

4-1-1983

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Recommended Citation

Peter A. Alces, *The Efficacy of Guaranty Contracts in Sophisticated Commercial Transactions*, 61 N.C. L. REV. 655 (1983).Available at: <http://scholarship.law.unc.edu/nclr/vol61/iss4/3>

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THE EFFICACY OF GUARANTY CONTRACTS IN SOPHISTICATED COMMERCIAL TRANSACTIONS

PETER A. ALCES[†]

Even though contracts of guaranty are not subject to uniform standards of interpretation throughout the states, both case law and statutory development have tended to evidence a strong sympathy for the guarantor. In spite of this trend, Professor Alces suggests that creditors' counsel can, through careful drafting, do much to assure the enforceability of the guaranty contract. A scrupulously structured guaranty contract, one that anticipates possible defenses to liability in explicit terms, may well be upheld, even in cases in which guarantors occupied weak negotiating positions vis-à-vis creditors. Moreover, the attack on the guaranty as a fraudulent conveyance under section 548 of the Bankruptcy Reform Act of 1978 can also be successfully avoided. In this instance, the creditor should be prepared to make the argument that solvency of the guarantor is to be assessed on the basis of a "going concern" value. Thus, careful anticipatory drafting, and well-reasoned analysis of "value" in the case of a fraudulent conveyance attack, may assist the creditor who seeks to enforce a contract of guaranty.

Contracts of guaranty arise in various contexts, take any one of several forms, and may be either secured by real or personal¹ property or entirely unsecured.² The law governing guaranties differs from state to state, and there

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1. Potential collateral for a guaranty may be the stock of the corporation whose obligation the principal is asked to guaranty. In that case the creditor will require the guarantor to execute a "Pledge Agreement," describing the parties' rights to the pledged stock, as well as a form of stock power signed in blank in order to facilitate efficient disposition of the securities. Although the value of the stock in the closely held corporate debtor is liable to be negligible by the time the creditor would be interested in foreclosing on it, taking the stock in pledge along with the attendant voting rights is an effective way to preclude the guarantor's dealing with the stock in a manner inconsistent with the creditor's best interests. In such transactions, however, the creditor must be careful to avoid, to the extent practicable, allegations that the creditor is "in control" of the debtor. See 11 U.S.C. § 101(25)(B)(iii) (Supp. V 1981) of the Bankruptcy Reform Act of 1978, which defines "insider" as "a person in control of the debtor corporation," and consider the ramifications of such a characterization in 11 U.S.C. § 547 (Supp. V 1981), dealing with "Preferences" under the Bankruptcy Code. Section 547(b)(4)(B)(i) extends the preference statute of limitations from 90 days to one year if "the creditor . . . was an insider; and . . . had reasonable cause to believe the debtor was insolvent at the time of the transfer." See also *infra* note 131.

2. The properties and characteristics of the so-called "guaranty" letter of credit are not considered in this article. See *O'Grady v. First Union Nat'l Bank*, 296 N.C. 212, 250 S.E.2d 587 (1978); Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716 (1973); Note, *Guaranty Letters of Credit: Problems and Possibilities*, 16 ARIZ. L. REV. 822 (1974).

is neither applicable uniform legislation³ nor comprehensive federal legislation⁴ in the area. That dearth of statutory guidance has frustrated commercial expectations. Current economic conditions⁵ and recent developments in the law⁶ have called attention to the serious consequences that attend the inconsistent treatment afforded contracts of guaranty in the courts.

A guaranty may be absolute, conditional,⁷ general, special,⁸ continuing,⁹

3. Certain provisions of the Uniform Commercial Code (UCC) deal specifically with the right of a guarantor, such as UCC § 3-606 (1978), which provides, in pertinent part:

Impairment of Recourse or of Collateral

(1) The holder discharges any party to the instrument to the extent that without such party's consent the holder

(a) 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 ineffective or unnecessary; or

(b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any party against whom he has a right of recourse.

UCC § 3-606 (1978) is limited to guaranties of "negotiable" instruments; therefore, its application is severely limited because many of the promissory notes used in sophisticated commercial transactions do not fit the UCC § 3-104 (1978) definition:

(1) Any writing to be a negotiable instrument within this Article [3] must

(a) be signed by the maker or drawer; and

(b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and

(c) be payable on demand or at a definite time; and

(d) be payable to order or to bearer.

See also *infra* text accompanying notes 96-111. See generally Brennan & Burdick, *Does the Guarantor Guarantee? Lender, Beware!*, 11 SETON HALL L. REV. 353 (1981); Hawkland, *The Liability of Accommodation Parties Under Article 3 of the Uniform Commercial Code*, 25 PRAC. LAW. 35 (1979).

4. The Bankruptcy Reform Act of 1978 (Bankruptcy Code), 11 U.S.C. §§ 509 ("Claim of codebtor"), 1301 ("Stay of action against codebtor") (Supp. V 1981) will have limited rather than pervasive impact on contracts of guaranty.

5. See, e.g., Petzinger, *Taking Shelter: AM International Gets a Vital Second Chance by Using Chapter 11*, Wall St. J., Apr. 23, 1982, at 1, col. 6 (describing the plight of a large national corporation and suggesting that the recession of the early part of this decade will subject many business relations to scrutiny in bankruptcy courts).

6. See *infra* text accompanying notes 134-75.

7. The "absolute" guaranty and "conditional" guaranty are procedural opposites of one another. Before a conditional guaranty may be enforced, certain prescribed conditions must be satisfied. A creditor may enforce an absolute guaranty notwithstanding the occurrence or nonoccurrence of any event either within or not within the contemplation of the parties at the time the guaranty was executed. A guaranty is deemed absolute unless its terms import some condition to the guarantor's liability. See *Glickman v. Collins*, 13 Cal. 3d 852, 533 P.2d 204, 120 Cal. Rptr. 76 (1975); *Moffett v. Miller*, 119 Cal. 2d 712, 260 P.2d 215 (1953); *Bank of Am. Nat'l Trust & Sav. Ass'n v. McRae*, 81 Cal. App. 2d 1, 183 P.2d 385 (1947); *Chios v. Marlow*, 39 Colo. App. 218, —, 563 P.2d 387, 389 (1977); *Riverside Nat'l Bank v. Manolakis*, 613 P.2d 438 (Okla. 1980); *Rucker v. Republic Supply Co.*, 415 P.2d 951 (Okla. 1966). See also *Bank of Kirkwood Plaza v. Mueller*, 294 N.W.2d 640, 644 (N.D. 1980); *State Bank v. Porter*, 167 N.W.2d 527 (N.D. 1969); *National Bank v. Equity Inv.*, 81 Wash. 2d 886, 506 P.2d 39 (1973); *Robey v. Walton Lumber Co.*, 17 Wash. 2d 242, 135 P.2d 95 (1943).

8. A "general" guaranty is made to no particular creditor, while a "special" guaranty vests rights in the requesting creditor. See *Joe Balestrieri & Co. v. Comm'r*, 177 F.2d 867 (9th Cir. 1949); *Austin v. New Brunswick Fire Ins. Co.*, 111 Mont. 192, 108 P.2d 1036 (1941).

unlimited,¹⁰ a guaranty of payment, or of collection or collectability.¹¹ Rather than treat all the permutations of the foregoing types of guaranties, this article focuses on the absolute, continuing, unlimited guaranty of payment made by corporations, partnerships, and individuals. The article summarizes the significant considerations that bear upon the use of guaranties by discussing pertinent cases and legislative developments. The approach necessarily precludes in-depth discussion of nonuniversal state law doctrines, but will include an analysis of the relevant aspects of contract¹² law, as well as the Bankruptcy Reform Act of 1978 (Bankruptcy Code) and those procedures by which lenders try to assure the enforceability of guaranties.¹³ Throughout the course of the article, reference will be made to certain standard guaranty provisions. The design is not to provide the foundation for a "canned form," but rather to complement the substantive material with practical suggestions.

I. APPLICABLE CONTRACT LAW

The law governing contracts of guaranty is normally the general common

9. A "continuing" guaranty is not limited to an isolated transaction but contemplates a series of transactions, often for an indefinite period of time. See *Standard Oil v. Houser*, 101 Cal. App. 2d 480, 225 P.2d 539 (1950); *Valley Nat'l Bank v. Foreign Car Rental, Inc.*, 157 Colo. 545, 404 P.2d 272 (1965); *Peoples Bank & Trust Co. v. Warner*, 35 Colo. App. 434, 535 P.2d 1132 (1975); *Ransom Distrib. Co. v. Lazy B Ltd.*, 35 Colo. App. 86, 532 P.2d 366 (1974); *Bonura v. Christian Bros. Poultry Co.*, 336 So. 2d 881 (La. Ct. App. 1976); *Magnolia Petroleum Co. v. Har-ley*, 13 So. 2d 84 (La. Ct. App. 1943); *Riverside Nat'l Bank v. Manolakis*, 613 P.2d 438 (Okla. 1980); *Rucker v. Republic Supply Co.*, 415 P.2d 951 (Okla. 1966); *Houston Furniture Distrib., Inc. v. Bank of Woodlake*, 562 S.W.2d 880 (Tex. Civ. App. 1978); *Reece v. First State Bank*, 555 S.W.2d 929 (Tex. Civ. App. 1977); *Blount v. Westinghouse Credit Corp.*, 432 S.W.2d 549 (Tex. Civ. App. 1968).

10. It is safer practice to avoid taking a limited guaranty because courts may be quite willing to accept the arguments of a limited guarantor that follow this type of reasoning: when a guaranty provides that the guarantor is to be liable for \$300 of a \$1000 indebtedness and only \$500 of that indebtedness remains unsatisfied at the time the creditor attempts to enforce the guaranty, it could be concluded that the \$300 guaranteed was part of the \$500 already paid. If such an argument were accepted by the court, the guarantor could be completely released from liability. To avoid such a result, the standard form of unlimited guaranty should be used with the addition of language to the effect that the guarantor's liability under the guaranty is limited to the specified amount. For a recent case in which the foregoing analysis was apposite, see *Memphis Sheraton Corp. v. Kirkley*, 640 F.2d 14 (6th Cir. 1981).

11. See *infra* text accompanying notes 16-22.

12. See *Howell v. Comm'r*, 69 F.2d 447 (8th Cir. 1934). The court noted in *Howell* that "the liability of a guarantor is secondary and collateral, and its enforcement depends upon certain conditions. The liability of a surety is original, primary and direct." *Id.* at 450. See also *Pickett v. Rigsbee*, 252 N.C. 200, 113 S.E.2d 323 (1960); *S.N.M.L. Corp. v. Bank of N.C.*, 41 N.C. App. 28, 254 S.E.2d 274 (1979). See generally L. SIMPSON, *HANDBOOK ON THE LAW OF SURETYSHIP* 6 (1950); *Radin, Guaranty and Suretyship*, 17 CALIF. L. REV. 605 (1929); Note, *The Waiver of Defenses by Guarantors in Guaranty Contracts and the Nonwaiver Provisions of the Uniform Commercial Code*, 5 VT. L. REV. 73 (1980). The article will not consider the impact of suretyship law.

13. Commentators have considered the corporate law issues surrounding contracts of guaranty, particularly the ultra vires doctrine. See *Bird, The Guaranty: A Dilemma for Corporate Managers*, 23 SW. L.J. 872 (1969); *Coquillette, Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 CASE W. RES. L. REV. 433, 438-46 (1980); *Kriedman, The Corporate Guaranty*, 13 VAND. L. REV. 229 (1959); Note, *Upstream Financing and the Use of the Corporate Guaranty*, 53 NOTRE DAME LAW. 841 (1978); Note, *The Corporate Guaranty Revisited: Upstream, Downstream, and Beyond—A Statutory Approach*, 32 RUT. L. REV. 312 (1979). See also Annot., 71 A.L.R. 3d 639 (1976). In order to avoid undue repetition, this article will not consider corporate law issues but will commend the reader to the exhaustive analyses cited above.

law of the several states.¹⁴ There are, however, some state statutes that confront specific issues.¹⁵ Such statutes are not pervasive, and, for the most part, do little to promote uniformity among the states. This section of the article will explore the applicable contract law as the necessary foundation for any critical observations regarding contracts of guaranty.

A. Terminology

It is important at the outset to distinguish between a *guaranty of payment* and a *guaranty of collection*. Perhaps the clearest description of that distinction is found in section 3-416 of the Uniform Commercial Code (UCC), which is applicable in every jurisdiction in the United States:¹⁶

Contract of Guarantor

(1) 'Payment guaranteed' or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due, he will pay it according to its tenor without resort by the holder to any other party.

(2) 'Collection guaranteed' or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due, he will pay it according to its tenor, but only after the holder has reduced his claim against the maker or acceptor [principal debtor] to judgment and execution has been returned unsatisfied, or after the maker or acceptor has become insolvent or it is otherwise apparent that it is useless to proceed against him.

(3) Words of guaranty which do not otherwise specify guarantee payment.

While Article 3 of the UCC is directed specifically to matters of negotiable instrument law,¹⁷ the distinction presented in section 3-416 is useful outside the body of law governing commercial paper.¹⁸ The section provides a pre-

14. "Contracts of guaranty are subject to the . . . general law of contract when not otherwise provided." *O'Grady v. First Union Nat'l Bank*, 296 N.C. 212, 220, 250 S.E.2d 587, 593 (1978). See also RESTATEMENT OF LAW OF SECURITY § 82 comment g (1941). See generally *Dole, Notice Requirements in Guaranty Contracts*, 62 MICH. L. REV. 57 (1963).

15. See, e.g., OKLA. STAT. tit. 15, §§ 321-344 (1971); *infra* text accompanying notes 118-26. See also NEW YORK LAW REVISION COMM'N, REPORT OF THE LAW REVISION COMMISSION FOR 1961, at 279-80 (1961); *supra* note 3.

16. While Louisiana has not adopted Articles 2 or 9, the State has chosen to join the rest of the nation insofar as commercial paper is concerned.

17. See *supra* note 3.

18. A guaranty of payment has been defined as an absolute undertaking to pay a debt at maturity if the principal obligor does not do so. *Preferred Inv. Co. v. Westbrook*, 174 N.W.2d 391, 395 (Iowa 1970). *Accord* *Midway Nat'l Bank v. Gustafson*, 282 Minn. 73, 165 N.W.2d 218 (1969); *Bank of Sun Prairie v. Opstein*, 86 Wis. 2d 669, 273 N.W.2d 279 (1979); *United States v. Klebe Tool & Die Co.*, 5 Wis. 2d 392, 92 N.W.2d 868 (1958). See *Annot.*, 53 A.L.R. 2d 522 (1957); *Annot.*, 14 A.L.R. 924 (1921). A guaranty of collection, on the other hand, is conditional. It merely binds the guarantor to pay if the claim guaranteed is not collectible by due diligence. *Ammerman v. Miller*, 488 F.2d 1285, 1295 (D.C. Cir. 1973); *accord* *Schaeffer v. Gilmer*, 353 So. 2d 847 (Fla. Dist. Ct. App. 1977); *Northwestern Bank v. Cortner*, 275 So. 2d 317 (Fla. Dist. Ct. App. 1973); *American Bank & Trust Co. v. Blue Bird Restaurant & Lounge, Inc.*, 279 So.2d 720 (La. Ct. App. 1973); *State Bank v. Porter*, 167 N.W.2d 527 (N.D. 1969); see also *supra* note 7. For cases distinguishing between the two forms of guaranty, see *State Bank v. Porter*, 167 N.W.2d 527 (N.D. 1969); *Robey v. Walter Lumber Co.*, 17 Wash. 2d 242, 135 P.2d 95 (1943).

sumption in favor of reading a signature (perhaps indorsement) as constituting a guaranty of payment.¹⁹ The crucial difference between a guaranty of payment and a guaranty of collection involves the procedural prerequisite to enforcement of the guaranty. The creditor who has received the guaranty of collection must prosecute his claim against the principal debtor to judgment (and perhaps beyond) with "due diligence"²⁰ before he may collect from the guarantor.²¹ That precondition involves potentially significant time and expense and forces the creditor to make numerous tactical decisions, any one or more of which may be attacked as manifesting something less than "due diligence."²²

Courts often strictly construe guaranties of collection to deny recovery against the guarantor. The Court of Appeals for the Second Circuit recently found a "final decision" lacking in *M.W. Zack Metal v. International Navigation Corp. of Monrovia*.²³ The guaranty provided that "the undersigned company herewith guarantees to pay upon first request the agreed sum, plus interest and costs, in the amount to which the plaintiff is entitled pursuant to a final decision of the German courts or on basis of a settlement agreement."²⁴ Because the German appeals court had failed to make an accounting of costs and interest, the court of appeals held that there was no "final decision" as intended by the contract of guaranty. The court was not persuaded by the argument that the assessment of interest and costs was a mere clarification of the extent of the guarantor's liability²⁵ rather than a prerequisite determination that a "final decision" had been rendered.²⁶

While a survey of the issues surrounding prejudgment remedies, post-judgment remedies, and the interstices of such procedures is outside the scope of this article, in general the practical difficulties that attend such collection devices mitigate in favor of avoiding guaranties of collection at all costs. The

19. Compare *Bank of Am. Nat'l Trust & Sav. Ass'n v. McRae*, 81 Cal. App. 2d 1, 183 P.2d 385 (1947) [and] *Rucker v. Republic Supply Co.*, 415 P.2d 951 (Okla. 1966) (both finding a presumption in favor of reading a guaranty as absolute) with *Liquidating Midland Bank v. Stecker*, 40 Ohio App. 510, 179 N.E. 504 (1930) (in which the court found that use of the word "guaranty" suggests a conditional rather than absolute obligation to pay).

20. See *Greene v. Martin W. Hysong Co.*, 193 A.2d 893 (D.C. 1963); *First Nat'l Bank v. Southern Cotton Oil Co.*, 76 Ga. App. 779, 47 S.E.2d 288 (1948); *U.S. Rubber Co. v. Champs Tires, Inc.*, 73 N.J. Super. 364, 180 A.2d 145 (App. Div. 1962).

21. If the creditor does not pursue the claim against the principal debtor with due diligence, the creditor will not be able to maintain an action against the guarantor. Such lack of due diligence may have also prejudiced the guarantor's subrogation right, see *infra* text accompanying notes 49-58, and thereby released the guarantor. See also *Schaeffer v. Gilmer*, 353 So. 2d 847 (Fla. Dist. Ct. App. 1977); *Keller v. General Motors Acceptance Corp.*, 233 La. 320, 96 So. 2d 598 (1957); *Bank of Kirkwood Plaza v. Mueller*, 294 N.W.2d 640 (N.D. 1980); *Van Petten v. Oregon Bank*, 42 Or. App. 367, 600 P.2d 507 (1979).

22. For example, if the creditor delays the initiation of litigation against the principal debtor in hopes of reaching an out of court settlement, the creditor may be found to have shown less than due diligence if the delay turns out to have compromised the creditor's litigation posture.

23. 675 F.2d 525 (1982).

24. *Id.* at 530 n.7.

25. See *id.* at 530-32 (Cardamone, J., concurring in part, dissenting in part).

26. For North Carolina cases that deal with the crucial distinction between guaranties of payment and collection, see *Investment Properties v. Norburn*, 281 N.C. 191, 188 S.E.2d 342 (1972); *Arcady Farms Milling Co. v. Wallace*, 242 N.C. 686, 89 S.E.2d 413 (1955); *American Bank*

problems associated with enforcing collection guaranties mandate that they only be used when competitive factors absolutely require. In light of the typical negotiating posture between creditor (stronger) and debtor (weaker), competitive factors seldom so require. Thus, the form of guaranty used most typically by creditors is a guaranty of payment.

The creditor will insist upon a *continuing guaranty* when a sequence of advances²⁷ are to be made to the principal debtor.²⁸ Such a guaranty is not restricted to a simple isolated transaction and may be effective for an indefinite time until revoked. Guaranty contracts in commercial finance transactions²⁹ are typically continuing because such transactions contemplate future advances³⁰ to the principal obligor over the term of the credit agreement.³¹

B. Defenses to Guaranty Liability

Perhaps as a result of a judicial preference for debtors or lawmakers' fear of creditor overreaching, or a combination of the two, the enactment of statutory law and the evolution of common law have betrayed a discernible deference to any party that becomes obligated to answer for the debt of another.³² Many of the cases may be reconciled only by concluding that when confronted with a guarantor who elicits sympathy, the courts are willing to find numerous reasons to abrogate the guaranty contract. This sentimental deference to the plight of the guarantor has seldom been the source of venerable legal principles.³³ The courts are not always careful in articulating the bases of their

& Trust Co. v. Elzey, 26 N.C. App. 29, 214 S.E.2d 800, *cert. denied*, 288 N.C. 252, 217 S.E.2d 662 (1975); First Nat'l Bank v. Black, 10 N.C. App. 270, 178 S.E.2d 108 (1970).

27. UCC § 9-204(3) (1978) validates "future advances": "In line with the policy of this Article toward after-acquired property interests this subsection validates the future advance interest, provided only that the obligation be covered by the security agreement." *Id.* comment 5.

28. "Where by the terms of the written guaranty it appears that the parties look to a future course of dealing or a succession of credits, it is generally considered a continuing guaranty." *Scovill Mfg. Co. v. Cassidy*, 275 Ill. 462, 465, 114 N.E. 181, 184 (1916). See *supra* note 9.

29. Commercial finance transactions are defined as those "secured lending relationships involving loans secured by accounts receivable, with or without other collateral." PRACTICING LAW INST., COMMERCIAL FINANCE, FACTORING AND OTHER ASSET-BASED LENDING 11 (1980). In general usage, commercial finance is understood as encompassing asset-based lending, lending against the strength of the debtor's assets, and not his general reputation, business performance, or capability. See generally *id.*

30. The typical future advance clause will be found in the definition section of the loan agreement under the caption "Indebtedness," "Liabilities," or "Obligations." The pertinent part of a "Liabilities" definition may read as follows: "'Liabilities' shall refer to all liabilities, obligations, and indebtedness of any and every kind, whether heretofore, now, or hereafter owing, arising, due or payable from Borrower to Lender." The security interest, then, will be granted to secure those "Liabilities."

31. Typically the loan is extended to provide the borrower with working capital, as opposed to asset or stock acquisition funding.

32. The statutes of frauds in virtually every state require all contracts that answer for the debt of another to be in writing to be enforceable. See, e.g., *Warren v. White*, 251 N.C. 729, 112 S.E.2d 522 (1960) (citing N.C. GEN. STAT. § 22-1 (as then in effect; current version, 1965)).

33. If the sentiment of the North Carolina Supreme Court in *O'Grady v. First Union Nat'l Bank*, 296 N.C. 212, 250 S.E.2d 587 (1978), is an accurate indication, creditors taking guaranties in the state should be most careful. In *O'Grady* the supreme court invoked the rules that "the terms of a written contract are to be construed most strongly against the party who drafted the instrument." *id.* at 227, 250 S.E.2d at 597 (citing *Jones v. Palace Realty Co.*, 226 N.C. 303, 305, 37

decisions or in cogently applying the available doctrines.³⁴

The only practical response by creditors' legal counsel necessarily resembles something of a shotgun approach. Corporate and commercial attorneys have drafted guaranty forms that are designed to avoid the proguarantor law. Many of the terms of such guaranties seem tautological because they are closely related to or are even mere permutations of the defenses to guaranty liability that they are intended to obviate. It must be reiterated that all of the defenses are not available in all jurisdictions.

1. Creditor Action that Increases Guarantor's Risk

It is generally understood that the contract of guaranty is separate and distinct from the contract between the creditor and the principal debtor.³⁵ Practically speaking, however, that distinction has received uneven treatment in some jurisdictions. In many cases, if the principal obligation is extinguished, the guarantor's obligation is also extinguished.³⁶ Similarly, a classic defense recognized by the courts arises when the creditor in some way fails to honor its obligation to the debtor.³⁷ A guarantor may, by the assertion of that defense, avoid part or all of his liability to the creditor.³⁸

A New York case provides a useful illustration of this type of defense to guaranty liability. In *Walcutt v. Clevite Corp.*³⁹ the New York Court of Appeals drew a subtle distinction between a guarantor's assertion of an independent cause of action existing in favor of his principal as a defense or counterclaim,⁴⁰ and a defense to liability based on a total or partial failure of

S.E.2d 906, 907 (1946)), and "the liability of a guarantor is not to be enlarged beyond the strict terms of the contract," *id.* at 227, 250 S.E.2d at 597 (citing *George D. Witt Shoe Co. v. Peacock*, 150 N.C. 448, 449, 64 S.E. 437, 438 (1909)) to reach a very proguarantor result arguably founded on grammatical niceties rather than thoughtful legal analysis.

34. See, e.g., *Manufacturers Trading Corp. v. Harding*, 181 F.2d 609 (7th Cir. 1950); *infra* text accompanying notes 62-63.

35. *Riverside Nat'l Bank v. Manolakis*, 613 P.2d 438, 441 (Okla. 1980). Several North Carolina decisions have acknowledged that a guaranty is collateral to the creditor-principal debtor contract and creates secondary liability. See, e.g., *EAC Credit Corp. v. Wilson*, 281 N.C. 140, 144, 187 S.E.2d 752, 754 (1972); *Perfecting Serv. Co. v. Product Dev. & Sales Co.*, 259 N.C. 400, 418, 131 S.E.2d 9, 23 (1963) (citing 24 AM. JUR. *Guaranty* § 11, at 879-80 (1939) (guaranty requires two contracts, one binding the principal debtor, and the other engaging the responsibility of the guarantor)).

36. *Woods-Tucker Leasing v. Kellum*, 641 F.2d 210, 213 (5th Cir. 1981). See also *Central Soya Co. v. Epstein Fisheries, Inc.*, 676 F.2d 939, 943 (7th Cir. 1982).

37. See also 10 S. WILLISTON, *CONTRACTS* § 1213 (3d ed. 1967). Cf. *Keystone Acceptance Corp. v. Dynallectron Corp.*, 445 F.2d 729 (D.C. Cir. 1971) (creditor barred from recovering from guarantor when creditor does not completely fulfill the agreement with principal debtor); *Credit Managers Ass'n v. Superior Court*, 51 Cal. App. 3d 392, 124 Cal. Rptr. 242 (1975) (guarantor may assert any defense that the principal debtor could assert).

38. For discussion of partial or complete discharge of guarantors of negotiable instruments, see *Provident Bank v. Gast*, 57 Ohio St. 2d 102, 386 N.E.2d 1357 (1979); Note, *Discharge of Guarantors Under U.C.C. § 3-606—Total or Pro-Rata Discharge Upon Release of Another Guarantor*, 9 CAL. U.L. REV. 365 (1979).

39. 13 N.Y.2d 48, 191 N.E.2d 894, 241 N.Y.S.2d 834 (1963).

40. The court observed:

The situation [in the instant case] is readily distinguishable from cases in which the rule was fashioned that a guarantor when sued alone by the creditor cannot avail himself of an independent cause of action existing in favor of his principal as a defense or counter-

the creditor to perform obligations due the principal debtor. The facts of the case are sufficiently complex to warrant discussion. The three plaintiffs were sole shareholders⁴¹ of several corporations dealing in phonographic supplies. In February of 1959 plaintiffs sold their stock to defendant Clevite Corporation (Clevite) in return for stock in Clevite and signed noncompetition agreements with a ten-year duration. Plaintiff Walcutt also agreed to provide certain consulting services for \$20,000 per year. The remaining plaintiffs were each to receive \$10,000 per year for each of the ten years. Although the agreements were assignable, they also provided that Clevite would remain liable in the event the assignee defaulted.⁴²

In September of 1960 Clevite sold the assets of the phonographic supply business to one Richmond with the understanding that Richmond would form a new corporation, Walco Electronics Company, Inc. (Walco) and transfer the assets to Walco. The new corporation, in turn, assumed the liability to plaintiffs. When Walco defaulted on the payments, plaintiffs brought suit against Clevite (for breach of the payment provisions of the noncompetition agreements) and against Richmond on his personal guaranty to Clevite of the payment obligation under the agreements assumed by Walco.⁴³ Richmond responded that Clevite (the "creditor") made fraudulent representations to Richmond (the "guarantor") and Walco (the "debtor") concerning the assets transferred and, that relying upon such representations and warranties, Richmond and Walco were "induced to have Walco purchase the said [sic] inventories and other assets."⁴⁴ Essentially, Richmond alleged inventory shortages, a defense of partial failure of consideration.

The court framed the issue in this way: "[W]hether a guarantor, when sued alone, may avail himself of the defense of a *partial* failure of consideration arising out of the main contract."⁴⁵ The opinion acknowledged that there is no difficulty in those circumstances in which the creditor totally fails to perform its obligations to the principal debtor.⁴⁶ The court went further, however and held that "[w]here the consideration fails, either partially or entirely, neither the principal debtor nor the guarantor is accountable for anything

claim Thus a guarantor may not interpose his principal's defense of fraud since by doing so he would deprive the principal of his independent right to affirm or disaffirm Likewise, he may not assert his principal's claim of breach of warranty since "he might thus bar a large claim in cancelling a small one."

Id. at 55, 191 N.E.2d at 897, 241 N.Y.S.2d at 838 (quoting *Gillespie v. Torrance*, 25 N.Y. 306, 311 (1862) and citing *Ettlinger v. Nat'l Surety Co.*, 221 N.Y. 467, 468, 117 N.E. 945, 946 (1917)); *Elliot v. Brady*, 192 N.Y. 221, 85 N.E. 69 (1908); *Lasher v. Williamson*, 55 N.Y. 619 (1874); *Gillespie v. Torrance*, 25 N.Y. 306 (1862)).

41. The fourth shareholder died prior to the commencement of the trial. 13 N.Y.2d at 52, 191 N.E.2d at 895, 241 N.Y.S.2d at 835.

42. *Id.* at 54, 191 N.E.2d at 897, 241 N.Y.S.2d at 836.

43. The court noted, "Plaintiff's claims . . . are based upon the theory that they are third-party beneficiaries of Richmond's guarantee to Clevite, and, as such, are subject to all the equities between the parties to that agreement." *Id.* at 54, 191 N.E.2d at 897, 241 N.Y.S.2d at 837 (citing *Detmer Woolen Co. v. Van Horn*, 59 Misc. 163, 110 N.Y.S. 312 (1908)).

44. 13 N.Y.2d at 54, 191 N.E.2d at 896, 241 N.Y.S.2d at 837.

45. *Id.* at 55, 191 N.E.2d at 897, 241 N.Y.S.2d at 838 (emphasis added).

46. See 10 S. WILLISTON, CONTRACTS § 1264 (3d ed. 1967).

which has not been received."⁴⁷ Under this approach the guarantor may partially avoid its liability to the creditor. In light of the basic contract doctrine relied on by the New York Court of Appeals, it is unclear whether a creditor would be able to "contract-away" such a result when a guarantor asserts partial or complete failure of consideration.⁴⁸ That does not, however, mean that creditors cannot or will not try to preclude the interposition of such a defense by drafting an appropriate waiver into their form of guaranty.⁴⁹

In *O'Grady v. First Union National Bank*⁵⁰ the Supreme Court of North Carolina considered a situation in which the guarantors by their execution of the form of guaranty provided by the bank undertook to guarantee the performance of three principal debtors. Because of an irregularity in the bank's documentation of the transaction, only two, rather than the intended three debtors, were primarily liable on the debt. The court cited North Carolina authority for the proposition that "a material alteration of a contract between principal and creditor will discharge a surety"⁵¹ The omission or release of a principal destroys a surety's rights of subrogation against that principal.⁵² The court applied this rule to permit the guarantor to avoid any liability whatsoever on the guaranty.

To avoid releasing the guarantor a creditor must not in any way compromise the guarantor's subrogation right. In *Sterling Factors Corp. v. Freeman*⁵³ a New York court held that the creditor's failure to protect the guarantor's subrogation right released the guarantor. The court found in favor of the guarantor because the creditor's actions had effectively released the collateral securing the principal debt, rendering the guarantor's subrogation right worthless.⁵⁴ Similarly, in *First Bank and Trust Co. v. Post*⁵⁵ the court held that the

47. 13 N.Y.2d at 56, 191 N.E.2d at 897, 241 N.Y.S.2d at 838.

48. See also *Manufacturers Trading Corp. v. Harding* 181 F.2d 609, 611 (7th Cir. 1950).

49. The form of guaranty could provide: "The guarantor agrees that its obligations under this guaranty shall be absolute and unconditional, irrespective of any defenses available to the principal debtor arising under that certain Loan and Security Agreement between the Creditor and the principal debtor of even date herewith." Standardized forms of guaranty often provide that the guarantor's obligations shall be absolute and unconditional, irrespective of "any circumstance which might otherwise constitute a legal or equitable discharge or defense of or by a guarantor." It is suggested that such a term may be so broad as to be unenforceable, perhaps on grounds of unconscionability. A court might very well be more willing to enforce the waiver of a defense if the defense were more particularly described in the form signed by the guarantor.

The complaints of "unfortunate" lenders notwithstanding, there does exist a sound legal basis for requiring a creditor to treat his principal obligor with considerable deference. The common law provides that a guarantor who discharges the obligation of the principal debtor is subrogated to the claim of the creditor to the extent that the guarantor has contributed to the discharge. See *United States v. Frisk*, 675 F.2d 1079 (9th Cir. 1982); *United States v. Ballard*, 674 F.2d 330 (5th Cir. 1982); *Phares v. Barbour*, 49 Ill. 370 (1868); R.E.A. Constr. Co. v. Ervin Co., 33 N.C. App. 472, 235 S.E.2d 418 (1977); W. DEFUNIAK, *HANDBOOK OF MODERN EQUITY* 239 (2d ed. 1956); *RESTATEMENT OF SECURITY* § 132 (1941). See also discussion of UCC § 3-606 (1978), *supra* note 3.

50. 296 N.C. 212, 250 S.E.2d 587 (1978).

51. *Id.* at 224, 250 S.E.2d at 598 (citing *Fleming v. Borden*, 127 N.C. 214, 215, 37 S.E. 219, 220 (1900); *Hinton v. Greenleaf*, 113 N.C. 6, 7, 18 S.E. 56, 57 (1893)).

52. 296 N.C. at 224, 250 S.E.2d at 598.

53. 50 Misc. 2d 715, 271 N.Y.S.2d 343 (Sup. Ct. 1966).

54. See also *Osborne v. Smith*, 18 F. 126 (D. Minn. 1883).

creditor's failure to file a financing statement⁵⁶ constituted a significant impairment of the security for the principal obligor's debt and effected a release of the guarantor.⁵⁷ Again, a creditor may avoid releasing the guarantor in such a situation if the guaranty contract provides that the guarantor will remain bound notwithstanding the creditor's failure to perfect his security interest in the collateral securing the principal debtor's obligation.⁵⁸

A particularly interesting case dealing with the effect of increased risk to guarantors is *State Bank of East Moline v. Gus Cirivello*,⁵⁹ a 1978 decision of the Illinois Supreme Court. Thirteen parties intended to sign as coguarantors of a loan extended by the plaintiff bank. Ultimately, however, only twelve signatures appeared on the guaranty. The form of guaranty used by the bank provided that the guaranty was unconditional. The court did not feel constrained by the language of the guaranty contract and held that the execution of the form by all of the originally-intended guarantors constituted a condition precedent to the liability of any of the guarantors. Each of the actual guarantor's risk was increased because there were only twelve instead of thirteen guarantors among whom the risk could be apportioned.⁶⁰

Perhaps carrying a good idea too far, courts have also granted guarantors relief when there is any modification whatsoever of the contract between the creditor and the principal debtor unless the consent of the guarantor is first

55. 10 Ill. App. 3d 127, 293 N.E.2d 907 (1973).

56. See UCC § 9-402 (1978), describing the elements of a financing statement.

57. See also *Piasecki v. Fidelity Corp.*, 339 Mich. 328, 330, 63 N.W.2d 671, 673 (1954). But see *American Bank of Commerce v. Covolo*, 88 N.M. 405, 540 P.2d 1294 (1975), in which the court found that the creditor-bank's failure to properly perfect a collateral interest in a liquor license with the State Beverage Control Department did not absolve the guarantors of liability.

58. Such a waiver may be phrased in substantially these terms:

The guarantor agrees that its obligations hereunder shall be absolute and unconditional irrespective of any failure by the Creditor to take any steps to preserve its rights to any security or collateral for the Liabilities or the release of all or any portion of the collateral by the Creditor or the Creditor's failure to perfect or keep perfected its security interest or lien in any portion of the collateral.

59. 74 Ill. 2d 426, 386 N.E.2d 43 (1978).

60. See *Miami Nat'l Bank v. Fink*, 174 So. 2d 38 (Fla. Dist. Ct. App. 1965) (guaranty unenforceable against guarantor when condition that the SBA participate in loan as guarantor remained unfulfilled); *U.S. Gypsum Co. v. Sampson*, 496 S.W.2d 687 (Tex. Civ. App. 1973) (where guaranty agreement is joint rather than joint and several, the release of one of the joint obligors operates as a release of the other joint obligors). But see *Commercial Credit Corp. v. Sorgel*, 274 F.2d 449 (5th Cir.), cert. denied, 364 U.S. 834 (dismissal with prejudice of two of three coguarantors does not release the third guarantor); *Williams v. Reed*, 113 Cal. App. 2d 195, 248 P.2d 147 (1952) (Release of one joint guarantor of a promissory note does not extinguish the obligation of any of the others); *Oil Tool Exch. v. Schuh*, 67 Cal. App. 2d 288, 153 P.2d 976 (1944) (The satisfaction of a judgment against one guarantor does not release another guarantor from liability); *Hall v. First Nat'l Bank*, 145 Ga. App. 267, 243 S.E.2d 569 (1978) (discharge of two guarantors through refusal to accept their tenders does not ipso facto result in discharge of a third guarantor). A 1979 decision of the North Carolina Court of Appeals construed the effect of a coguarantor's termination of his guaranty obligation on the nonterminating guarantor's liability. The court found that the nonterminating guarantor's liability was not extinguished. The coguarantors were not "jointly responsible for a particular amount of credit extended to the corporation, but instead . . . each of them [was] liable to a maximum of \$10,000, just as if a separate guaranty had been signed by each of them." *Pearce Young Angel Co. v. Don Becker Enter., Inc.*, 43 N.C. App. 690, 694, 260 S.E.2d 104, 106 (1979).

obtained.⁶¹ An example of such a result is found in a decision of the Seventh Circuit Court of Appeals, *Manufacturers Trading Corp. v. Harding*.⁶² Plaintiff finance company purchased and took assignments of accounts receivable from Skandia, and Harding indemnified plaintiff against any loss resulting from the assignment of the accounts. The accounts were fraudulent. At Skandia's request plaintiff had assigned the accounts to a third party, and when it was discovered that the accounts were not genuine, plaintiff and the third-party assignee reached a compromise agreement. The assignment to the third party was accomplished through a reassignment to Skandia and an immediate assignment to the third party. The court held:

[i]nasmuch as the guarantors and the indemnifiers had merely agreed to guarantee the collection of the accounts receivable and to protect plaintiff against loss, when plaintiff was completely reimbursed for its original outlay and the subject matter of the contract redelivered to Skandia, the liability of the guarantors ended. . . . [The guarantors] never made any guaranty of protection of plaintiff against liability for its own misrepresentation.⁶³

Thus, the modification of the contract between the creditor and the principal debtor released the guarantors. Certainly it may be argued that the reassignment in *Harding* represents an extreme type of "modification"; nevertheless, it is difficult to justify the result reached by the court. It appears that the equities did not lie with the guarantors, who were afforded significant protection by the court, but with the plaintiff who was the victim of fraud. As the opinion does not reproduce the form of guaranty used by Manufacturers Trading Corporation, however, it is not clear whether a *Harding* result could be precluded by a careful, complete drafting of the guaranty and a particularly indulgent solicitude of the guarantor's rights over the course of the credit relationship whenever there is the slightest possibility that those rights might be implicated. It would appear that the reasoning in *Harding* could obtain even if the modification benefits the guarantor, by reducing either the likelihood of principal debtor default or the extent of the guarantor's potential liability.

The foregoing cases suggest that a creditor's arguments, no matter how reasonable, might not prevail when directed at a guarantor favored by the court. How, then, may a creditor safely deal with the many modifications and waivers that are typically encountered during the course of a credit relationship? Though by no means a safe harbor, a creditor can place some reliance on the guarantor's advance consent (at the time the guaranty is executed) to any and all modifications and waivers; such consent would naturally be a provision of the guaranty form itself. Attorneys should not be reluctant to describe explicitly the modifications and waivers to which the guarantor is being

61. The guaranty form may contain a provision pursuant to which the guarantor acknowledges that no modification of the contract between the creditor and the principal debtor will affect the liability of the guarantor. Courts confronted with partial or total failure of the consideration flowing to the debtor from the creditor may not feel constrained by such a waiver clause. See *supra* text accompanying notes 39-49.

62. 181 F.2d 609 (1950).

63. *Id.* at 611-12.

asked to give his prior consent; the use of examples would be entirely appropriate.⁶⁴

In any event, advance consent will not be relied upon to the exclusion of other safeguards. Written consents are obtained from all guarantors when the terms of the contract between the creditor and principal debtor are altered in any way.⁶⁵ In fact, a written acknowledgement could be secured from the guarantor each time the principal debtor requests a waiver of a contract term.⁶⁶

2. Notice Requirements

Some courts have shown concern with the creditor's failure to afford his guarantor notice of certain occurrences that may arise in common guaranty transactions. Failure to give a guarantor notice when notice is required either by the terms of the guaranty contract, the loan agreements, the common law, or applicable statutory law⁶⁷ can release the guarantor.⁶⁸ There are three principal types of notice that may become pertinent to almost any guaranty transaction: (1) notice of acceptance, (2) notice of subsequent transactions,⁶⁹ and (3) notice of default or enforcement action against the principal debtor.

a. Notice of Acceptance

The requirement of notice of acceptance is consistent with the idea that a contract of guaranty, like any other type of contract, requires a "meeting of the minds," an agreement by both parties. Therefore, the courts have occasionally considered the guarantor's execution of a guaranty to be an "offer," which must be expressly "accepted" prior to its revocation by the proposed guarantor. "Notice of intention to accept is notice to the guarantor by the creditor that the latter intends to extend credit in reliance on the guaranty. Its purpose is to enable the guarantor to plan his affairs intelligently. . . . Notice of intention to accept . . . is necessarily contractual in theory."⁷⁰ This is not a

64. Most extensions of credit to which the particular creditor is party give rise to predictable later modifications. The fairly detailed catalogue of credit requirements, any one or more of which may be modified or waived during the course of a credit relationship, should provide a ready source of examples which the contract of guaranty could specifically bring to the attention of the guarantor.

65. Such alterations are normally requested in writing by the principal debtor and may only be accepted by the creditor in writing. When the written request for modification or waiver is received by the creditor, a copy of the request could be sent to the guarantor with an accompanying letter requiring the guarantor to object or consent to the alteration and to attach its (the guarantor's) signature to the request letter itself with the notation "approved" or "disapproved" above the signature. That type of clear indication of the guarantor's response to a modification or waiver request would likely be difficult evidence for a court to ignore.

66. It may very well be good practice for the creditor to apprise the guarantor of the debtor's request even when the creditor has no intention of approving the request.

67. Most forms of guaranty and loan agreements prepared by creditors will contain no such notice requirement. Certainly it is more likely that they will contain waivers of notice. For discussions of waiver of notice of acceptance, see *Hickey Pipe & Supply Co. v. Fitzgerald*, 3 Cal. App. 2d 389, 39 P.2d 472 (1934); *Wehle v. Baker*, 97 Ga. App. 111, 102 S.E.2d 661 (1958); *Guggenheimer & Co. v. Gilmore*, 29 Ga. App. 540, 116 S.E. 67 (1923).

68. See generally 1 A. CORBIN, *CONTRACTS* §§ 68-69, at 283-87 (1963).

69. See *supra* text accompanying notes 64-66.

70. *Dole, Notice Requirements of Guaranty Contracts*, 62 MICH. L. REV. 57, 59-60 (1963). In

provocative area of the law.⁷¹ The rules are rather clear cut and readily lend themselves to coherent analysis.

Notice of acceptance may be waived by the guarantor when he executes the guaranty contract.⁷² If the guaranty is absolute in form, as when the form is labelled "Absolute Guaranty" or merely recites in the text that it is an absolute guaranty, the prevailing view provides that no notice of acceptance is necessary.⁷³ There is also statutory law to the same effect.⁷⁴ A waiver of acceptance is necessarily drafted into any guaranty form that contains a recitation of the consideration flowing to the guarantor. A nominal consideration is sufficient ("for good and valuable consideration") to evidence the mutual assent, or "meeting of the minds."⁷⁵ Mere delivery of the guaranty to the guarantor will suffice to form the contractual relationship.⁷⁶ In addition, and consistent with commercial reality, acceptance often may be inferred: if, with the guarantor's knowledge, the guaranty is received and relied upon by the creditor, the acceptance requirement is satisfied.⁷⁷ Most often the guaranty will be executed in response to the creditor's request and the principal contract or loan agreement will be contemporaneous with the guaranty, in which case no additional notice of acceptance is required.⁷⁸

It has been held that acceptance of a continuing guaranty⁷⁹ at the time the guaranty is originally offered does not obviate the need for notice of acceptance when the creditor negotiates subsequent advances or extensions of the original indebtedness.⁸⁰ The better view, however, provides that unless a

the typical transaction, the guarantor may be a principal of the debtor and is, in fact, well aware of the creditor's "acceptance" of the guaranty. See also Campbell, *The Notice Due to a Guarantor*, 35 MICH. L. REV. 529 (1937); Rogers, *Notice of Acceptance in Contracts of Guaranty*, 5 COLUM. L. REV. 215 (1905).

71. See Dole, *supra* note 70, at 66, wherein the tension between the "condition precedent" and the "condition subsequent" methods of acceptance analysis is disposed of as "indistinguishable apart from verbal formulation" (citing H. ARANT, SURETYSHIP § 26, at 69 (1931)). See generally 1 S. WILLISTON, CONTRACTS § 69A, at 219-22 (3d ed. 1957).

72. See Dole, *supra* note 70, at 67, and authority cited therein. It should be noted, however, that acceptance itself is not waived by mere waiver of notice of acceptance. See also Guggenheimer & Co. v. Gilmore, 29 Ga. App. 540, 116 S.E. 67 (1923).

73. Wehle v. Baker, 97 Ga. App. 111, 102 S.E.2d 661 (1958); Motor Supply Co. v. Hunter, 251 Miss. 837, 171 So. 2d 870 (1965); Clear Fir Sales Co. v. Carolina Plywood Distrib., Inc., 13 N.C. App. 429, 185 S.E.2d 737 (1972); Cobb v. Texas Distrib., Inc., 524 S.W.2d 342 (Tex. Civ. App. 1975); Robey v. Walton Lumber Co., 17 Wash. 2d 242, 135 P.2d 95 (1943); *In re Estate of Mingesz*, 70 Wis. 2d 734, 235 N.W.2d 296 (1975).

74. See the courts' consideration of applicable statutory law in Thorpe v. Story, 10 Cal. 2d 104, 117-18, 73 P.2d 1194, 1202 (1937); Abbott v. National Bank of Commerce, 176 Okla. 629, 630, 56 P.2d 886, 887 (1936); Burns v. Ferguson, 576 P.2d 784, 786 (Okla. Ct. App. 1977); Continental Life Ins. Co. v. Barnes, 56 S.D. 410, 412, 228 N.W. 809, 810 (1930).

75. See Huckaby v. McConnon & Co., 213 Ala. 631, 634, 105 So. 886, 888 (1925); Barnett Bank v. Marable, 385 So. 2d 66, 67 (Ala. Civ. App. 1980); Shur-Gain Feed Div., William Davies Co. v. Huntsville Prod. Credit Ass'n, 372 So. 2d 1317, 1320 (Ala. Civ. App. 1979). See also Johnson v. Staenglen, 85 F. 603 (5th Cir. 1898).

76. See Angelo Iafate Co. v. Detroit & N. Sav. & Loan Ass'n, 80 Mich. App. 508, 264 N.W.2d 45 (1978).

77. See Dole, *supra* note 70, at 76.

78. Rawleigh, Moses & Co. v. Kornberg, 210 F.2d 176, 182 (8th Cir. 1954); Eastman Oil Well Survey Co. v. Hamil, 416 S.W.2d 597, 604-08 (Tex. Civ. App. 1967).

79. See *supra* note 9.

80. See Security State Bank v. Gray, 224 Mo. App. 980, 25 S.W.2d 512 (1929).

guarantor of future advances specifically requires notice of acceptance, such notice is deemed to be waived.⁸¹ Also, if shown through a course of performance,⁸² course of dealing, or perhaps even usage of trade,⁸³ that it is the creditor's practice to accept guaranties from the guarantor, no notice of acceptance is necessary.⁸⁴

b. Notice of Subsequent Transactions

This form of notice was suggested above in the discussion on modification of contract terms,⁸⁵ and even if it were not recognized as a "notice" requirement in all circumstances, a careful creditor should inform his guarantor of all significant transactions between the creditor and the principal debtor. Credit documentation routinely contains a clause providing the address to which notices may be sent and some reasonable period of time after dispatch in the United States mails⁸⁶ by which delivery will be presumed.⁸⁷ It is generally assumed that the guarantor assents to the proposed transaction if he does not object after receiving notice. In reality, however, no responsible creditor's attorney would counsel his client to rely on such an assumption. A form of waiver or assent to the transaction⁸⁸ should be provided by the creditor, along with a stamped, self-addressed envelope to accommodate immediate consent to the transaction. If the consent is not returned within a reasonable period of time, a telephone call should follow. Certainly this procedure is the safest.

81. See *Swisher v. Deering*, 204 Ill. 202, 205-07, 68 N.E. 517, 518 (1903); *Southdale Center Inc. v. Lewis*, 260 Minn. 430, 439, 110 N.W.2d 857, 863 (1961); *National Bank v. Security Elevator Co.*, 161 Minn. 30, 41-42, 200 N.W. 851, 856 (1924).

82. UCC § 2-208 (1978) provides, in pertinent part:

Course of Performance or Practical Construction

(1) Where the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement.

83. UCC § 1-205 (1978) provides, in pertinent part:

Course of Dealing and Usage of Trade

(1) A course of dealing is a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct.

(2) A usage of trade is any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question. The existence and scope of such a usage are to be proved as facts. If it is established that such a usage is embodied in a written trade code or similar writing the interpretation of the writing is for the court.

84. *Swisher v. Deering*, 204 Ill. 203, 68 N.E. 517 (1903).

85. See *supra* text accompanying notes 65-66.

86. A typical provision might read as follows:

Notice. Any notice hereunder shall be in writing, and shall be deemed to have been validly served, given, or delivered five (5) calendar days following deposit in the U.S. Mails, with proper postage prepaid and properly addressed to the party to be notified.

It is only reasonable that the creditor take into account postal and geographic realities when drafting such a presumption.

87. Courts may be more willing to observe such a presumption if the notice provision or creditor practice requires use of certified or registered mail.

88. The waiver should be made to appear as pedestrian as possible. In this circumstance it would be appropriate to avoid the use of word processing. A pretyped form with obvious blanks completed by hand might best achieve the effect intended.

Some states⁸⁹ may require that notice be given to the guarantor on a regular basis to keep the guarantor apprised of the balance due on the principal debtor's account.⁹⁰ Notice of any adjustment to payment terms is also a common form of subsequent transaction of which a guarantor should be apprised. The justification for both of these notice requirements would also be the necessity of enabling the guarantor to order his affairs⁹¹ and the protection of the guarantor's subrogation right.⁹² Although it would likely not be necessary to receive the guarantor's approval of the balance due on the principal debtor's account,⁹³ if a creditor and debtor decide to adjust payment terms, the written consent of the guarantor should be secured.

Contemporary authority suggests that notice is not necessary unless the terms of the guaranty contract so provide.⁹⁴ Nevertheless, because a recalcitrant guarantor may be expected to grasp at any (even dubiously) available straw to avoid liability altogether or at least to delay collection efforts, the right to notice of subsequent transactions will be expressly waived in the form of guaranty.⁹⁵

c. Notice of Default

This aspect of notice requirements has been a focus of recent case law development. Several courts have held that a creditor must notify the guarantor of the existence of a default by the principal debtor and of the creditor's

89. See, e.g., *Rapelye & Purdy v. Bailey*, 3 Conn. 438 (1828) (guarantor must receive notice prior to each extension of credit); *Babcock v. Bryant*, 29 Mass. (12 Pick.) 133 (1831) (guarantor not liable until after reasonable notice that goods have been delivered under the contract guaranteed). Dole, *supra* note 70, at 85-86, suggests that the vitality of the rule is dubious because none of the cases providing for notice of transactions has been recently reaffirmed (citing *Campbell*, *supra* note 70, at 548). But see *infra* text accompanying notes 96-111.

90. In commercial finance and similar lending transactions strict enforcement of a notice of subsequent transactions requirement would require that the guarantors be sent a copy of the periodic statement that is sent to the principal debtor. While that procedure would not present a particularly onerous burden to creditors, the cost would surely be passed on to the principal debtor. Moreover, that cost would quite often be unjustified because guarantors are very often the principals of the debtor or an affiliate or subsidiary of the principal debtor. See, e.g., *Standard Roller Bearing Co. v. Bergdoll*, 214 F. 175 (E.D. Pa. 1914); *Boyd & Rickets v. Snyder*, 49 Md. 325 (1878); *Gloucester Mut. Fishing Ins. Co. v. Boyer*, 294 Mass. 35, 200 N.E. 557 (1936).

91. See *supra* text accompanying note 71.

92. See *supra* text accompanying notes 49-58.

93. Because most loans have a "cap" on the amount the debtor may borrow, and the guarantor's potential liability will be up to that amount, there would seem to be little need to keep the guarantor apprised of the balance due so long as the amount does not exceed the predetermined ceiling. See also *supra* note 10.

94. See Dole, *supra* note 70, at 85-86; *Campbell*, *supra* note 70, at 548-50. See also RESTATEMENT (FIRST) OF CONTRACTS § 56 (1923); RESTATEMENT OF SECURITY § 86 (1937). Perhaps the most convincing indication of the current attitude toward notice of subsequent transactions is the lack of any case holding such notice necessary in the absence of a guaranty specifically so providing.

95. One possible wording to achieve this effect would be:

Creditor is authorized, without notice or demand and without affecting the liability of the Guarantor under this Guaranty, from time to time to (1) extend credit or advance loans to principal debtor, (2) renew, extend, accelerate, or otherwise change the terms of the Loan Agreement, (3) accept partial payment of the Liabilities, and (4) settle, release, compromise, collect, or otherwise liquidate the Liabilities. Guarantor also waives all notice of the existence, creation, or incurring of new or additional indebtedness or obligations by the principal debtor under the Loan Agreement.

intention to exercise rights against the debtor or against the collateral securing the debt.⁹⁶ The issue is made particularly interesting by part five of Article 9 of the UCC, which deals with the rights of parties to a secured loan when the debtor is in default.⁹⁷

Recent cases have equated a guarantor of secured debt to a secured debtor, one who "owes payment or other performance of the obligation secured."⁹⁸ Application of that conclusion has afforded such guarantors significant protection. Nowhere has the sting of that reading of Article 9 been felt more profoundly than under the notice requirements of the UCC. Section 9-504(3) provides in pertinent part:

Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reason-

96. That requirement may be difficult to fulfill when the principal debtor is frequently in default (for technical rather than substantial reasons) and could pose practical problems in loan administration. Again, the concerns expressed with regard to notice of transactions are apposite. See *supra* note 90.

97. Part five of UCC Article 9 contains the provisions dealing with the parties' rights upon default. While "default" is nowhere defined in the UCC, Professor Clark has catalogued fourteen events of default contained in typical loan and security agreements:

- (1) Failure to make an installment payment when due;
- (2) Failure to make payments on other obligations, whether or not cross-collateralized, including overdrafts;
- (3) Breach of warranty that the debtor is the owner of the collateral free of any other encumbrance;
- (4) The filing of any competing financing statement against the collateral, even though it may be later;
- (5) Failure of the debtor to defend the collateral against any competing claims;
- (6) Sale of the collateral (except in ordinary course) without the creditor's prior written consent;
- (7) Failure to keep the collateral adequately insured, with a loss payable clause running in favor of the secured creditor and the right of the creditor to make up any delinquent premiums and charge it to the unpaid debt;
- (8) Failure to allow the creditor to inspect the collateral upon demand at any reasonable time;
- (9) Failure to make prompt payment of taxes on the collateral;
- (10) Loss, theft, substantial damage, or destruction of the collateral, or the making of any levy, attachment, or garnishment against it by a competitor;
- (11) Failure of account debtors to pay their obligations in due course when accounts receivable, executory contract rights, chattel paper, or instruments are involved, even in non-notification financing;
- (12) The debtor's death, dissolution, termination of existence, or insolvency (defined broadly to include (a) liabilities exceeding assets and (b) inability to pay debts as they come due);
- (13) Assignment for the benefit of creditors, appointment of a receiver, or the commencement of bankruptcy proceedings by or against the debtor; and
- (14) Whenever the secured party "in good faith believes that the prospect of payment, performance or realization on the collateral is impaired."

B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 4.2[1], at 4-5 (1980) (footnote omitted). The occurrence of default (13) would not be effective in the bankruptcy setting because of the provisions of §§ 365(b), (e), and (f)(3) of the Bankruptcy Reform Act of 1978. 11 U.S.C. §§ 365(b), (e), (f)(3) (Supp. V 1981). That circumstance should not dissuade creditors from using the "ipso facto" or "bankruptcy" clauses altogether, however, because such clauses are still effective outside the bankruptcy context.

98. UCC § 9-105(1)(d) (1978) defines "debtor," in part, as "the person who owes payment or performance of the obligation secured, whether or not he owns or has rights in the collateral, and includes the seller of accounts or chattel paper."

able notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the *secured party to the debtor*, if he has not signed *after default* a statement renouncing or modifying his right to notification of sale.⁹⁹

In *State Bank of Burleigh County Trust Co. v. All-American Sub, Inc.*¹⁰⁰ the Supreme Court of North Dakota held that in all situations in which a creditor would be required by law to give notice of enforcement efforts to the principal debtor, the creditor must also give such notice to the guarantor, notwithstanding the guarantor's predefault express waiver of notice in the guaranty contract. An Alabama court, in *First Alabama Bank of Montgomery, N.A. v. Parsons*,¹⁰¹ reached the same result. The court reasoned that because the unconditional guarantor would fit the definition of a "debtor" under the UCC and because a guarantor would be liable for any deficiency after the sale of the collateral, the guarantor had a sufficient stake in the "commercially reasonable"¹⁰² disposition of the collateral to require that he be afforded the same protections which the UCC assures the principal debtor. The court relied on a New York decision to support its conclusion:

[t]he purpose of U.C.C. § 9-504(3) is to notify all persons having an interest in the collateral so that they may protect their interests. Notice of sale allows those persons to safeguard any right of redemption, to bid at the sale, to procure other bidders, or otherwise insure that a fair price is received for the collateral. Because a guarantor is liable for any deficiency after sale, he has at least as much at stake in a sale after default as the debtor does.¹⁰³

Based on decisions such as the foregoing, it has been suggested that the clearly discernible trend¹⁰⁴ of recent authority extends Article 9 notice protections to guarantors.¹⁰⁵

99. UCC § 9-504(3) (1978) (emphasis added): "Secured Party's Right to Dispose of Collateral After Default; Effect of Disposition."

100. 289 N.W.2d 772 (N.D. 1980).

101. 390 So. 2d 640 (Ala. Civ. App. 1980).

102. UCC § 9-504(3) (1978). "The test of commercial reasonableness is essentially an objective standard, which incorporates much pre-Code law but changes old judicial decisions holding that a sale in 'good faith' was sufficient." B. CLARK, *supra* note 97, ¶ 4.7, at 4-46. See *Empire Life Ins. Co. v. Valdak Corp.*, 468 F.2d 330 (5th Cir. 1972). See also *S.M. Flickinger Co. v. 18 Genessee Corp.*, 71 A.D.2d 382, 423 N.Y.S.2d 73 (1979). See generally Annot., 59 A.L.R. 3d 369 (1974).

103. 390 So. 2d at 642 (Ala. Civ. App. 1980) (citing *Chase Manhattan Bank, N.A. v. Natarrelli*, 93 Misc. 2d 78, —, 401 N.Y.S.2d 404, 412 (Sup. Ct. 1977)).

104. See *Commercial Discount Corp. v. King*, 515 F. Supp. 988 (N.D. Ill. 1981); *First Ala. Bank v. Parsons*, 390 So. 2d 640 (Ala. Civ. App. 1980); *Clune Equip. Leasing Corp. v. Sprangler*, 615 S.W.2d 106 (Mo. Ct. App. 1981); *Chase Manhattan Bank, N.A. v. Natarrelli*, 93 Misc. 2d 78, 401 N.Y.S.2d 404 (Sup. Ct. 1977); *State Bank of Burleigh County Trust Co. v. All-American Sub, Inc.*, 289 N.W.2d 772 (N.D. 1980). See also *Rushton v. Shea*, 423 F. Supp. 468 (D. Del. 1976); *Barnett v. Barnett Bank*, 345 So. 2d 804 (Fla. Dist. Ct. App. 1977); *Bank of Gering v. Glover*, 192 Neb. 575, 223 N.W.2d 56 (1974); *Zions First Nat'l Bank v. Hurst*, 570 P.2d 1031 (Utah 1977).

105. See *Mack Fin. Corp. v. Scott*, 100 Idaho 889, 606 P.2d 993 (1980). See generally Note, *supra* note 12, at 84. That turn of events is particularly disturbing for creditors, because it is likely that those rights which a debtor is not able to waive prior to default will, in turn, not be waivable by the guarantors at the time they execute the contract of guaranty.

Section 9-501(3)(a) to (e) of the UCC:

Rather than abandon all hope, however, creditors would be well-advised to argue along the lines suggested by the District Court for the Southern District of New York in *American Express International Banking Corp. v. Sabet*.¹⁰⁶ The district court distinguished those cases in which "[t]he term 'debtor' has been construed to extend beyond the owner of the collateral to a non-owner obligor such as a guarantor or other party with a right of recourse against the collateral, or claim for contribution or reimbursement. . . ."¹⁰⁷ If the right to subrogation has been waived by the guarantor (which is a standard guaranty form provision)¹⁰⁸ the creditor may successfully argue that the reasoning of the cases construing a section 9-105(1)(d) "debtor" to include a guarantor is effectively undermined. The *Sabet* court found that once the right of recourse against the collateral through subrogation, contribution, or reimbursement is avoided, it "makes little commercial sense" to afford the guarantor the protection of section 9-504(3).¹⁰⁹ While that analysis is not

prevent[s] the debtor from waiving certain important rights *before* default: (1) the right to require disposition of the collateral on default, (2) the right to notification of sale of the collateral, (3) the right to require that every aspect of the sale be commercially reasonable, (4) the right to surplus proceeds, (5) the right to redeem the collateral before the secured party has disposed of it, contracted to dispose of it, or agreed to accept it in satisfaction of the debt, and (6) the right to hold the secured party liable for damages, including minimum statutory damages as provided in Section 9-507.

R. BRAUCHER & R. RIEGERT, INTRODUCTION TO COMMERCIAL TRANSACTIONS 505 (1977) (emphasis in original).

But decisions such as that of the United States District Court for the Northern District of Illinois in *National Acceptance Co. of Am. v. Wechsler*, 489 F. Supp. 642 (N.D. Ill. 1980), confirm that there is a well-reasoned minority view to the contrary:

[T]he Court does not believe that a guarantor's status as a debtor under section 9-504(3) compels the conclusion that a guarantor may not waive the rights accorded thereunder. First, it should be observed that the collateral in question is not owned by the guarantor. Thus, while it may be unconscionable to permit a secured party . . . to dispose unreasonably of a debtor's property, the same cannot be said as to a guarantor, who by definition has a lesser interest in that collateral. Second, the Court must consider the general purpose of guaranty agreements. Such agreements facilitate the issuance of loans by ensuring that the lender has a ready source from which it can collect in the event of default by the debtor. To this end, it would not be unusual for a lender to require a guarantor to waive objections to payment that otherwise might be available. The Court does not believe that section 9-501(3) was intended to preclude such agreements.

489 F. Supp. at 647-48. *See also* *Vickers v. Chrysler Credit Corp.*, 158 Ga. App. 434, 280 S.E.2d 842 (1981) (a guarantor may assert that collateral was not disposed of in a commercially reasonable manner, but that does not necessarily lead to the conclusion that a guarantor is a "debtor" entitled to notice of disposition of collateral); *Commercial Discount Corp. v. Bayer*, 57 Ill. App. 3d 295, 298, 372 N.E.2d 926, 929 (1978) (suggesting that a guarantor could waive rights that the principal debtor could not waive under part five of Article 9 of the UCC).

106. 512 F. Supp. 463 (S.D.N.Y. 1980).

107. *Id.* at 470-71 (citing *Chase Manhattan Bank, N.A. v. Natarrelli*, 93 Misc. 2d 78, 401 N.Y.S.2d 404 (Sup. Ct. 1977); *Northern Fin. Corp. v. Chatwood Coffee Shop*, 4 U.C.C. Rep. Serv. (Callaghan) 674 (N.Y. Sup. Ct. 1967)).

108. A typical provision might read as follows:

Until the Liabilities shall have been paid in full, the Guarantor hereunder shall have no right of subrogation or contribution and hereby waives the right to enforce any remedy which the Creditor now has or hereafter may acquire against the principal debtor or any other guarantor of the Liabilities.

109. 512 F. Supp. at 471.

110. In *First Ala. Bank v. Parsons*, 390 So. 2d 640 (Ala. Civ. App. 1980), the court found that a guarantor requires the protection of UCC § 9-504(3) (1978) "[b]ecause a guarantor is liable for any deficiency after sale [of the collateral]." 390 So. 2d at 642. In the face of that type of analysis,

unassailable,¹¹⁰ the District Court for the Southern District of New York is too well-respected a commercial tribunal for creditors' counsel to ignore when trying to enforce a guaranty contract.¹¹¹

C. *Winning the Battle of the Forms*

In light of the very apparent judicial preference for guarantors, creditors are often left with the impression that there is precious little they can do to safeguard their rights vis-à-vis guarantors. Contract-drafting limitations notwithstanding,¹¹² the cases have provided some support for the idea that a scrupulously composed contract of guaranty may withstand the attack of even the most pitiable guarantor.

A 1976 decision of an Illinois appellate court, *Jacobson v. Devon Bank*,¹¹³ considered a form of guaranty that provided:

The liability hereunder shall in no wise be affected or impaired by (and said Bank is hereby expressly authorized to make from time to time, without notice to anyone) any sale, pledge, surrender, compromise, release, renewal, extension, indulgence, alteration, exchange, change in, or modification of any said indebtedness, liabilities and obligations, either expressed or implied or any contract or contracts evidencing any thereof, or any security or collateral therefor.¹¹⁴

The guarantor notified the creditor that he was no longer associated with the principal debtor and would not be party to any new guaranties in connection with renewals and extensions of the original debt. After that notification, the debtor and creditor agreed to subsequent renewals and extensions of the original debt. In due course the debtor defaulted.

After acknowledging the general rule " 'that guaranty agreements are to be strictly construed in favor of the guarantor' . . . and 'the liability of a guarantor cannot be extended by construction,' " ¹¹⁵ the court concluded that the scope of the language in the guaranty could not be overcome. Judge Goldberg was unable "to conceive of a broader or more inclusive form of guaranty."¹¹⁶ There was absolutely no limitation on the exposure of the guarantor for the court to construe.¹¹⁷

The Supreme Court of Oklahoma reached a similarly sensible result in

the argument suggested here by reference to *Sabet* would probably not save the day for the creditor.

111. See Note, *supra* note 12, at 85 (citing 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 304 (1965); McNulty v. Codd, 157 Ga. App. 8, 276 S.E.2d 73 (1981), in which the court concluded without qualification that a guarantor is not entitled to notice of disposition of collateral because the Code nowhere provides that such notice be afforded a guarantor (citing Brinson v. Commercial Bank, 138 Ga. App. 177, 225 S.E.2d 701 (1976)).

112. See *supra* note 105 and authorities cited therein.

113. 39 Ill. App. 3d 1053, 351 N.E.2d 254 (1976).

114. *Id.* at 1054, 351 N.E.2d at 255.

115. *Id.* See also King Korn Stamp Co. v. Guaranty Bank & Trust Co., 114 Ill. App. 2d 428, 252 N.E.2d 734 (1969).

116. *Jacobson v. Devon Bank*, 39 Ill. App. 3d 1053, 1056, 351 N.E.2d 254, 256 (1976).

117. See also Application of Bickel, 14 Ill. App. 3d 813, 303 N.E.2d 541 (1973); Claude S. Corp. v. Henry's Drive-In, Inc., 51 Ill. App. 2d 289, 201 N.E.2d 127 (1964).

Riverside National Bank v. Manolakis,¹¹⁸ but went a step further in its protection of creditors. The guaranty contract provided that the guarantor's "liability would not be 'affected or impaired' by any 'failure, neglect or omission' of the bank to protect, in any manner, the collection of the indebtedness or the security given therefor."¹¹⁹ The Oklahoma statute under consideration by the court in *Manolakis* provided that if a mortgagee failed to seek a deficiency judgment within ninety days after the foreclosure sale, the principal debtor's obligation would be absolutely terminated.¹²⁰ The court had previously decided in *Apache Lanes, Inc. v. National Educators Life Insurance Co.*¹²¹ that the protection afforded by that statute extended to guarantors of the mortgage debt as well.¹²² At issue in *Manolakis* was whether the form of unconditional guaranty could effectively deprive the guarantor of the statutory protection afforded him by the Oklahoma Supreme Court's decision in *Apache Lanes*.

Justice Opala recognized that the creditor's decision to pursue or not to pursue a deficiency claim could affect the guarantor's subrogation right.¹²³ But he refused to go so far as necessarily to discharge a guarantor whenever the statute discharged the principal debtor:

[The discharge or nondischarge of the guarantor] must, of course, depend on the nature of the guarantor's undertaking. Giving *Apache* the meaning for which the guarantor contends would make legally impermissible and hence unenforceable any guarantor's promise that is broad enough to survive § 686 discharge of the principal debtor. There is no statutory warrant for so restricting the creditor's power to exact a broader promise and the guarantor's capacity to bargain away his § 344¹²⁴ defenses. In short, the protection of § 686 applies only to debtors. It does not make illegal those contracts that allow the guarantor's liability to survive § 686 discharge nor can it, *per se*, operate to exonerate the guarantor from liability on an obligation deemed "satisfied" by that section.¹²⁵

118. 613 P.2d 438 (Okla. 1980).

119. *Id.* at 442.

120. OKLA. STAT. tit. 12, § 686 (1971) provides, in pertinent part:

In actions to enforce a mortgage, deed of trust, or other lien or charge, a personal judgment or judgment . . . shall be rendered for the amount or amounts due Notwithstanding the above provisions no judgment shall be enforced for any residue of the debt remaining unsatisfied as prescribed by this Act after the mortgaged property shall have been sold, except as herein provided. Simultaneously with the making of a motion for an order confirming the sale or in any event within ninety days after the date of the sale, the party to whom such residue shall be owing may make a motion in the action for leave to enter a deficiency judgment upon notice to the party against whom such judgment is sought If no motion for a deficiency judgment shall be made . . . the proceeds of the sale regardless of amount shall be deemed to be in full satisfaction of the mortgage debt and no right to recover any deficiency in any action or proceeding shall exist.

121. 529 P.2d 984 (Okla. 1974).

122. *Manolakis*, 613 P.2d at 441.

123. *Id.* See also *supra* text accompanying notes 96-111.

124. OKLA. STAT. tit. 15, § 344 (1971) provides that "[a] guarantor is not exonerated by the discharge of his principal by operation of law, without the intervention or omission of the creditor."

125. 613 P.2d at 441 (footnote added).

That language maintains the essential distinction between the creditor-debtor and the creditor-guarantor relationships, and should encourage lenders not to forsake the contract of guaranty despite the fact that even the most complete forms have not always passed muster. Succinctly, if perhaps inelegantly, the result in *Manolakis* suggests that the baby should not be thrown out with the bath water.¹²⁶

A recent decision of the United States District Court for the Northern District of Illinois, *Commercial Discount Corp. v. King*,¹²⁷ also required that the guarantor remain bound by the contract of guaranty he had signed. In a memorandum opinion, Judge Shadur considered the guarantor's interposition of seven separate defenses and had little difficulty finding each of them ineffective to preclude enforcement of the "continuing, absolute and unconditional guaranty."¹²⁸ Each of defendant guarantor's affirmative defenses ran directly counter to the clear language of the form of guaranty.

In response to the guarantor's complaint that the creditor exceeded credit limits authorized under the Loan and Security Agreement, the court's opinion cited the express terms of the guaranty to the effect that such overadvances, even without notice to the guarantor, would "in no way affect or impair" the enforcement of the guaranty.¹²⁹ The guarantor also asserted that the guaranty had been terminated, and raised questions about the application of payments the creditor received after the alleged termination date. That defense was also summarily dismissed by reference to the terms of the guaranty.¹³⁰ Defenses premised on the creditor's alleged "control"¹³¹ of the debtor, the effect of the debtor's bankruptcy,¹³² and the creditor's alleged failure to join other guarantors and to deal properly with the collateral securing the principal debtor's obligation, merited, in the language of the opinion, "short shrift."¹³³

Judge Shadur's opinion is particularly valuable to creditors because the guarantor in that case was not particularly sophisticated. He was an individual who argued that "as a nonprofessional guarantor he [was] entitled to strict construction of the documents in his favor."¹³⁴ The court refused to permit

126. See also *supra* note 105.

127. *Commercial Discount Corp. v. King*, No. 78-C-3442 (N.D. Ill. Sept. 23, 1980), *vacated in part*, 515 F. Supp. 988 (N.D. Ill. 1981).

128. *Id.*, slip op. at 3 (quoting the express language of the guaranty). The court appended the very complete form of guaranty to its opinion.

129. *Id.* at 2 (quoting the express language of the guaranty). The contract of guaranty provided, in pertinent part:

This guaranty shall be a continuing, absolute and unconditional guaranty, and shall remain in full force and effect until written notice of its discontinuance shall be actually received by CDC, and also until any and all of said indebtedness, obligations and liabilities before receipt of such notice shall be fully paid.

No. 78-C-3442, slip op. at 3 (N.D. Ill. Sept. 23, 1980).

130. *Id.*

131. *Id.* The court again referred specifically to the language quoted *supra* note 129. See also Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975).

132. No. 78-C-3442, slip op. at 3-4.

133. *Id.* at 5.

134. *Id.* at 2.

that reasoning to preclude the enforcement of the "unequivocal and unambiguous terms"¹³⁵ of the form contract of guaranty.¹³⁶

Two recent appellate decisions in North Carolina have upheld the strict language of the guaranty contracts notwithstanding the objection of the guarantors. In *Love v. Bache & Co.*¹³⁷ the North Carolina Court of Appeals recognized that guaranties are governed by contract principles, and cited encyclopedic authority for the proposition that "[a] guarantor is bound by an agreement in the guaranty contract which permits extensions of time [A]n extension of time within the intent of the agreement does not discharge the guarantor."¹³⁸ In *Cities Service Oil Co. v. Howell Oil Co.*¹³⁹ the court had previously noted that the law of the state is well-settled: "[t]he rights of the plaintiff as against the guarantors, defendants herein, arise out of the guaranty contract and must be based on that contract."¹⁴⁰ Both *Love* and *Cities Service* are encouraging for creditors because the guarantors did not enjoy a strong negotiating posture vis-à-vis the creditor. Nevertheless, the appellate panels upheld the strict language of the guaranty contracts.¹⁴¹

II. FRAUDULENT CONVEYANCES AND THE BANKRUPTCY REFORM ACT

On October 1, 1979, the Bankruptcy Reform Act (Bankruptcy Code) came into effect replacing the prior Bankruptcy Act, which had been the effective federal insolvency law for over fifty years.¹⁴² Like its predecessor, the

135. *Id.* In a subsequent decision, *Commercial Discount Corp. v. King*, 515 F. Supp. 988 (N.D. Ill. 1981), portions of the memorandum opinion were vacated in light of events occurring after the creditor's motion for summary judgment was fully briefed. That turn of events, however, should not compromise the legal analysis of Judge Shadur's original memorandum opinion. The later developments dealt with issues of notice of sale of collateral due a guarantor. See *supra* text accompanying notes 96-111. For an example of a court's construing a contract of guaranty in the light most favorable to the creditor, see *Federal Deposit Ins. Corp. v. Fagan*, 674 F.2d 302 (4th Cir. 1982). In *Fagan* the court of appeals held that a guarantor who assumed liability for "all debts and obligations of the Borrower" was liable for reasonable attorney's fees of the creditor, because the note executed by the debtor included payment of reasonable attorney's fees as an obligation of the debtor.

136. Judge Wisdom, in a 1981 decision of the Court of Appeals for the Fifth Circuit, held that notwithstanding the guarantors' equitable defenses, the application of funds language in the guaranty contract was absolutely binding on the guarantors. "The guarantors, therefore, have contractually waived any equitable right they might otherwise have had to control the order of application." *Bob Maxfield, Inc. v. American Motors Corp.*, 637 F.2d 1033, 1041 (5th Cir. 1981). See also *Woods-Tucker Leasing Corp. v. Kellum*, 641 F.2d 210 (5th Cir. 1981) (guarantor's prior consent to modifications precluded guarantor from objecting to subsequent alteration of creditor-principal debtor agreement).

137. 40 N.C. App. 617, 253 S.E.2d 351 (1981).

138. *Id.* at 619, 253 S.E.2d at 353 (citing 38 AM. JUR. 2D *Guaranty* § 94, at 1100 (1968)).

139. 34 N.C. App. 295, 237 S.E.2d 921 (1977).

140. *Id.* at 299, 237 S.E.2d at 924 (citing *EAC Credit Corp. v. Wilson*, 281 N.C. 140, 145, 187 S.E.2d 752, 755 (1972)).

141. See also *North Carolina Nat'l Bank v. Corbett*, 271 N.C. 444, 156 S.E.2d 835 (1967) (creditor's failure to insert limitation of guarantor's liability in space provided did not preclude enforcement of unlimited guaranty).

142. The Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 100-1326 (Supp. V 1981), represents the first major revision of federal insolvency law in the last fifty years. In Pub. L. No. 91-354, 84 Stat. 468, effective July 24, 1970, Congress formed the Commission on the Bankruptcy Laws of the United States. The Commission concluded its work on July 30, 1973, and Congressman Edwards introduced the draft statute on January 4, 1977. The Bankruptcy Reform Act became law on

Bankruptcy Code directly provides a federal fraudulent conveyance law and indirectly incorporates state fraudulent conveyance law through a "strong arm" provision.¹⁴³ The applicable federal law is found in section 548:

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor—

(1) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted; or

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.¹⁴⁴

A guaranty is clearly an "obligation incurred," and granting a security interest in personal property or a mortgage or deed of trust interest in real property to collateralize the guaranty would constitute a "transfer" for purposes of section 548.

Professor Rosenberg, in an article construing the intended application of the prior fraudulent conveyance law to contracts of guaranty,¹⁴⁵ identified three types of guaranty contract: (1) the "downstream" guaranty; (2) the "upstream" guaranty; and (3) the "cross-stream" guaranty.¹⁴⁶ When a parent corporation guaranties the indebtedness of its subsidiary, the parent is a downstream guarantor. Such an arrangement normally poses no fraudulent

November 6, 1978. The Commission sought to curb the increasing inadequacies of the prior law in four major areas: (1) the lack of useful reorganizational tools, which resulted in an increasing number of straight bankruptcies (liquidation); (2) the mounting administrative cost occasioned by delays in the system; (3) the lack of uniformity throughout the bankruptcy system; and (4) the lack of adequate protection of respective creditor and debtor interests. COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 595, 93d Cong., 1st Sess. 3-4 (1973).

143. 11 U.S.C. § 544(b) (Supp. V 1981) provides:

The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

The chief significance of the incorporation of state law into the Bankruptcy Code is the extension of the federal one year statute of limitations period to as much as five years in some states.

144. 11 U.S.C. § 548 (Supp. V 1981). Section 67(d) of the prior law governed fraudulent conveyances. 11 U.S.C. § 67(d) (1976).

145. Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235 (1976).

146. *Id.* at 238.

conveyance problems because the guarantor is receiving legally adequate consideration. The parent is an "investor" in the subsidiary and the extension of loan proceeds to the subsidiary, which is facilitated by the guaranty, "protects the integrity and value of the principal's [parent's] investment."¹⁴⁷ The creditors of the parent, then, cannot complain, because by protecting the value of its asset (the subsidiary), the parent "helps to assure repayment of the principal's [parent's] direct creditors."¹⁴⁸ Only upstream and cross-stream guaranties may give rise to fraudulent conveyance problems: in those contexts the creditors of the guarantor have their positions compromised in favor of the creditors of the principal debtor, an entity whose financial welfare could not inure to their benefit.¹⁴⁹

Thanks to the eternal vigilance of bankruptcy trustees, there is little doubt that cases will arise to question the scope of the language of subsection 548(a)(1), "actual intent to hinder, delay, or defraud." But of primary concern to lenders should be subsection 548(a)(2), which provides that taking a guaranty is a fraudulent conveyance if "less than a reasonably equivalent value" is given in exchange for the guaranty and the guarantor is rendered "insolvent" thereby. In an upstream guaranty situation, in which the subsidiary guarantees the obligation of the holding company, it is difficult to see what value, if any, is received by the guarantor. It is not at all clear that the fiscal well-being of the parent directly benefits the subsidiary to the same extent that incurring the guaranty obligation diminishes the subsidiary. Hence, "reasonably equivalent value" may be lacking.

The guarantor's failure to receive "reasonably equivalent value" for the guaranty obligation incurred does not alone subject the guaranty contract to avoidance by the debtor's representative in bankruptcy.¹⁵⁰ It must also be

147. *Id.*

148. *Id.*

149. The author describes the commercial role of "upstream" and "cross-stream" guaranties as follows:

Typical circumstances in which a lender will require "upstream" guaranties are those in which its lending relationship is with a holding company and the bulk of the assets upon which the lender bases its credit judgment are distributed among the holding company's subsidiaries. In order to be in a position in which it reasonably can anticipate repayment out of the liquidation of those assets, the lender will require the subsidiaries to guaranty the obligation of the holding company and will frequently require that the guaranty of each subsidiary be secured by a security interest in its assets. . . .

Id. at 238 n.3.

The "cross-stream" guaranty is indicated in the case in which two or more corporations are wholly owned by the same principals, particularly where they are involved in related activities and share a common destiny. Thus, for example, when one entity owns the land and plant from which the operations of another are conducted and both are owned by the same person or persons, a cautious lender will require that the nonborrowing affiliate guaranty the obligation with a security interest in, or lien on, the assets of the guarantor.

Id. at 238-39 n.4.

150. In a Chapter XI proceeding under the Bankruptcy Code, the debtor may remain in possession during the reorganization. *See* 11 U.S.C. § 1102 (Supp. V 1981). Therefore, references to the bankruptcy trustee in Chapter XI proceedings are to be read as referring to either a trustee or a debtor in possession.

shown that the debtor at the time of the guaranty's execution¹⁵¹ was insolvent, or would be rendered insolvent as a result of the guaranty, or would be left with "an unreasonably small capital," or intended to incur debts that the debtor would be unable to pay at maturity.¹⁵² The Bankruptcy Code defines "insolvency" in section 101(26) as "financial condition such that the sum of the entity's debts is greater than all of such entity's property, at a fair valuation."¹⁵³

Creditors' counsel will suggest that every guaranty obligation is necessarily balanced by a concomitant asset: the subrogation right against the principal debtor. Also, when multiple parties guaranty an obligation, each of the guarantors has a right of contribution from the other guarantors.¹⁵⁴ Professor Rosenberg has suggested, however:

Some conceptual problems are presented in this approach. The notion that the guaranty of a solvent obligor is offset by a contingent asset based on the right of subrogation is simply not realistic; when and if the guarantor is called upon to perform, the value of that contingent asset in all likelihood would be discounted severely because *it probably would be no longer collectible*. Otherwise, the guarantor would not have been called upon to perform.¹⁵⁵

The commentator offered no authority supporting that view, and, in fact, cited authority which holds to the contrary.¹⁵⁶ A subsequent case has held that contingent subrogation and contribution rights are valuable assets, at least so far as the fraudulent conveyance analysis is concerned. In *In re Ollag Construction Equipment Corp.*¹⁵⁷ the Second Circuit considered the situation of Ollag, a corporation with physical assets valued at about \$140,000.¹⁵⁸ The corporation's only significant liabilities were its contingent obligations as a guarantor of the debt of its parent corporation. The panel found that those liabilities "were tied to certain intangible assets . . . Ollag had a right of subrogation to recover against [the principal debtor] on the [creditor's] claims. Moreover, Ollag could demand contribution from the co-guarantors."¹⁵⁹ The court made no reference to Professor Rosenberg's commentary, but clearly rejected his

151. See 11 U.S.C. § 67d(5). See also Rosenberg, *supra* note 145, at 252.

152. See UCC § 1-201(23) (1978), which defines an "insolvent" as an entity that "either has ceased to pay [its] debts in the ordinary course of business or cannot pay [its] debts as they become due or is insolvent within the meaning of the federal bankruptcy law."

153. 11 U.S.C. § 101(26) (Supp. V 1981).

154. See *supra* text accompanying notes 59-60.

155. Rosenberg, *supra* note 145, at 256 (emphasis added).

156. See *In re Bowers*, 215 F. 617, 618 (N.D. Ga. 1914), in which the court reasoned that:

the liability of a person as a surety or indorser, if the principal is solvent and abundantly able to pay, is not such a liability as could be counted against him on the question of his solvency or insolvency, because, if called on to pay such debt, he would immediately have an asset which would be equal to the amount he would be required to pay.

See also *Wingert v. Hagerstown Bank*, 41 F.2d 660 (4th Cir.), *cert. denied*, 282 U.S. 871 (1930).

157. 578 F.2d 904 (2d Cir. 1978).

158. *Id.* at 908 n.12.

159. *Id.* at 908. The court found the bankruptcy judge's holding that the subrogation and contribution rights were "worth little" to be clearly erroneous. *Id.*

analysis.¹⁶⁰

It may very well be that the right of subrogation or contribution would be of insignificant value in the case of some guaranties. When the language of Professor Rosenberg's conclusion is considered,¹⁶¹ it seems that his analysis has some validity when applied to guaranties of collection,¹⁶² in which the guarantor is called upon to perform only after the creditor's collection efforts have proved unavailing.¹⁶³ In the case of guaranties of payment, however, the form of guaranty typically required by creditors, the commentator's analysis breaks down and is clearly contrary to case law. Nevertheless, prudent creditors should not rely on a bankruptcy court's following the analysis suggested in *Ollag*.¹⁶⁴ In a multicorporation setting, a creditor will always insist upon the related corporation's providing "consolidating,"¹⁶⁵ rather than merely "consolidated,"¹⁶⁶ financial statements. Creditors with significant leverage may be able to require their debtors to adjust their corporate structure, for example through merger, to avoid taking what may ultimately be characterized as an "upstream" guaranty.

The shortcomings of Professor Rosenberg's analysis and the soundness of the Second Circuit's opinion in *Ollag* have been recognized by a creditor's attorney, William Coquillette.¹⁶⁷ Coquillette considered the fate of upstream guaranties under state law, particularly in those states that have adopted the Uniform Fraudulent Conveyances Act (UFCA). In the course of some very cogent treatment of the value of subrogation and contribution rights in the context of the contingent liability represented by a guaranty, Coquillette suggested that there is no significant distinction between the treatment of up-

160. See also *Schwartz v. Comm'r*, 560 F.2d 311 (8th Cir. 1977); *Syracuse Eng'g Co. v. Haight*, 97 F.2d 573 (2d Cir. 1938); *Updike v. Oakland Motor Car Co.*, 53 F.2d 369 (2d Cir. 1931); *Wingert v. Hagerstown Bank*, 41 F.2d 660 (4th Cir.), cert. denied, 282 U.S. 871 (1930); *First Nat'l Bank v. Jefferson Sales & Distrib., Inc.*, 341 F. Supp. 659 (S.D. Miss. 1971), *aff'd per curiam*, 460 F.2d 1059 (5th Cir. 1972).

161. See language emphasized *supra* text accompanying note 155.

162. See *supra* text accompanying notes 16-22.

163. See *supra* text accompanying notes 20-22.

164. A recent bankruptcy court decision, however, has cited the *Ollag* decision with approval and valued subrogation and contribution rights as counterbalances to the contingent liability represented by a guaranty contract. See *In re Hemphill*, 18 Bankr. 38 (S.D. Iowa 1982).

165. "Consolidating" financial statements reveal the separate and distinct financial profile of each of the related corporate entities.

166. "Consolidated" financial statements are:

balance sheets, income statements, and statements of changes in financial position of a parent company and its subsidiaries, lumped together as though they were a single company with one or more divisions or branches. The grouping of all financial matters ignores legal entities. The purpose is to make the communication of financial results to shareholders and creditors meaningful by eliminating intercompany receivables, payables, investments, income, losses, and expenses. The parent company must have a controlling interest—defined as a majority voting interest either directly or indirectly—in the subsidiary in order for consolidation to be required.

I. KELLOGG, *HOW TO USE FINANCIAL STATEMENTS* §§ 1.38-1.41 (2d ed. 1979). Kellogg warns that any analysis of parent-subsidiary financial statements must take into account the "potential for manipulation between the two entities." *Id.*

167. Coquillette, *supra* note 13. Coquillette is associated with the firm of Jones, Day, Reavis & Pogue, in its Cleveland office.

stream guaranties under the UFCA and their treatment under the Bankruptcy Code. He asserted the equivalence of the two statutes with regard to their definition of "insolvency" in order to extend the reasoning of the *Ollag* decision, a bankruptcy case, to state fraudulent conveyance actions under the UFCA:

Instead of referring to "present fair salable value" of assets, the Bankruptcy Act referred to a "fair valuation of the aggregate of [its] property." This difference should not preclude application of the *Ollag* holding in the context of the UFCA. Although the concept of salability was not expressed in the Bankruptcy Act definition, it was necessarily implied in the concept of "a fair valuation."¹⁶⁸

The commentator is correct, but he does not go far enough. By failing to distinguish between "present fair salable value" (UFCA) and "fair valuation" (Bankruptcy Code), Coquillette overlooked what may constitute a strong argument for the creditor resisting a trustee's fraudulent conveyance attack. The phrase "present fair salable value" has been construed as a liquidation value standard:

Before an asset is counted, it must have a market value, measured by a willing seller and a willing buyer, and it must be subject to liquidation within a reasonably immediate period of time. Thus, if an asset can be converted to cash only in the future, it will not be included on the asset side.¹⁶⁹

Commenting upon that liquidation value appraisal, Coquillette acknowledged that "[a]ssets which are very valuable to the corporation in its business but which are hard to sell present a problem, and some courts would have such assets excluded from the calculation."¹⁷⁰ It appears, then, that to equate the "fair valuation" standard of bankruptcy law with the UFCA insolvency standard suggests that "fair valuation" means mere liquidation value.

A creditor asserting that his guarantor was solvent at the time the guaranty was executed may very well argue that the guarantor's assets should be valued as of that date on a basis similar to a "going-concern" value rather than on a liquidation value basis. There is authority to support just such an argument. In discussing "value" in the context of a Chapter XI¹⁷¹ proceeding under the Bankruptcy Act, Judge Cyr determined in *In re American Kitchen*

168. *Id.* at 457.

169. Rosenberg, *supra* note 145, at 254-55. *But see* *Duncan v. Landis*, 106 F. 839, 859 (3d Cir. 1901) ("A man's property, at a fair valuation, may amount to sufficient to pay his debts although he might not be able to realize at once the amount of that valuation."); *Tumarkin v. Gally*, 127 F. Supp. 94 (S.D.N.Y. 1954) (balance sheet standard).

170. Coquillette, *supra* note 13, at 455. *See also* *Glenmore Distilleries Co. v. Seideman*, 267 F. Supp. 915 (E.D.N.Y. 1967).

171. Chapter XI of the Bankruptcy Act provided for business reorganizations. The following discussion of value is particularly apposite to fraudulent conveyance analysis because the assets of a business not yet in bankruptcy (at the time of the conveyance) should certainly be as entitled to the "going-concern" valuation suggested as those of a business already in a Chapter XI proceeding.

*Foods, Inc.*¹⁷² that the value obtainable through a "commercially reasonable disposition" of the assets was the appropriate construction of the Act's concept of "value."¹⁷³ It has been suggested that "Judge Cyr's consistent use of a standard shaped by the commercial realities at each stage of the proceeding and the use of a standard approaching full going-concern value . . . may well influence decisions of courts operating under the Code."¹⁷⁴ Creditors defending an upstream or cross-stream guaranty in a Chapter 11 proceeding¹⁷⁵ should assert Judge Cyr's valuation analysis in order to establish the solvency of the guarantor at the time the guaranty was executed. A recent bankruptcy court decision¹⁷⁶ has acknowledged that "[u]nless a business is on its deathbed . . . the 'fair value' of its assets, within the meaning and purview of 547(b) of the Bankruptcy Code,¹⁷⁷ is the going concern value or fair market price."¹⁷⁸

Finally, when considering the potential fraudulent conveyance ramifications of guaranties taken from an "insolvent" guarantor, the commentators have apparently ignored section 548(c) of the Bankruptcy Code. That section provides that if the trustee does set aside a transaction (such as a grant of a security interest to collateralize a guaranty) as fraudulent, the creditor may retain a lien against the property transferred to the extent of any value given by the creditor "in good faith."¹⁷⁹ In order to attempt to establish that "good faith," a creditor may require an "Affidavit of Solvency"¹⁸⁰ from one or more

172. 2 BANKR. CT. DEC. (CRR) 715 (N.D. Me. 1976). See also *In re Pembroke Manor Apts.*, 547 F.2d 805 (4th Cir. 1977); *In re Blazon Flexible Flyer, Inc.*, 407 F. Supp. 861 (N.D. Ohio 1976).

173. 2 BANKR. CT. DEC. at 720-21. Section 548(d)(2)(A) of the Bankruptcy Code defines "value" as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." 11 U.S.C. § 548(d)(2)(A) (Supp. V 1981). That definition, however, is inapposite for the purposes of determining a valuation standard.

174. ILLINOIS INST. OF CONTINUING LEGAL EDUC., BANKRUPTCY PRACTICE UNDER THE BANKRUPTCY REFORM ACT OF 1978, at 11-8 (1980). Judge Cyr was speaking to the issue of adequate protection (now codified at 11 U.S.C. § 362(d) (Supp. V 1981)) but his analysis is also useful beyond that discrete subject area.

175. Chapter 11 of the Bankruptcy Code is titled "Reorganization." It would seem that Judge Cyr's analysis could also be applied to Chapter 7 "Liquidation" proceedings, because the nature of the debtor at the time of the allegedly fraudulent conveyance is the same whether relief is ultimately sought under Chapter 7 or 11.

176. *In re Utility Stationery Stores, Inc.*, 12 Bankr. 170 (N.D. Ill. 1981).

177. 12 Bankr. at 176 (Section 547 is concerned with "Preferences").

178. *Id.* (citing *Langham, Langstrom & Burnett v. Blachard*, 246 F.2d 529, 532 (5th Cir. 1957); *In re Fred D. Jones Co.*, 268 F. 818, 819 (7th Cir. 1920); *In re Windsor Indus. Inc.*, 459 F. Supp. 270, 276 (N.D. Tex. 1978).

179. 11 U.S.C. § 548(c) (Supp. V 1981) provides:

Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on any interest transferred, may retain any lien transferred, or may enforce any obligation incurred, as the case may be to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

The last clause of that section may cause creditors some difficulty because the party attacking the conveyance as fraudulent will argue that the creditor in fact gave no value to the debtor. "Value" in subsection (c), however, may be read as distinct from the "reasonably equivalent value" in subsection (a)(2)(A). That standard could be easier for the creditor to satisfy.

180. These affidavits are sometimes referred to as "Guaranties of Validity."

of the principals of the guarantor corporation.¹⁸¹ While by no means fail-safe, the document requires the principal's attestation to the solvency of the corporate guarantor. The self-serving purpose of the form is transparent, but that should not necessarily compromise its effectiveness.

The affidavit has value beyond the fraudulent conveyance context. It typically provides that the affiant will assist the creditor in liquidating the collateral at a specified rate of salary¹⁸² for a specified period of time.¹⁸³ The creditor is not, of course, obligated to retain the affiant in its employ but is given the option of doing so. In any event, such an option is not worthwhile (in other words, not "cost-effective") if the creditor must initiate litigation to enforce it. Many responsible affiants will, however, feel a moral obligation to fulfill the terms of the affidavit.¹⁸⁴ Nevertheless, it would be neither overly zealous nor entirely inappropriate to take a personal guaranty as well as an Affidavit of Solvency from the principal, if the structure of the transaction allows.

III. CONCLUSION

Many of the cases applying common law and statutory provisions have displayed a substantial bias in favor of the interests of those who contract to answer for the debt of another. The (perhaps unfortunate) creditor who has relied, presumably in good faith, on the enforceability of the guaranty obligation has often been the victim of arguably ill-reasoned proguarantor decisions. While many of the defenses to guaranty liability are founded on cogent and equitable legal reasoning, the courts' inconsistencies have hampered the integrity of credit documentation. Nevertheless, reports of the demise of the guaranty contract are exaggerated. Through careful and complete documentation combined with scrupulous attention to the rights of the guarantor, creditors may place significant stock in the efficacy of the guaranty. The persuasive legal arguments presented in this article are available to lenders' counsel. By implementing these suggestions, creditors' attorneys may even be able to steer a careful course between the Scylla and Charybdis of fraudulent conveyance and UCC protections that guarantors are wont to assert in order to avoid liability.

181. The affidavits may or may not be taken in lieu of a personal guaranty from the debtor's principal. Corporate principals often refuse to sign a guaranty when a creditor drafts it to provide a collateral interest in the principal's primary residence.

182. This rate of salary is usually based on the rate paid to the principal in the three months prior to the principal debtor's default under the loan agreement.

183. The period is normally no longer than required to effect a commercially reasonable disposition of the principal debtor's assets.

184. This is particularly true in the case of many of the entrepreneurs who enter into financing arrangements with commercial finance companies. Such people take the responsibilities of their corporation as their own, notwithstanding the corporate legal fiction.

