Business Credit News

CREDIT REPORTS 210-225-7106
COLLECTION 210-225-7106
FAX SERVICES 210-225-1777
WEB SITE: www.bcmstx.com
E-MAIL: bcms@bcmstx.com

Business Credit and Management Services Co of Texas
4407 Walzem Rd #205
San Antonio, TX 78218

JULY 2018

"Guaranties And Other Forms"

By: David Balovich

The simplest and most common form of third party obligation available to creditors is the guaranty. This ancient legal form of "pledge" is defined as a commitment made by a person to pay the debt or to fulfill some other obligation of another person, in the event of default. The language of a guaranty need not be formal to be enforceable and there is no requirement that guarantees be recorded. With the complete abolishment of the Deprizio Rule in the Bankruptcy Reform Act of 2005 there is no reason not to obtain as many guaranties as is possible. Guarantees are, however, subject to the Statute of Frauds requirement that "pledges to pay the debts of another" be reduced to writing and signed by the person making the guaranty, or the "guarantor".

VERBAL GUARANTIES ARE NOT ENFORCEABLE.

In addition to the requirement that a guaranty must be in writing, every guaranty must also include elements necessary to make an enforceable contract. These elements include:

- Identification of the parties, including the guarantor(s), the party whose debt is to be guaranteed, and the creditor
- A clear commitment by the guarantor to perform, i.e. exactly what will happen and when
- Consideration for the guarantor to make the commitment

THE PROBLEMS WITH GUARANTEES

Back in the day when clients engaged us to audit their credit files we often found the majority of credit applications had not been updated in quite awhile, in some cases never, and application included a boilerplate guaranty of no more than a paragraph or two and did not include two of the three elements mentioned above.

In reviewing the boilerplate guaranty, we encountered the following sentence: *The guarantor waives protest, presentment and notice of dishonor.* This language leads us to believe that whoever created the guaranty was either trying to find a way to draft a lock-tight guaranty that would negate any "suretyship defenses." There are many of these types of defenses that enable a guarantor to evade its obligations due to the actions of the creditor that often increases the guarantor's risk. Or the wording was taken from another guaranty, possibly a longer one, and minimized to fit the guaranty included on the credit application, which, we believe, was more likely, the case.

GUARANTY LAW AND THE UCC

Guaranty law is largely court-made and because guarantees are promises to pay made by parties not otherwise liable to creditors, courts have a tendency not to strongly enforce them. That is, if there exists any ambiguity or uncertainty in the language of the guaranty it will usually be interpreted adversely towards the creditor. Further, a number of states have enacted statutes imposing specific limitations on guarantees, such as requirements that the maximum aggregate amount of liability on the guaranteed debt is specified and that guaranties are current with respect to the date signed. These rules vary from state to state and as a result, there is no generally accepted statues of time or list of suretyship defenses. So when drafting guarantees attorneys generally try to cover every base. A good creditor's rights attorney knows that an endorser of a

negotiable instrument is a surety — "*... if an instrument is dishonored, an indorser is obliged to pay the amount due on the instrument ... according to the terms of the instrument at the time it was indorsed....*" (This can be found in Section 3-415 of the post- 1990 Article 3, Negotiable Instruments, of the Uniform Commercial Code)

What's more, the creditor's rights attorney knows that Article 3 of the UCC gives a specific statutory instruction as to how to negate one particular form of suretyship defense. Of course those attorneys who elected not to take the Uniform Commercial Code course in law school usually haven't a clue and generally are the ones who simply cut and paste form guaranties to fit whatever the need their clients are seeking.

Under Article 3, if the guarantor is obligated on a purchase where payment is due on 30 day terms, September 1, and the creditor, as holder of the invoice and guaranty, extends the time for payment to the debtor until September 15 (thus extending the time for payment of the invoice) or delays notifying the guarantor that the original purchase terms as stated on the instrument (invoice) has been dishonored, then the guarantor may have a defense to his obligation. Article 3 does provide specific words that can be incorporated into the guaranty that can make this defense difficult to the guarantor. That phrase is "*By the terms of the instrument, presentment is not necessary to enforce the obligation of indorser"* and "*The indorser whose obligation is being enforced has waived presentment.*" (Section 3-504 of Article 3.)

The other difficult aspect of guaranty enforcement is duration. Consider this situation: Amalgamated, Inc. opens a credit account with creditor X, but only after Amalgamateds' president provides creditor X with a personal guaranty. Nine years later, Amalgamated defaults on its payment obligation to Creditor X, and creditor X pursues the guarantor for payment. The guarantor objects saying that he sold Amalgamated to others, three years after the account was opened with creditor X and he has had no interest in the operations of Amalgamated since his departure. Creditor X argues the guaranty plainly guarantees payment in event of default by Amalgamated, Inc., and it is also a continuing guaranty and valid unless revoked in writing. The guarantor admits he did not revoke the guaranty.

Can creditor X collect from the guarantor?

State courts will generally enforce guarantees as drafted and signed by the parties unless the effect would be injurious to public policy. In cases like our example, courts often attempt to find for the guarantor on the basis of any available legal theory – except the law of guaranty. Creditors probably cannot rely on the courts to enforce guarantees with unlimited duration. Several states have even proposed laws (California, New York, Pennsylvania) to automatically require renewal of all guarantees after specified time periods. It is, therefore, probably advisable to include expiration terms in commercial guarantees, and to carefully monitor renewals as needed.

WHAT IS A GUARANTY?

Creditor's rights attorneys' inform us a guaranty isn't a negotiable instrument but rather a contract and the guaranty can be drafted to do whatever the parties mutually agree to do. The law of guaranty then is nothing more than a set of rules that establishes when default occurs and the obligations of the parties in default, in writing. Thus the extension of time is only one of the defenses available to the guarantor. Moreover, under the pre-1990 version of Article 3, "*when words of guaranty are used, presentment, notice of dishonor and protest are not necessary to charge the user*." (§ 3-416(5)). We mention the pre-1990 version of Article 3 of the UCC because many of the "form" guaranties in existence and still being used today have not been changed to reflect the post-1990 Article 3 revisions.

In every obligation by one party to the guaranty there are reciprocal obligations of the other parties and it is important to be aware that any party may have defenses based on the conduct of the other two parties. For example the guarantor could be partially or totally discharged from its guaranty if the creditor took actions that increased the guarantor's risk. For example: say the debtor was past due or made it known to the creditor that they were not going to be able to pay present obligations on the due date but the creditor continued to sell to the debtor because they had a guaranty. This action on the part of the creditor increases the risk to the guarantor. If the guarantor can show that the creditor was careless in its performance and placed the guarantor at increased risk the guarantor could be deemed as not responsible for any of the debt incurred beyond the past due amount and the Court, if it chose, could rule the guarantor not responsible for any of the debt.

We have seen some guaranties that include language that states, "*the guarantor's obligation under this guaranty is primary and not secondary."* That's a nice try on the part of the drafter and such a statement may succeed as a waiver of suretyship rights but common sense says if it is a primary obligation, then it can't be a guaranty and in order for it to be a primary obligation the guarantor would have had to have benefit of the consideration.

COMMON TYPES OF GUARANTIES

The most common types of guarantees used in commercial credit transactions are.

Personal Guaranty. As the name suggests, personal guarantees are obtained from individuals. This very common guaranty is standard procedure for most creditors in extending credit to new, small, family owned, or financially weak businesses. Typically, personal guarantors are principals in the debtor business, although persons unrelated to the debtor can guarantee its debts. Personal guarantors promise to pay upon default of
the debtor, and creditors may look to the guarantors' personal assets for payment.
This raises the practical question for creditors, whether the guaranty provides any real value in event of enforcement; evaluation of the guarantor's personal creditworthiness
is essential to answer the question. Further, a guaranty from a proprietor or general partner adds no value for a creditor. This may also be true of members of a limited liability company whose state does not recognize the LLC as corporations.

Corporate Guaranty. Corporate guarantees are often seen in the context of establishing trade accounts for spin-off companies, new or small debtors in which the corporate guarantor has a vested financial interest, and circumstances where the guarantor needs an uninterrupted supply of goods from the creditor to its critical vendor. In each case, the guarantor acts in self-interest to assist the debtor obtain credit, and the creditor gains vital protection from loss. Corporate guarantors should be financially scrutinized as carefully as any debtor.

Board Resolutions. Although all employees of a corporation are legally "agents",
only certain employees are authorized by the Board of Directors to enter into
agreements or bind the corporation through guarantees or security agreements.
These employees are authorized during meetings of the Board of Directors and the information is entered in the minutes of the Board. It is vital when securing any agreement that the signature of the party signing on behalf of the corporation be binding. The legal method for this is to have a board resolution completed and signed by the Corporate Secretary attesting to the fact that the person signing the Agreement is authorized to bind the corporation by its' Board of Directors.

WHERE DO THESE DOCUMENTS COME FROM?

At some point in time someone mentions at an industry credit meeting or other function that they are in need of a guaranty or other form. Another creditor responds saying they have one and will fax it over that afternoon. The requesting creditor changes the names and dates, and the guaranty ends up in another company's forms file and so it goes.

One thing is clear — the creditor, neither one, usually has no idea what the provisions mean in those forms. Most likely, they think it means that (1) the creditor doesn't have to present the guaranty when it demands payment (it says "*waives presentment*,"), and (2) the guarantor will have no right to object to the demand for payment ("*waives protest*"). Although that is the way the document reads it does not mean it is legally correct.

UCC Article 3 was substantially revised in 1990. In particular, old Section 3-606, which described the actions of the holder that would discharge a guarantor (that is, the "suretyship defenses") was replaced by new Section 3-605, which among other things, added the following helpful provision: *(i) A [guarantor] is not discharged under this section if … the instrument or a separate agreement provides for waiver of discharge under this section either specifically or by general language indicating that the parties waive defenses based on suretyship or impairment of collateral.*

So under post-1990 Article 3, you can waive all suretyship defenses by including the phrase "*I waive defenses based on suretyship or impairment of collateral*." But those words usually don't appear in the majority of the boilerplate guaranties because they were created prior to 1990 under the old UCC Article 3.

The point is not that non-creditor rights attorneys are often ignorant of commercial law principles (they are), or that they are too prone to defer to out-dated forms (they do!). Article 3 suretyship principles are not central to most lawyers' concerns, and usually credit professionals are not asking their attorneys to update their forms and if they do the majority of company attorneys are not up-to-date in creditor's rights law. They just look for a form or ask another attorney if they have a form.

I know this because I get calls and emails regularly from associations, other creditors and their attorneys, people I don't even know, who have found my website and inquire if I have such and such form available. My point is the too often tendency of forms to contain language that once was correct but is not any more.

IS THERE ANYTHING WE CAN DO?

Lately, as we discover these standard forms of legal boilerplate that seem to reproduce not only within industries but also cross-pollinate into others (we suspect this occurs as credit professionals change jobs and take their forms with them to their new company) we ask the question, "What else can we do?" The majority of these boilerplate documents were once created in legal practice and very seldom are they updated. Not surprisingly, lawyers are more interested in solving problems then creating forms. The result is there exists a majority of standard legal forms being used that may or may not protect those who are using them.

What's to be done? There are a few who often publish forms of commercial law documents, with commentary, but these seldom have the institutional backing to ensure that they are kept up to date. Even forms publications offered by various credit associations are usually not updated but instead are just recycled with a new printing date. The UCC Commission has a Permanent Editorial Board for the UCC, but not for commercial law forms. And even if you publish a useful form, it's not clear that a legal journal or association will want to publish annual updates that make the minor changes (no income in it).

When the revisions to Article 9 of the UCC were introduced I created a manual updating the procedures, definitions and new forms to be used under the revised UCC Article 9 (RA-9), and although it was sent out to several industry (legal and commercial credit) forms publishers it was clear that no one wanted to publish it. In fact, several wrote back suggesting if I had a website I should just post it there.

And there's another problem: Even if there were a reliable source for up-to-date forms, it's unclear that they would be used. Law firms tend to use their own forms, because they want to offer a product that differs from the product offered by other attorney firms. It's one of the dirty little secrets as to why legal expenses are so high, the battle of the forms. And if they don't have a particular form in their library they don't want to tell the client that they acquired the document from a publicly available source that may or may not be up-to-date.

Credit professionals need to review their forms annually with qualified legal counsel to make certain the documents they are using to protect the second most important asset of their organization are up-to-date and can be relied upon.

I wish you well.

********** **JULY 2018** **********

Day	Date	Group	Location	Time
Tues	3	Austin Construction	Tres Amigos Restaurant, 7535 E Highway 290, Austin, TX	11:30
Tues	10	Corpus/Victoria/La/RI	Holt Cat, Corpus Christi TX & Conference Call	11:30
Thurs	12	SW Food Credit Group	Las Palapas, 4802 Walzem Rd, San Antonio TX	11:00
Tues	17	Austin Construction	Tres Amigos Restaurant, 7535 E Highway 290, Austin, TX	11:30
Thurs	19	Austin Ad Media	Phone Conference Meeting 1-800-791-2345	2:00
Thurs	19	Fuel & Lube/Heavy Eq.	Phone Conference Meeting 1-800-791-2345	2:30
Thurs	19	HVAC Credit Group	Texas Air Products, San Antonio TX	11:30
Fri	20	SW Electrical Group	The Onion Creek Country Club, Austin TX	11:30
Tues	24	SA Construction	Las Palapas, 4802 Walzem Rd, San Antonio TX	11:30

EASY ACCESS TO LEGAL INFORMATION

Did you know you could go on-line to get the legal list bulletin? You can download legal information (mechanic liens, state, and federal liens, suits, bankruptcies, abstract of judgments, etc) on any of the following counties: Travis, Williamson, Hays, and Bexar. To access go to our web site at www.bcms.com . All you have to do is go to BCMS Online, enter your membership information and make selection under Legal Bulletin. It will bring you to the legal information you need. Select the county, type of legal information and the time period requested. Type in the word **all** at the search information box. Also, you can type in the business name to receive all legal information on that specific company. For help on how to use the legal bulletin on-line give us a call at (210)225-7106.

BCMS COLLECTION SERVICE

Our collections staff is willing and certainly able to take on those tough, overdue accounts to which you've been devoting too much of your valuable time. We act promptly, personally contacting the debtors on the same day we receive your accounts. We are equal opportunity collectors, that is, no matter where your debtors live in the nation or who they are, we will find them and collect. In cases where we don't collect, we charge no fee, albeit we do so grudgingly…..we don't like failure. For your protection, all funds collected are placed in trust accounts. Also, all employees and attorney's are bonded. When you hit that wall in your collection efforts, give us a call at (210)225-7106 or you can fax your problems to us at (210)225-1777.