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GUARANTOR

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In Defense of the Guarantor

Changes in the Laws Relating to the Discharge of Secondary Obligors

By Richard R. Gleissner

Introduction

In 1994, the S.C. Supreme Court set the stage in commercial transactions that left guarantors largely defenseless. Since then, changes in the law of commercial transactions have been largely ignored or left unnoticed in commercial litigation. This article seeks to explore these ignored or unnoticed changes that may provide defenses to a guarantor.

The law of guarantors as of 1994

In South Carolina, guarantees were seen as separate and distinct agreements and not negotiable instruments allowing for the protections of parties to the instrument under South Carolina's former Section 36-3-606. Guarantees are contracts, and general contract law governs their interpretation. In *Citizens & Southern National Bank of South Carolina v. Lanford*, 313 S.C. 540, 543-44, 443 S.E.2d 549, 550-51 (1994), the Supreme Court of South Carolina addressed an unambiguous guaranty as follows:

> A guaranty of payment is an absolute or unconditional promise to pay a particular debt if it is not paid by the debtor at maturity. *AMA Management Corp. v. Strasburger,* 309 S.C. 213, 420 S.E.2d 868 (Ct. App.1992). Under an absolute guaranty of payment, the creditor may maintain an action against the guarantor immediately upon default of the debtor. *Peoples Federal S & L v. Myrtle Beach Retirement Group,* 300 S.C. 277, 387 S.E.2d 672 (1989).

Specifically, in addressing the defenses raised on behalf of the guarantor and the genuine issues of material fact related to those defenses, the Supreme Court held that guarantors were not entitled to the protections provided by former

Section 36-3-606: (a) release of the principal, (b) extension of time, (c) modification of the primary obligor's agreement, (d) impairment of collateral and (e) other conduct impairing the ability of the guarantor to recover from the principal. *See* former code section S.C. Code Ann. § 36-3-606(1)(b) (Law Co-op. 2003). Further, although not addressed in the opinion, under the same logic, the defense of tender of payment would similarly not be available to a guarantor. *See* former code section S.C. Code Ann. § 36-3-604(2) (2003).

Thus, under *Lanford*, there were few defenses for a guarantor. The law started to change in 2001 with the adoption of the revised Article 9 of the Uniform Commercial Code (UCC), and this change was strengthened and reinforced by the adoption of the revised Articles 3 and 4.

Article 9—Inclusion of protections for guarantors

Under Article 9 of the UCC, guarantors may be referred to as accommodating parties or secondary obligors. When Article 9 uses the generic words "debtor" or "obligor," those terms include a guarantor. By including a guarantor within these generic terms, the duties of the creditor to the debtor or obligor flow to the guarantor. Section 36-9-608(a)(4) states the general rule that a "[creditor] shall account to and pay a debtor for any surplus, and the obligor is liable for any deficiency." S.C. Code Ann. § 36-9-608(a)(4).

Upon default, the creditor may take possession of the collateral. S.C. Code Ann. § 36-9-609. After the creditor takes possession, every aspect of disposition of the collateral "must be commercially reasonable." S.C. Code Ann. § 36-9-610. The requirement of commercial reasonableness extends to the method, manner, time, place and all other terms of the disposition. *Id.* Included in the requirements of Article 9 is the requirement to provide notice to the guarantor. *See* S.C. Code Ann. § 36-9-611 (relating to notice in all transactions); S.C. Code Ann. § 36-9-613 (relating to contents and form of notification); S.C. Code Ann. § 36-9-614 (relating to contents and form of notification in a consumer-goods transaction). Further, this right to a notice can only be waived by an agreement entered into after the default, not in the initial guaranty. *See* S.C. Code Ann. § 36-9-624.

If the creditor does not act in a commercially reasonable manner, Section 36-9-625 provides remedies to the guarantor, including the elimination of a deficiency and the possibility of a recovery for a potentially lost surplus under Section 36-9-626. *See* S.C. Code Ann. §§ 36-9-625-626. Further, if the creditor fails to comply with a section of the code, the burden of proof is on the secured party to show that the amount of the proceeds that would have been realized is not equal to the obligation. *See* S.C. Code Ann. § 36-9-626(a)(4).

Thus, in situations where Article 9 applies, the guarantor has statutory defenses, and many of these defenses cannot be waived in the initial guaranty.

Incorporation of the laws of sureties

In 2008, the South Carolina legislature adopted newer versions of the UCC's Articles 3 and 4. Like the older versions of the UCC, the newer versions provide certain defenses to actions on instruments and appear to limit the application of these defenses to a "party to the instrument." For example, a party to the instrument is someone actually signing the instrument as a maker, drawer, acceptor or indorser. *See* S.C. Code Ann. § 36-3-103(11) (defining Principal Obligor); § 36-3-103(17) (defining Secondary Obligor); and § 36-3-419 (defining accommodating party). Thus, the newer sections appear to provide no assistance to the defense of the guarantor, which is still seen as a separate undertaking. However, some defenses may be developed upon closer inspection of the comments to these sections.

For example, the first and second official comments to Section 36-3-605 refer explicitly to the Restatement of Suretyship and Guaranty. In fact, the second comment posits an example similar to the facts of *Lanford* and states that suretyship and guaranty law should apply to that transaction.

The incorporation of the surety defenses for guarantor liability is further strengthened in the statutory language of Section 36-3-603(a). That section deals with the issue of tender and states:

> If tender of payment of an obligation to pay an instrument is made to a person entitled to enforce the instrument, the effect of tender is governed by principles of law applicable to tender of payment under a simple contract.

S.C. Code Ann. § 36-3-603(a) (Law Co-op. 2009 Supp.). The "principles of law applicable to tender of payment under a simple contract" may be a reference to the general laws of suretyship and guaranty as manifested in the Restatement.

Thus, through the adoption of the newer versions of Articles 3 and 4 of the UCC, the South Carolina legislature has provided guarantors with hope that they may have defenses against unreasonable and unjustified actions by the creditor.

Defenses created by the Restatement

As with most commercial transactions, most of the defenses provided to guarantors in the Restatement may be varied by the written contract between the parties. Restatement (Third) of Suretyship & Guaranty § 6 (1996). However, if the written contract seeks to eliminate a suretyship defense, it may create an argument that the guaranty is an adhesion contract that is unconscionable. Further, some general defenses are so fundamental to the guaranty relationship that they may be seen as not capable of being waived "in the contract creating the secondary obligation." See Restatement § 48.

Generally, the Restatement provides defenses for a guarantor based upon the following actions by the creditor:

1. Release of the principal (Section 39);
2. Extension of time on primary obligation (Section 40);
3. Modification of the underlying obligation (Section 41);
4. Impairment of collateral (Section 42);
5. Allowing the statute of limitations to run on the underlying obligation (Section 43);
6. Other conduct impairing the ability of the guarantor to recover from the principal obligor (Section 44); and
7. Refusing a tender of performance (Section 46).

Release of the principal obligor (Section 39)

It would seem logical that if the primary obligor is released by the creditor, that discharge of the underlying obligation would also discharge the guarantor. After all, the guarantor is only guarantying the underlying obligation, and if the underlying obligation is no more, there is nothing left to be guaranteed. The Restatement seems to follow this logic in Section 39.

In commercial transactions, however, sometimes it is reasonable to release the primary obligor and preserve the creditor's rights against the guarantor. In the old days, some jurisdictions adopted the reservation of rights doctrine. Under this doctrine, the creditor could preserve his rights against the guarantor through a mere declaration that it was "reserving rights." In some cases, the declaration did not even need to be provided to the guarantor. The Restatement rejects the reservation of rights doctrine in a rather unflattering comment, stating specifically "the traditional reservation of rights doctrine has outlived whatever usefulness it may have had." Restatement § 38 cmt. a. Now, if a creditor wants to preserve its rights against the guarantor, it must follow the procedures in Section 38 of the Restatement. Specifically, to preserve the creditor's rights against the guarantor, the creditor must preserve the guarantor's "recourse" against the principal obligor. Restatement § 38(2). Simply, if the creditor's actions discharge the primary obligor, the guarantor should also be discharged unless the creditor takes some action to preserve the guarantor's rights against the primary obligor. Thus, under the Restatement, creditors can no longer unilaterally discharge the primary obligor in hopes that they can still proceed against a guarantor.

Extension of time on primary obligation (Section 40)

Creditors routinely extend the time of performance on primary obligations through renewals and extensions. Most form guarantees allow for such extensions and renewals. In fact, that is the definition of a continuing guaranty. Section 40 of the Restatement provides that if an extension is given on the primary obligation, that "extension also extends the time for performance by the guarantor." Restatement § 40(a). However, if the extension occurs without the consent of the guarantor and causes a loss to the guarantor, the guarantor is discharged to the extent of that loss. Restatement § 40(b). Further, the guarantor may have a "claim

against the [creditor] to the extent provided in § 37(4)." Restatement § 40(d). So, not only could an extension result in the discharge of a guarantor, but could even result in a counterclaim for damages by the guarantor against the creditor.

Modification of the underlying obligation (Section 41)

Similar to extensions, primary obligors and creditors routinely modify the terms of a primary obligation, and such flexibility is usually given these parties in form guarantees. Obviously, to the extent the modification alters the performance requirements, so too are the guarantor's duties "correspondingly modified." Restatement § 41(a). If the modification creates a "substituted contract" or imposes risks on the guarantor fundamentally different from those imposed by the original transaction, the guarantor is discharged. Restatement § 41(b)(i). Further, even if the modification does not rise to this level, the guarantor may still be discharged to the extent that the modification would otherwise cause the guarantor a loss. Restatement § 41(b)(ii). Also similar to extensions, if the creditor changes the risks imposed on the guarantor, the guarantor may have a "claim against the [creditor] to the extent provided in § 37(4)." Restatement § 41(d).

Impairment of collateral (Section 42)

The Restatement provides the following non-exhaustive list of actions by a secured creditor that might impair the value of a security interest in collateral pledged for a primary obligation:

> (a) failure to obtain or maintain perfection or recordation of the interest in collateral;
> (b) release of collateral without substitution of collateral of equal value or equivalent reduction of the underlying obligation;
> (c) failure to perform a duty to preserve the value of collateral owed to the principal obligor or the secondary obligor; and
> (d) failure to comply with applicable law in disposing of collateral.

Restatement § 42(2). If the creditor is a secured creditor and impairs the value of its own security interest, the guarantor may be "discharged to the extent" of such impairment. Restatement § 42(1). In this situation, the Comments explain,

> Thus, when the [creditor] impairs the value of the collateral, the [creditor] impairs the ability of a [guarantor] who performs the secondary obligation to pass the costs of that performance to the principal obligor. As between the principal obligor and the [guarantor], it is the principal obligor that ought to bear this cost. The [creditor's] impairment of collateral interferes with this allocation. Accordingly, the [guarantor] is discharged to the extent of the impairment of collateral.

Restatement § 42 cmt. a. Such impairment argument would be fact intensive. As discussed earlier, Article

9 puts the burden of proof on the creditor to show that the amount of the proceeds from a commercially reasonable sale would not have been equal to the amount of the obligation. It is unclear who bears the burden of proof for the extent of the loss under the Restatement.

Allowing the statute of limitations to run on the underlying obligation (Section 43)

The Restatement specifically addresses the situation in which the creditor allows the running of the statute of limitations on the underlying obligation. To the extent the primary obligor can avoid the obligation to the creditor by asserting the statute of limitations, the guarantor is also discharged from duties to the creditor. Restatement § 43.

Other conduct impairing the ability of the guarantor to recover from the principal (Section 44)

In addition to conduct relating to impairment of collateral, the creditor may engage in other conduct that could impair the rights of the guarantor against the primary obligor. For example, the creditor might impair the obligor's duty of performance or duty to reimburse, or might impair the guarantor's right of restitution or subrogation. To the extent that any of these actions cause the guarantor a loss, the guarantor is discharged from its duties. Restatement § 44. The Restatement looks at the guaranty relationship as a three party relationship with duties flowing between all three parties, the primary obligor, the creditor and the guarantor. If the creditor engages in activity that detrimentally impacts the relationship between the primary obligor and the guarantor, the guarantor may be discharged to the extent of that loss.

Refusing a tender of performance (Section 46)

Logically, if the primary obligor tenders performance and the creditor refuses that tender, it only makes sense that the guarantor would be "discharged to the extent that the performance tendered would have discharged the" guarantor. Restatement § 46(1). Similarly, if the guarantor tenders performance and the creditor refuses, the guarantor "is discharged to the extent that refusal of such tender causes the [guarantor] a loss." Restatement § 46(2). A tender is "a valid and sufficient offer of performance," and the terms of the performance are determined by the underlying agreement between the parties. *See* Restatement § 46 cmt. A.

Conclusion

Defending a guarantor can be a difficult task. The Supreme Court's decision in *Lanford* offered little hope. With the adoption of revised Article 9 in 2001 and revised Articles 3 and 4 in 2008, with specific references to the general law of suretyship and guaranty, perhaps some defenses will be available against some of the more egregious conduct engaged in by creditors.

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