Guaranty. Guarantor’s liability for the Obligations shall remain independent and unconditional. Lender’s exercise of such rights or remedies may affect or eliminate Guarantor’s right of subrogation or recovery against Borrower or others. Guarantor has assumed the risk of any such loss of subrogation rights, even if caused by Lender’s acts or omissions.”

### **Defense 20: Absence Of Borrower Default**

Some lenders try to enforce a guaranty even before the borrower has actually defaulted. Because a guarantor’s liability does not arise until default has occurred on the guaranteed obligations, any lender should confirm and document the borrower’s default, so as not to jump the gun. If a lender tries to collect on the guaranty absent a borrower default, the guarantor may counterclaim for lender liability. *See Centerre Bank*, supra (Mo. Ct. App. 1985) (bank’s action against guarantor was not premature, because borrower had signed a demand note and demand was made, and no fiduciary relationship existed between bank and guarantor); *see also Frame v. Boatmen’s Bank of Concord Village*, 824 S.W.2d 491 (Mo. Ct. App. 1992) (explaining and validating *Centerre* case). Any written demand on the guarantor should include a statement of the basis of the borrower’s default. Absent a default, a lender should not try to enforce a guaranty. This article offers no drafting tip that would change that principle.

### **Defense 21: Borrower Defenses On Underlying Debt**

The law considers a guarantor’s obligation to be secondary to a borrower’s primary obligation to the lender. Thus, if the borrower has a valid defense on its obligation, a guarantor could potentially assert the same defense.

Courts have generally held that if a borrower’s defense is “real” and renders the underlying debt void, that will release the guarantor from liability. *See, e.g., Richardson v. Foster*, 170 P. 321 (Wash. 1918) (affirming obligor’s use of usury as a defense and allowing guarantor to set up the same defense, because usury voided the underlying debt). If, however, a borrower’s defense is “personal” — e.g., failure of consideration, breach of warranty, or fraud in the underlying transaction — the courts will generally enforce a guaranty. *See, e.g., Walcutt v. Clevite Corp.*, 191 N.E.2d 894 (N.Y. 1963); *Culver v. Parsons*, 777 N.Y.S 2d 536 (N.Y. App. Div. 2004). The same applies if the underlying obligations are unenforceable because of the statute of frauds. *See Backus v. Feeks*, 129 P. 86 (Wash. 1913). In sum, the line between “real” and “personal” defenses is roughly comparable to that defined in the law of negotiable instruments. *See* U.C.C. §3-305.

A similar distinction exists in cases involving fraud. For example, “fraud in the factum” is analogous to a “personal defense,” whereas “fraud in the inducement” would be analogous to a “real defense” that might

allow a guarantor to terminate liability. *See Langley v. Federal Deposit Ins. Corp.*, 484 U.S. 86 (1987) (affirming summary judgment for FDIC because defendants did not show they were tricked in the sense that they did not know what they were signing, which would constitute “fraud in the factum”).

The Circuits have split on whether the 1942 Supreme Court case *D’Oench Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), the common-law predecessor to 12 U.S.C. §1823(e), remains good law. In any case, it seems that the courts have continued to develop a federal holder-in-due-course doctrine since the *Langley* case, or at least have not completely abandoned application of the federal common law doctrines, even while limiting their application. *See* Financial Institutions Reform Recovery and Enforcement Act (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (1989); *O’Melveny & Myers v. FDIC*, 512 U.S. 79 (1994); *DiVall Insured Income Fund Ltd. Pshp. v. Boatmen’s First Nat’l Bank*, 69 F.3d 1398, 1401 (8th Cir. 1995); *Campbell Leasing, Inc. v. Federal Deposit Ins. Corp.*, 901 F.2d 1244 (5th Cir. 1990).

**Drafting tip:** Any guaranty should include language like this:

“This Guaranty remains fully enforceable regardless of any defenses Borrower may assert against the Obligations, including failure of consideration, breach of warranty, statute of frauds, statute of limitations, accord and satisfaction, and usury. Guarantor’s liability under this Guaranty shall be primary and not secondary, in the full amount of the Obligations. Guarantor is fully obligated under this Guaranty even if Borrower had no liability when Borrower signed the Loan Documents or later ceases to be liable under any Loan Document, whether through insolvency or otherwise.”

A careful guarantor will call this language overbroad, saying the guarantor should, for example, have the benefit of any defenses that the borrower could claim as a result of: (a) actual payment or performance; or (b) the lender’s acts or omissions. The concept makes sense, but drawing the right lines will not always be easy. The devil is in the details.

## **Defense 22: Intercorporate Guaranty As Fraudulent Transfer**

The Bankruptcy Code allows a bankruptcy trustee (or a debtor in possession) to avoid “any obligation incurred by the debtor” if the debtor received “less than a reasonably equivalent value” in exchange for the obligation and was or became insolvent at the time of incurring it. 11 U.S.C. §548. Trustees (and debtors in possession) can and do use this authority to argue that both “cross-stream” and “upstream” guaranties are voidable as fraudulent transfers. (In a cross-stream guaranty, an entity guaranties the obligations of some other entity controlled by the same direct or indirect parent company. In an up-stream guaranty, an entity guaranties the obligations of its direct or indirect parent company.) *See Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981); *Marquis Products, Inc. v. Conquest Carpet Mills, Inc.*, 150 B.R. 487, 490 (Bankr. D. Me. 1993) (a transfer that confers economic benefit on debtor is not voidable, because it does not impair debtor’s net worth). Courts sometimes accept these arguments, focusing on the fact that the guarantor, considered on its own, received no direct value at all for giving its guaranty. In other cases, however, the court will look at the benefit to the corporate group as a whole, and honor an individual entity’s guaranty because the guarantor was part of the benefitted corporate group.

This bankruptcy risk can readily arise in the case of real estate portfolio loans, where different partnerships or limited liability companies own each property and act as co-borrowers. Here, the lender may take steps to structure and document the portfolio loan so as to mitigate the risk, such as highlighting the nonrecourse nature of the loan, having the co-borrowers enter into a contribution agreement, requiring a “deep pocket” indemnity against the risk, and the like. Joshua Stein, *Bankruptcy Risks in Structuring Portfolio Loans*, 7 Capital Sources for Real Estate 9 (2007). Such measures may mitigate a lender’s risk. A lender can also take some comfort from the recent reversal of the infamous *TOUSA* decision of 2009. See *Official Committee of Unsecured Lenders of TOUSA, Inc. v. Citicorp N. Am., Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009) (treating upstream guaranty as fraudulent conveyance because conveying subsidiaries had a property interest in the proceeds of the financing transferred to certain repaid creditors, received only minimal value in exchange for the transfer, and were insolvent), *rev’d*, *In re TOUSA, Inc.*, 444 B.R. 613 (S.D. Fla. 2011) (reversing bankruptcy court’s main decision on creditors and setting aside bankruptcy court’s purported requirement for repaid creditors to disgorge loan proceeds, but remaining silent on bankruptcy court decision invalidating fraudulent transfer savings clause in guaranty). Still, the fraudulent transfer defense remains one that lenders must keep in mind.

### **Defense 23: Recovery Of Preferences**

When a borrower enters the pre-bankruptcy death spiral, it often cannot pay all its creditors and must choose which creditors to pay. Here, a borrower might make a last-minute payment on the guaranteed debt so as to avoid triggering a guaranty, often given by the borrower’s principal. A bankruptcy court might later require the lender to disgorge that payment, because it amounted to a voidable preference. 11 U.S.C. §547. A guarantor could argue that the disgorged payment discharged the guarantor’s obligations, even though the lender ultimately had to disgorge it. See *In re Roblin Industries, Inc.*, 78 F.3d 30 (2d Cir. 1996); *In re Herman Cantor Corp.*, 15 B.R. 747 (Bankr. E.D. Va. 1981). Although case law exists that negates this argument, any guaranty should — and typically will — still make very clear that payments of this type do not release the guarantor. See *Centre Ins. Co. v. SNIL Corp. (In re SNIL Corp.)*, 380 B.R. 204 (B.A.P. 9th Cir. 2007), *aff’d per curiam*, 571 F.3d 826 (9th Cir. 2009) (lender’s return of a preferential payment generally revives guarantor liability); see also *Wallace Hardware Co., Inc. v. Abrams*, 223 F.3d 382 (6th Cir. 2000); *In re Robinson Bros. Drilling, Inc.*, 6 F.3d 701 (10th Cir. 1993).

**Drafting tip:** If any payment on the guaranteed obligations is invalidated as a preference, this should reinstate the guarantor’s obligation, through language such as this:

“If Lender receives any payment on the Obligations and later must return any such payment for any reason, whether by court order, administrative order, settlement, or otherwise in connection with any Insolvency Proceeding, Guarantor shall remain liable for the full amount returned as if Lender had never received such payment. Any termination of this Guaranty or cancellation of Obligations resulting from any such returned payment shall have no effect.”

## Defense 24: Automatic Stay

The final common guarantor defense arises from the automatic stay in bankruptcy. That stay prohibits enforcement actions against the debtor, and in some unusual cases even against a guarantor that is not itself in bankruptcy. This stay applies explicitly to co-debtors (such as a guarantor) if a bankruptcy takes the form of a chapter 12 farm reorganization, 11 U.S.C. §1201, or a chapter 13 wage earner's plan, 11 U.S.C. §1301. But also note a relatively recent decision limiting the extension of the automatic stay to non-debtors related to debtors filing under Chapter 13. *In re McCormick*, 381 B.R. 594 (Bankr. S.D.N.Y. 2008). Though a chapter 11 business reorganization offers no comparable automatic stay to protect guarantors, some courts have enjoined lenders from proceeding against guarantors on the theory that such enforcement, or payment by a party closely related to the borrower, would disrupt the borrower's reorganization. *See, e.g., In re Granite Partners, L.P.*, 194 B.R. 318 (Bankr. S.D.N.Y. 1996); *Pravin Banker Associates v. Banco Popular del Peru*, 165 B.R. 379 (S.D.N.Y. 1994); *In re Otero Mills, Inc.*, 25 B.R. 1018 (D.N.M. 1982). *But see In re Supermercado Gamboa, Inc.*, 68 B.R. 230, 234 (Bankr. D.P.R. 1986) (opining that *Otero Mills* creates too relaxed a standard for the degree of detrimental impact on reorganization that can invoke the automatic stay to protect a guarantor).

As a general matter, courts may extend the automatic stay to non-bankrupt third parties under "unusual circumstances." These could include circumstances where judgment against the third party will amount to a judgment or a finding against the debtor or where a claim against a non-debtor will have an immediate adverse economic impact on the debtor's estate. *See A.H. Robins Co., Inc. v. Piccinin*, 788 F.2d 994 (4th Cir. 1986), *cert. denied*, 479 U.S. 876 (1986); *see also Queenie, Ltd. v. Nygard Int'l*, 321 F.3d 282 (2d Cir. 2003).

Though some existing case law suggests that courts will not extend the automatic stay to guarantors, no specific case law bars this extension. *See Lynch v. Johns-Manville Sales Corp.*, 710 F.2d 1194 (6th Cir. 1983); *CAE Industries Ltd. v. Aerospace Holdings Co.*, 116 B.R. 31 (S.D.N.Y. 1990). Therefore, a lender cannot assume that a guaranty will provide a safe, quick, and effective end run around a borrower bankruptcy, even if the guarantor stay out of bankruptcy.

## Conclusion

Although these days counsel to real estate lenders (at least outside the nation's primary commercial real estate markets) may spend more time reading guaranties than writing guaranties, lenders will sometimes have opportunities to rewrite guaranties. The suggestions in this article may help in that process, and in negotiating new guaranties as new lending continues to revive. This commentary may also help lenders avoid pitfalls that could interfere with their enforcement of guaranties.

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