The Law of Guaranties and Sureties: The Next Round of Litigation?

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In the present economy, creditors are increasingly coming up empty handed when attempting to enforce obligations against debtors who are unable to pay. As a result, attention is being focused on enforcing guaranties in the next round of litigation. This article examines the basic laws involving guaranties.

A guaranty is a contractual obligation under which a lender or creditor may enforce against the guarantor the obligation of some other party. The guarantor promises to answer for the debt or default of that other party, called the primary obligor or principal debtor.

There are different types of guaranties. A payment guaranty promises to make payment upon a default of the primary obligor. A collection guaranty promises to make payment, but only after the lender has attempted collection against the primary obligor. A continuing guaranty promises to pay future, new liabilities of the primary obligor to the lender in subsequent transactions. By contrast, a performance guaranty promises to perform the non-monetary obligations upon the default of the primary obligor. In the construction context, a completion guaranty obligates the guarantor to complete construction or provide funds to do so if the borrower defaults on its construction loan. The remedy for breach of a performance or completion guaranties, however, may be limited to damages rather than specific performance.

Other forms of guaranties seen in loan transactions include non-recourse carve-out guaranties, which cover a borrower's recourse liability on an otherwise non-recourse loan. These are sometimes referred to as "bad boy" guaranties. A "springing" guaranty may be triggered if the borrower files a bankruptcy case or attempts to block foreclosure by the lender.

A guaranty typically must be in writing. No separate consideration is required if the guaranty is executed at the same time of the primary obligation. Otherwise, the guaranty must be supported by separate consideration.

The enforcement of a guaranty may involve several different laws. The general law of guaranties is contained in the Civil Code. Where personal property security is involved, the Commercial Code provides a guarantor with certain rights. Where real property security is involved, one-action and anti-deficiency rules may come into play. Where insolvency or bankruptcy is involved, state fraudulent transfer law and federal bankruptcy law may become relevant.

The Civil Code provides the guarantor with defenses that, unless waived, limit the rights of the creditor. However, the Code also authorizes waiver of virtually all defenses, and provides a number of model waivers that can be included in a guaranty. Typically, an institutional creditor's guaranty form will include extensive waivers.

If not waived, there are many protections available for guarantors in the Civil Code and case law. For example, the obligation of the guarantor may not be greater or more burdensome than the principal obligation. In addition, a guarantor's obligation is reduced to the extent a creditor accepts any partial satisfaction of the debt. Another defense provides that a guarantor is exonerated to the extent the creditor alters, impairs or discharges the principal obligation without the creditor's consent. Finally, a creditor may be required to disclose facts that materially increase the risk beyond which the guarantor intended to assume; otherwise the lender may be subject to claims of misrepresentation or fraud.

While the foregoing simplifies substantive areas of the law, it underscores the need to get counsel involved early in drafting and enforcing guaranties. This is especially true in the present economy, where risks of insolvency or default of debtors is of heightened concern.