Guaranty Agreements - Avoid Pittfalls that could Invalidate

Guaranties Are Strictly Construed Against the Lender

Although guaranties have been commonly used tools in lending practice for many decades, the law continues to view guaranties unfavorably—a view having originated in the courts of England hundreds of years earlier. Legal principles frequently recited in modern courts are that:

1. if there is uncertainty in the language of the guaranty, the language will be construed in favor of the guarantor and against the lender;

2. a guarantor's liability cannot be extended beyond the obligation actually described in the guaranty, even where the parties obviously intended for the guaranty to cover some other or additional debt; and

3. all essential elements of the guaranty must be in writing, or the guaranty will be unenforceable.

The first two principles should be kept in mind as a general rule of thumb and reason for perpetual caution: if there is a problem with a guaranty, the lender will probably be the loser. It is the lender's responsibility to make sure that everything in the guaranty is correctly completed.

The third principle requires a more thorough understanding. In order for a guaranty agreement to be enforceable, it has to be in writing, the writing has to be signed by the guarantor, and the writing has to contain each of the following essential elements:

1. the identity of the lender;

2. the identity of the primary obligor;

3. the identity of the guarantor; and

4. a description of the debt being guarantied.

If the guaranty agreement fails to adequately address any one or more of these elements, it will be unenforceable.

Identity of the Lender

The guaranty agreement must identify the creditor to whom the obligation is owed (in other words, the name of the lender). This is an easily understandable concept. A problem is most likely to arise where fill-in-the-blank forms are used, and the wrong names are put in the wrong blanks—leading to absurd situations such as the bank guarantying a loan made by the borrower.

In the event of such an obvious error, a court will not usually "read between the lines" to enforce the guaranty as the parties actually intended. The court will enforce the guaranty exactly as it is written (meaning the guaranty will have no value to the bank).

Courts do permit use of "successors and assigns" language when identifying the lender in a guaranty, and the lender should assure that its guaranty form includes language providing that the guaranty will run to the benefit of any successor or assignee of the lender. As mergers, asset purchases, and name changes are commonplace, such language is important (and is included in most commercially available forms utilized by banks—but it never hurts to check twice to be sure).

Identity of the Primary Obligor

The guaranty agreement must identify the borrower whose debt is being guarantied. This is a simple rule, but it is perhaps the most common cause of guaranties being found unenforceable. With fill-in-the-blank type forms, make sure the right names are put in the right places. The guarantor should not be guarantying a debt of the bank, or a debt of the guarantor.

The correct name for the borrower must be used. Although that seems like obvious guidance, it is frequently ignored. Problems arise most often where the borrower is an entity such as a corporation. In the eyes of the law (for most purposes, at least) corporations and limited liability companies are considered as legal "persons" just like individuals. Like individuals, these entities have actual, legal names. It would seem absurd, for example, to use the name "Mark Mills" instead of the legal name "Mack Miller" in a guaranty, simply because the two names sound similar and share many common letters. Yet it is not uncommon to see situations where, for example, the name "Mills Properties" or "Mills Farms, Inc." is listed as the borrower instead of the legal name "Mills Farm Properties, Inc."

When preparing the guaranty use the exact, correct name of the entity based on documentation obtained from the secretary of state's office. Do not rely on oral representations from the borrower, and do not assume that being "close" to the proper name will be sufficient for enforceability.

Keeping in mind the concept of "entities as persons," it is important to remember that the debt of one corporation is not the debt of another corporation simply because both entities are owned and operated by the same individual.

Example

> Mark Mills, a farmer, is the sole member and manager of two limited liability companies: Mills Farm, LLC and Mills Properties, LLC. Mills Farm, LLC owns the equipment and personalty used in Mills' farming operation, while Mills Properties, LLC owns the real property used in the operation.
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> Mills wants to obtain an operating loan, so Bank provides a line of credit to Mills Farm, LLC. Bank obtains a personal guaranty from Mark Mills, whereby all debts then or thereafter owing from Mills Farm, LLC to Bank are guarantied.
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> Later in the season, Mills requests that Bank provide additional credit. This time, Bank makes a lump-sum loan to Mills Properties, LLC. Bank does not require Mark Mills to sign a separate guaranty, as Mills and the loan officer orally agree that the earlier guaranty will just apply to all of the debts that any of Mills' companies owe to the Bank.
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> In this situation, Mark Mills is not responsible for payment of the Mills Properties, LLC debt. His oral agreement is not enforceable against him, as guaranty obligations have to be in a signed writing to be enforceable. Moreover, the written guaranty must properly identify the debtor whose debts are being guarantied. Mills Properties, LLC is a different "person" from Mills Farm, LLC, so the guaranty cannot be extended to cover the debt of both entities.

In situations involving a package of multiple guarantied loans to related entities, it is absolutely crucial to double check the loan documents to assure that there is a written guaranty for each and every obligor appearing on any of the promissory notes given in the transaction. "Cross guaranties" between the different primary obligors can also be helpful. In the example above, if Mills Farm, LLC had guarantied the obligations of Mills Properties, LLC, then Mark Mills would have been responsible for payment of both entities' debts.

Identity of the Guarantor

The guaranty agreement must adequately identify the person who is guarantying the debt. Compared to the other essential elements of a guaranty, courts have been more liberal in construing this requirement. The courts have held that, so long as it is clear from the document that the person is signing as a guarantor, the person's signature alone is sufficient to identify the guarantor even if the person's name is not printed. So, for example, if a guaranty reads "the undersigned hereby guaranties the payment and performance" etc., and Mark Mills places his signature on a line marked "guarantor," the guaranty will sufficiently identify the guarantor even though Mills' name is not separately printed elsewhere in the guaranty. Of course, relying on this approach is not advisable. The guaranty should clearly state the correct legal name of the guarantor.

It is most crucial that the guaranty does not misstate the guarantor's name. The names of the borrower and the guarantor should not be switched on fill-in-the-blank forms. While Mark Mills' signature alone might be enough to bind him if there is no other name printed in the guaranty, it will probably not be enough to bind him if some other person or entity is described as the guarantor elsewhere in the guaranty agreement.

There have been situations where, mistakenly, the corporate borrower was identified as the guarantor of a loan made to the corporation (itself), with the corporate president signing the guaranty. Though it is obvious that the intent of the parties was for the president to individually guaranty the corporate debt, appellate courts have refused to apply the guaranty beyond its exact language regardless of the parties' actual intent. Courts have explained that it is the lender's responsibility to read the documents it prepares and to spot any errors (like a borrower guarantying its own debt), rather than relying on the courts to correct the clear mistakes of the lender.

Example

> Bank makes a loan to Mills Farm, LLC, and intends to obtain a personal guaranty from its sole member and manager Mark Mills. By mistake, the name "Mills Farm, LLC" is inserted into the blanks for both the borrower and guarantor, such that the guaranty literally reads as though the entity is guarantying its own debt. Mark signs the guaranty, on a line reading "Mark Mills, Manager."
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> What is the likely result if Bank tries to enforce the guaranty? Mark Mills will not be liable, as the guaranty identifies the guarantor as Mills Farm, LLC. Although it may seem absurd, the terms of the guaranty will be applied literally regardless of the parties' actual intent.

As the above example suggests, it is also the lender's responsibility to assure that the guaranty is clear as to whether the signor is executing the guaranty in his individual capacity or in his corporate capacity. If the guaranty is unclear, it will not likely impose individual liability on the signor. The court may presume that the individual was signing only on behalf of the entity.

Description of the Debt

The guaranty agreement must describe the debt that is being guarantied. Broad, all inclusive language such as "all present and future debts of borrower to lender," or "all amounts now or hereafter owed by borrower to lender" has repeatedly been upheld by the courts. Where the guarantor is guarantying all debts of the borrower, the guaranty sufficiently describes the debt if it so states. Wherever possible, the lender should seek to obtain broad "all debts" guaranties.

If the guaranty covers only a specific debt, the lender must be more careful. The rule for specific debt guaranties is that both the amount of the debt and the due date of the debt must be stated either in the guaranty itself, or in another writing specifically referenced in the guaranty. This is usually accomplished by making specific reference, in the guaranty, to the promissory note being guarantied. The reference should describe the note by date, promisor, promisee, and original principal amount. Loan number and maturity date may also be expressly stated in the reference. The guaranty should be clear that it also covers all modifications, refinancings, and renewals of the described promissory note.

For specific debt guaranties, the information in the reference must be correct. Again, courts will strictly construe the guaranty against the lender, and will readily leave the lender to suffer from its own mistakes. The following example is based upon the facts of an actual Georgia appellate case:

> Lessor offers to lease premises to Tenant (a corporation), but requires that Tenant's president individually guaranty payment of the lease. The lease and a separate guaranty are prepared, and all parties review and approve the documents. Tenant's president signs the guaranty on Friday, December 7. The guaranty describes the debt as "all amounts owing by Tenant to Lessor pursuant to that Lease of even date herewith."
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> The parties desire that both the president and the secretary of Tenant sign the lease document, to assure that the signature is properly authorized. Secretary is unavailable on Friday, December 7. On Monday, December 10, the lease is signed by the president and the secretary, and dated December 10. Tenant defaults on the lease, and Lessor sues President on the guaranty. *Result?*
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> The guaranty is unenforceable. Although there was no dispute that President intended to guaranty the lease, the written guaranty agreement did not accurately describe the lease. The guaranty, dated December 7, described a lease "of even date herewith." The lease was dated December 10. Thus, the president had no individual liability to the Lessor as the court would not enforce the lease beyond its literal language.

The above example illustrates the harsh effects of the strict legal requirements for guaranties. The lender must be exceedingly careful to avoid mistakes in preparation of guaranties. As the saying goes, "no one is perfect"—but with respect to guaranties, the lender will pay a price for imperfection.