The promise, Part I

Creditors, guarantors and discharge protections

By Stuart D. Ames and Elizabeth A. Martialay

Commercial FINANCE

How often has your bank client presented you with a new loan proposal or commitment letter involving two or more borrowers? Do you simply accept this structure and begin drafting loan documents or do you first ask the client why it desires multiple-borrowers rather than a single borrower with the other "makers" serving as guarantors of the loan?

It is the premise of this article that in many credit transactions, bankers and bank counsel who prefer a multiple-borrower arrangement over a borrower-guarantor structure may mistakenly believe that adding credit-enhancing parties as additional borrowers provides a higher probability of repayment. This common misconception about such structures can lead to the inadvertent discharge of a co-maker's obligation for the loan if certain drafting techniques are not used.

We explore the suretyship discharge issues involved in multiple-obligor structures and suggest methods for avoiding their inherent pitfalls. Michael Maglio's companion article explores the fraudulent transfer law implications of using guarantors or co-makers as providers of credit support for the principal obligation.

In modern financial transactions it is common, as it has been for thousands of years, for creditors to rely not only on the credit of a borrower but also on the credit of another party that "lends" or "sells" its credit to enhance the creditworthiness of the loan transaction to the lender. Many business lawyers consider the role of a surety or guarantor to be rather straightforward.

In fact, however, there are different types of sureties and different bodies of law governing them. Certain aspects of the law of suretyship are implicated in structuring an obligation with multiple "principal" obligors (or co-makers), one or more of whom provide credit support for the principal obligation but not all of whom are direct beneficiaries of the financing that creates that obliga-

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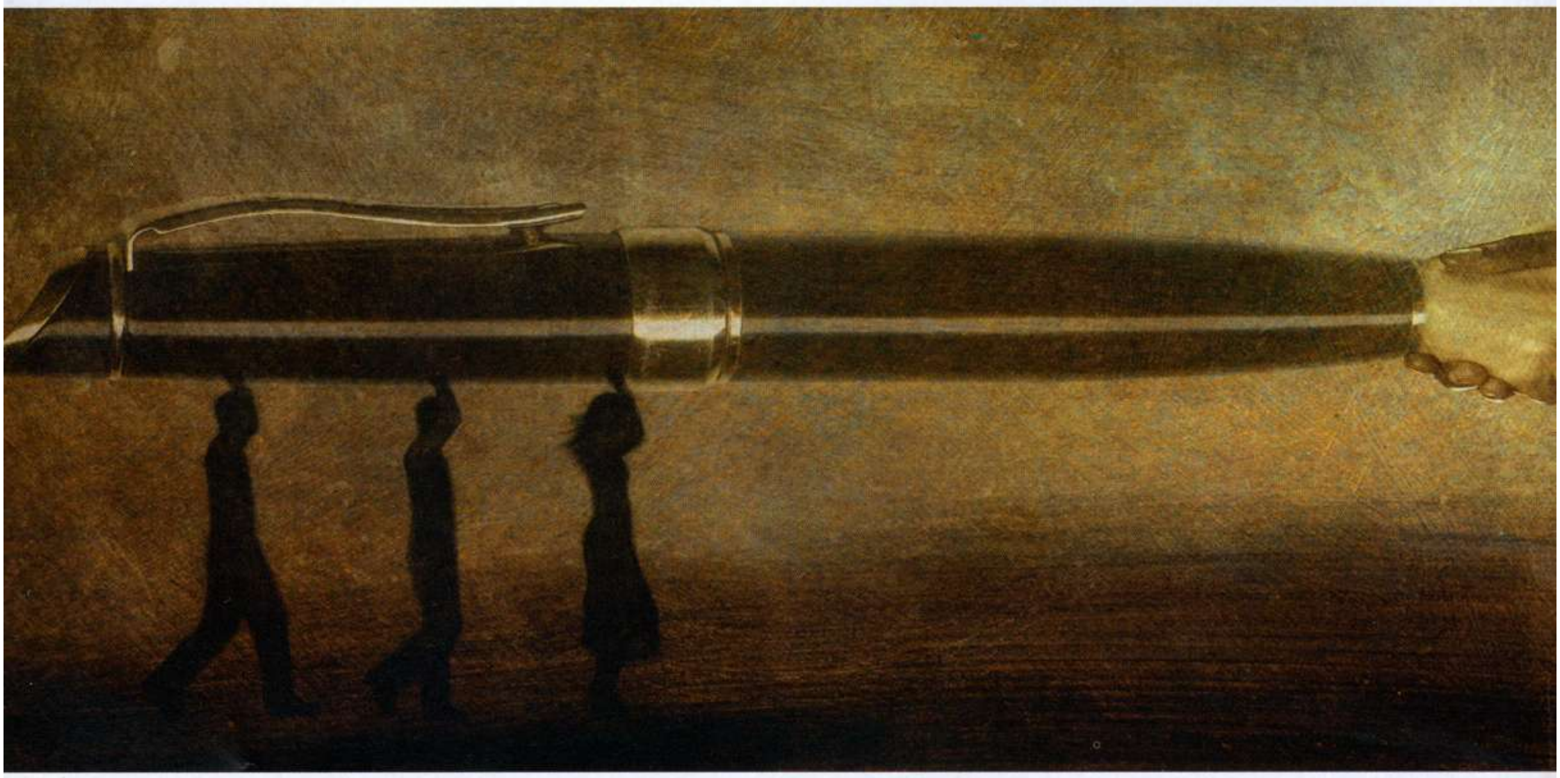

Jon Krause

The promise, Part II

Corporations, obligations and fraudulent conveyances

Commercial FINANCE

By Michael F. Maglio

Business combinations are becoming a lot more common as companies strive to compete in the global marketplace.

That means that multiple-obligor loan transactions, such as the one described in Stuart Ames' and Elizabeth Martialay's companion article, are also cropping up more frequently. Most business combinations are organized as a corporate group, usually with a holding company controlling one or more operating subsidiaries in one or more tiers. These subsidiaries often are engaged in related or complimentary businesses, and a strong synergy is contemplated.

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Lenders to corporate groups are often asked to disregard the legal separateness of the member companies. Credit facilities underwritten on the strength of the corporate group can translate into greater availability at a lower cost and make credit available to members of the group that can otherwise get it only at a substantially higher cost.

Lenders will typically require all of the members of the corporate group to provide some form of credit support for the credit facilities being requested. From the lender's perspective, the ability to spread the repayment obligations among the members of the corporate group on a joint and several basis reduces its risk of nonpayment and, if the credit facilities are to be secured, makes a greater pool of assets available for satisfying those obligations.

But underwriting on the basis of the corporate group has its risks. In their companion article, the authors explore the suretyship issues involved in multiple-obligor loan structures and suggest methods for avoiding inadvertent discharge of guarantors or other sureties.

This article explores the fraudulent transfer law implications involved in those structures. Bankers and bank counsel who prefer a co-borrower structure over a borrower-guarantor structure, or vice versa, may be surprised to learn that their preference matters little in the context of minimizing the fraudulent transfer risks inher-

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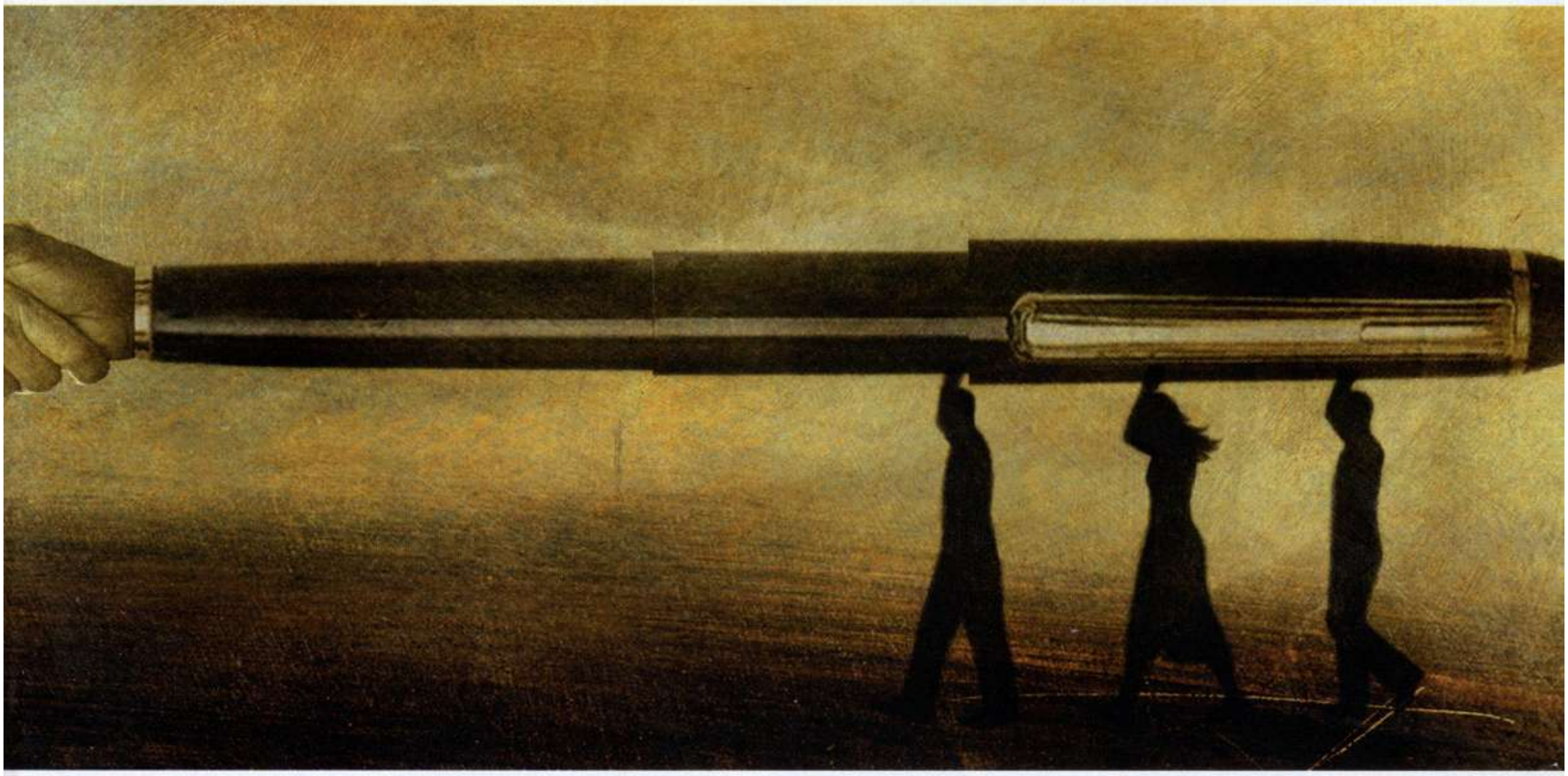

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tion. These will be discussed below.

In structuring a transaction, it is important to understand the legal characterization of each party and the related rights and obligations of the party. Take, for example, a simple financing transaction in which a loan, represented by a promissory note, is to be extended by Bank to Borrower corporation. Sub, a subsidiary of Borrower, has agreed to guarantee the loan. It is not clear whether any of the proceeds of the loan will be downstreamed to Sub for use in Sub's business, but Bank has taken Sub's assets into account in making its decision to extend credit to Borrower and is relying on those assets as a source of repayment of the debt if Borrower defaults.

This transaction could be documented in two different ways, and depending on which approach is used, a different body of law will apply to Sub's rights and obligations. Sub could sign the promissory note as a co-maker or Sub could sign a separate agreement in which it agrees to act as guarantor. The best choice will depend on the intended use of the proceeds and the role that Sub will play in the transaction. In either case, from Bank's perspective, the documents must contain language to ensure that Sub will not be able to subsequently avoid its promise to provide credit support for Borrower's obligations.

A few legal principles should be discussed before proceeding with our example.

"Surety" is a general term that encompasses many different relationships among parties. It is described in the comments to Section 1 of the Restatement of the Law (Third) – Suretyship and Guaranty (the Restatement) as any contractual arrangement where an obligee has recourse against a person or its property with respect to the obligations of another person to that obligee. The surety may be compensated (such as a bonding company) or uncompensated, may be primarily liable or secondarily liable for obligations on default and may be related or unrelated to the primary obligor.

Guarantors and "accommodation parties" are each types of sureties. Traditionally, the term "guarantor" referred to a surety that was obligated only on default of the primary obligor — formerly referred to as a "guarantor of collection." It is so common in current practice to draft unconditional guarantee agreements, that this term has become more general and now encompasses not only guarantors of collection, but also guarantors of payment.

Obligations are governed by common law or the UCC.

The rights and obligations of sureties and guarantors are principally governed by the common law, to the extent that it is not specifically displaced by Article 3 of the Uniform Commercial Code (UCC), Article 9 of the UCC (to the extent that a guarantor provides collateral to support its obligations) and the law of letters of credit. The latter two bodies of law will not be discussed here, but it is important to note that they also govern certain surety transactions.

"Accommodation party" is a term created by the drafters of Article 3 of the UCC to refer to the type of surety that is governed by that body of law — sureties on negotiable instruments. If a party (1) has signed an instrument for the purpose of incurring liability under it and (2) has not received any direct benefit under the instrument, then it is an accommodation party, and one must refer to Article 3 to understand the legal implications.

The accommodation party may sign at the time that value is obtained by the primary obligor or at any later time. The accommodation party may sign with words of guarantee (such as, "X, as guarantor"), may be an "anomalous endorser" (defined in the UCC as an endorsement by a person other than the holder of an instrument) or may be a co-maker (defined in the UCC as "a person who signs or is identified in a note as a person undertaking to pay").

In each of these cases, the accommodation party is jointly and severally liable with the primary obligor, unless its signature is accompanied by unambiguous language that it is guaranteeing collection rather than payment.

Whichever body of law applies, sureties have several defenses that they can raise to avoid liability. These are set forth in the Restatement, and there is an extensive body of case law dealing with the various situations in which they arise although the rules vary from jurisdiction to jurisdiction and from common law to the Uniform Commercial Code. The suretyship defenses, as they are called (and which are partially codified in Sections 3-604 and 3-605 of the UCC), are founded on the basic contract law principle that a contract requires a meeting of the minds, and one party alone cannot unilaterally change the terms of a contract.

Suretyship defenses are also based on preserving (or not impairing) the surety's rights against the primary obligor for reimbursement, restitution and subrogation. Thus, sureties may be discharged from their obligations in situations where the creditor and primary obligor, or the creditor alone, take actions that would alter the risks to the surety or otherwise put the surety in a situation that it had not bargained for. For example, discharge of a surety may occur if the amount of the obligation is increased, the repayment terms are extended or the value of collateral security for the obligation is reduced.

The main suretyship defenses (set forth in the Restatement) are:

- discharge or release of the primary obligor,
- grant of an extension of time to the primary obligor,
- other modifications to the underlying obligations of the primary obligor,
- impairment of collateral (for

instance, by failure to maintain a perfected security interest, release of collateral without adequate substitution, failure to preserve the value of collateral physically held by the creditor and failure to properly dispose of collateral),

- failure to enforce against the primary obligor within the applicable statute of limitations and
- other interference by the creditor with the surety's recourse against the primary obligor.

Each of these defenses involves a change that could make it more difficult for the surety to seek reimbursement from the primary obligor if the surety is obligated to perform; therefore, taking any of these actions without obtaining the consent of the surety may result in its full or partial discharge. If it is clear that the surety has been impaired, but too difficult to determine the amount of impairment, following the Restatement it is presumed that the impairment is equal to the full amount of the surety's obligations, unless the obligee can prove otherwise.

Section 3-605 of the UCC follows much of the common law with respect to sureties and guarantors in providing defenses for accommodation parties to negotiable instruments. It describes four circumstances where the accommodation party may be discharged, which are modeled on the Restatement and cover the first four bullets listed above. Thus, although the obligations and defenses of accommodation parties are governed by the UCC, most of the same concerns arise as when dealing with a guarantor under the Restatement.

It is important to note, however, that while the law relating to common law guarantors is abundant, there is very little case law under UCC Section 3-605, particularly as it was extensively revised in 2002. Since it is based on the Restatement, one can predict that courts would follow much of the case law developed with respect to that body of law, but there may be subtle differences in the analysis of the statute given that the UCC deals with a narrow subset of sureties.

Fortunately for lenders, the Restatement and the UCC recognize the freedom of parties to contract with one another and thus provide that sureties and accommodation parties may waive the suretyship defenses in advance. While both legal standards provide that the waiver language may be general as to suretyship defenses, general practice of lenders and their lawyers — based on experience and case law — is to require guarantors to sign lengthy and detailed waivers. Any well-drafted guaranty agreement will contain such provisions.

On the other hand, multiple-maker

Sample promissory note language

The joint and several obligations of each of the undersigned under this note shall be absolute and unconditional and shall remain in full force and effect until the entire principal, interest, penalties, premiums and late charges, if any, on this note and all additional payments, if any, due pursuant to any other loan document (collectively, the "obligations") shall have been paid and, until such payment has been made, shall not be discharged, affected, modified or impaired on the happening from time to time of any event, including, without limitation, any of the following, whether or not with notice to or the consent of any of the undersigned:

(a) the waiver, compromise, settlement, release, termination or amendment (including, without limitation, any extension or postponement of the time for payment or performance or renewal or refinancing) of any or all of the obligations or agreements of any of the undersigned under this note or any other loan document;

(b) the failure to give notice to any or all of the undersigned of the occurrence of a default under the terms and provisions of this note or any other loan document;

(c) the release, substitution or exchange by the holder of this note of any collateral securing any of the obligations (the "collateral") (whether with or without consideration) or the acceptance by the holder of this note of any additional collateral or the availability or claimed availability of any other collateral or source of repayment or any nonperfection or other impairment of any collateral;

(d) the release of any person primarily or secondarily liable for all or any part of the obligations, whether by bank or any other holder of the note or in connection with any voluntary or involuntary liquidation, dissolution, receivership, insolvency, bankruptcy, assignment for the benefit of creditors or similar event or proceeding affecting any or all of the undersigned or any other person or entity who, or any of whose property, shall at the time in question be obligated in respect of the obligations or any part thereof; or

(e) to the extent permitted by law, any other event, occurrence, action or circumstance that would, in the absence of this clause, result in the release or discharge of any or all of the undersigned from the performance or observance of any obligation, covenant or agreement contained in this note.

The joint and several obligations of the undersigned to bank under this note shall remain in full force and effect (or be reinstated) until bank has received payment in full of all obligations and the expiration of any applicable preference or similar period pursuant to any bankruptcy, insolvency, reorganization, moratorium or similar law, or at law or equity, without any claim having been made before the expiration of such period asserting an interest in all or any part of any payment(s) received by bank.

The undersigned expressly agree that bank shall not be required first to institute any suit or to exhaust its remedies against any of the undersigned or any other person or party to become liable hereunder or against any collateral, in order to enforce this note; and expressly agree that, notwithstanding the occurrence of any of the foregoing, the undersigned shall be and remain, directly and primarily liable for all sums due under this note and under the loan documents. On disposition by bank of any property encumbered by any collateral, the undersigned shall be and shall remain jointly and severally liable for any deficiency.

— *Stuart D. Ames and Elizabeth A. Martialay* promissory notes, even long-form notes, are sometimes drafted without suretyship law in mind and often do not contain the kind of language necessary to waive suretyship defenses. It is clear from case law, and under the Restatement and the UCC, that properly drafted waivers are effective to prevent discharge, so it is important for lender's counsel to ensure that their documents have the appropriate language when accommodation parties are signatories.

Coming back to our example, Bank can require Sub to sign the promissory note as a co-maker or sign a separate guaranty agreement. Optically, it may seem attractive to Bank to use less paper and have Borrower and Sub sign only one instrument. But it is important to remember that when more than one party signs an instrument, extra language may be required to deal with a party signing "for accommodation." If Sub signs the note but neither receives any of the proceeds of the borrowing under the note nor any other direct benefit from the borrowing (such as the parent company co-maker using such

Disputes may be difficult to resolve.

proceeds for the benefit of the Sub's business), it is likely that Sub is an accommodation party, in which case Bank needs to make sure that there is appropriate waiver language in the note (sample language is provided in sidebar).

As mentioned above, drafters of promissory notes often overlook the necessity to include suretyship defense waiver language, so lawyers must be aware of loan structures in which such waivers are essential to avoid unintended discharge. Finally, case law with respect to accommodation parties is generally limited, and disputes may be difficult to resolve because of the lack of precedent. Therefore, as a practical matter, prudence suggests that all multiple-maker notes contain such waivers, even when it is clear that all makers will benefit from the loan.

If Sub signs a guaranty agreement, this may involve an additional loan document, but it is also a more traditional method of achieving Bank's goals. Sub's role will be clearly defined and less work will be involved in modifying the promissory note or other documents to fit the loan transaction. The more extensive body of case law involving disputes between creditors and guarantors provides a desirable level of certainty in defining the obligations of the guarantor and the rights of the creditor.

In this situation there are two ways to skin the cat, but lawyers should be sensitive to the implications of having more than one signature on a note and the extra precautions they need to take if all the obligors in their transaction sign one instrument. The sidebar to this article contains sample promissory note language that drafters of co-maker instruments may want to consider to avoid discharge of a co-maker.

There is no fail-safe method nor magic words that will guaranty the enforcement of a surety's or guarantor's obligation on or with respect to an instrument. However, if lenders and their counsel when structuring loans to multi-tiered entities keep in mind the suretyship principles discussed above, and the fraudulent transfer principles discussed in the companion article, the risk of inadvertent discharge of the credit-enhancing party or parties can be minimized. blt