

**IN DEFENSE OF THE GUARANTOR:  
Changes in the Laws Relating to the  
Discharge of Secondary Obligor**

Prepared by and Presented by

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## **Introduction.**

In 1994, the South Carolina Supreme Court set the stage in commercial transactions that left guarantors largely defenseless. Since 1994 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.

Since 1994, the South Carolina General Assembly adopted a revised Article 9 of the UCC, effective in 2001,<sup>1</sup> and revised Articles 3 and 4 of the UCC, effective in 2008.<sup>2</sup> In both revisions, the role of a guarantor is addressed and potential defenses for the guarantor are envisioned. Specifically, Chapter 6 of Article 9 deals with the rights and obligations of a lender that is a secured party and the lender's actions in dealing with the collateral may create defenses for the guarantor. Similarly, Article 3 of the UCC provides numerous defenses to a guarantor that is a party to the instrument and the comments to that section signal these same defenses should be available to a guarantor that signs a separate guaranty.

This article will proceed by (1) discussing the law of guarantees in South Carolina as developed in 1994, (2) the discussion of guarantors in revised Article 9 and the defenses created in 2001 by the adoption of the revised Article 9, (3) the implicit incorporation of the Restatement of

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<sup>1</sup> In 2001 Act No. 67, effective July 1, 2001, the South Carolina General Assembly enacted the current version of Article 9 found in S.C. Code Ann. §36-9-101 et. seq.

<sup>2</sup> In 2008 Act No. 204, effective July 1, 2008, the South Carolina General Assembly enacted the current version of Articles 3 and 4 found in S.C. Code Ann. §36-3-101 et seq. and S.C. Code Ann. §36-4-101 et seq. In the adoption, instruments executed prior to July 1, 2008 are still governed by the 1962 Official Text of Articles 3 and 4 of the UCC as approved on May 5, 1966 and as effective in South Carolina on January 1, 1968.

the Law, Third, Suretyship and Guaranty (1996) (“the Restatement”) in the general law relating to the defense of guarantors when the new Articles 3 and 4 were adopted, and (4) the defenses created in the incorporation of the Restatement.

## 1. 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.<sup>3</sup> In *Citizens and 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 that existed as it related to those defenses, the Supreme Court held that these issues did not matter because guarantors were not entitled to the protections as provided by former Section 36-

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<sup>3</sup> Because a guarantee is by its definition an undertaking by one person to be liable for the debts of another, the guarantee must be in writing. Specifically, Section 32-3-10(2) of the South Carolina Code of Law states that “no action may be brought ... to charge the defendant upon any special promise to answer for the debt, default or miscarriage of another person ... unless the agreement upon which such action is brought ... is in writing.” See S.C. Code Ann. §32-3-10(2) (2007). Because it is a contract, the general contract defenses would still be available, however, this paper will not discuss the general contract defenses such as fraud in the inducement, breach by the plaintiff, impossibility, etc.

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 §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 §36-3-604(2) (2003).

Thus, under *Lanford*, one is left with the distinct impression that there are few defenses for a guarantor. But, the law started to change in 2001 with the adoption of the revised Article 9 and this change was strengthened and reinforced by the adoption of the revised Articles 3 and 4.

## **2. Article 9 - The 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 guarantors.<sup>4</sup> By including guarantors within these generic terms, the duties of the secured party to the debtor or obligor flow to the guarantors. Section 36-9-608(a)(4) states the general rule that a “secured party 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).<sup>5</sup>

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<sup>4</sup> *See* S.C. Code Ann §36-9-102(28) (defining debtor as anyone having “an interest, other than a security interest or other lien, in the collateral”); S.C. Code Ann. §36-9-102(59) (defining obligor to include anyone that “is otherwise accountable in whole or in part for payment or other performance of the obligation”); *Singleton v. Stokes Motors, Inc.*, 358 S.C. 369, 595 S.E.2d 461 (2004) (holding that a debtor includes anyone that owes payment or other performance of the obligation secured).

<sup>5</sup> Section 36-9-605 limits the people that these duties flow to by stating that a secured party does not owe a duty based on its status as a secured party to a person unless the secured party knows the person and knows how to communicate with

Upon default, the secured party may take possession of the collateral. S.C. Code §36-9-609. But after taking possession, every aspect of disposition of the collateral “must be commercially reasonable.” S.C. Code §36-9-610. The requirement of commercially reasonable 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 §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 Secured Party does not follow the requirements of acting in a commercially reasonable manner, Section 36-9-625 provides the 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 and §36-9-626. Further, if a section of the code is not complied with, 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).<sup>6</sup>

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

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the person. S.C. Code Ann. §36-9-605. Because guarantees must be in writing, the duties included in Article 9 would flow to guarantors, unless the lender is receiving written guarantees from people unknown to it.

<sup>6</sup> In consumer transactions, Section 36-9-626(b) provides that the limitation of subsection (a) does not limit the court’s determination and instead “may continue to apply established approaches.” These established approaches may be quite costly for a secured creditor. See *Singleton v. Stokes Motors, Inc.*, 358 S.C. 369, 595 S.E.2d 461 (2004)

### **3. The Incorporation of the Laws of Sureties.**

In 2008, the South Carolina legislature adopted newer versions of the UCC's Articles 3 and 4. The newer version of the UCC has significant changes from the 1962 version that South Carolina had been using since 1968. The adoption eliminated former Sections 36-3-604 and 36-3-606. The new sections most similar to these former sections are found at 36-3-603 and 36-3-605, respectively. These newer versions continued to provide for certain defenses and appear to continue to limit the application of these defenses to a "party to the instrument." A party to the instrument appears to continue to be limited to someone actually signing the instrument as a maker, drawer, acceptor or indorser. *See* S.C. Code §36-3-103(11) (definition of Principal Obligor); §36-3-103(17) (definition of 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. But, some defenses may be developed upon closer inspection of the comments to these sections.

The first official comment to Section 36-3-605 states:

This section contains rules that are applicable when a secondary obligor (as defined in Section 3-103(a)(17)) is a party to an instrument. These rules essentially parallel modern interpretations of the law of suretyship and guaranty that apply when a secondary obligor is not a party to an instrument. *See generally* Restatement of the Law, Third, Suretyship and Guaranty (1996). Of course, the rules of this section do not resolve all possible issues concerning the rights and duties of the parties. In the event that a situation is presented that is not resolved by this section (or the other related sections of this Article), the resolution may be provided by the general law of suretyship because, pursuant to Section 1-103, that law is applicable unless displaced by provision of this Act.

S.C. Code §36-3-605 (Official Comment 1) (Law. Co-op. 2009 Supp). Thus, the official comment

provides a clear indication that the law of suretyship is applicable in situations where 36-3-605 does not apply. Similarly, the second official comment states:

Like the law of suretyship and guaranty, Section 3-605 provides secondary obligors with defenses that are not available to other parties to the instruments. The general operation of Section 3-605, and its relationship to the law of suretyship and guaranty, can be illustrated by an example. Bank agrees to lend \$10,000 to Borrower, but only if Baker also is liable for repayment of the loan. The parties could consummate that transaction in three different ways. First if Borrower and Baker incurred those obligations with contracts not governed by this Article (such as a note that is not an instrument for purposes of this Article), the general law of suretyship and guaranty would be applicable. Under modern nomenclature, Bank is the “obligee,” Borrower is the “principal obligor,” and Baker is the “secondary obligor.” See Restatement of Suretyship and Guaranty Section 1. Then assume that Bank and Borrower agree to a modification of their rights and obligations after the note is signed. For example, they might agree that Borrower may discharge its repayment obligation by paying Bank \$3,000 rather than \$10,000. Alternatively, suppose that Bank releases collateral that Borrower has given to secure the loan. Under the law of suretyship and guaranty, the secondary obligor may be discharged under certain circumstances if these modifications of the obligations between Bank (the obligee) and Borrower (the principal obligor) are made without the consent of Baker (the secondary obligor). The rights that the secondary obligor has to a discharge of its liability in such cases commonly are referred to as suretyship defenses. The extent of the discharge depends upon the particulars circumstances. See Restatement of Suretyship and Guaranty Section 37, 39-44.

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The third possibility is that Borrower would use an instrument governed by this Article to evidence its repayment obligation, but Baker’s obligations would be created in some way other than by becoming party to that instrument. In that case, Baker’s rights are determined by suretyship and guaranty law rather than by this Article. See comment 3 to Section 3-419.

S.C. Code §36-3-605 (Official Comment 2) (Law. Co-op 2009 Supp.). These clear and unequivocal references to the general laws of suretyship provide defenses to individuals that are not “parties to

the instrument.” In fact, the third possibility is a description of the commercial transaction involved in *Lanford*. That note was a commercial instrument and the court found that the guarantor was not a party to the instrument.

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, similar to former section 36-3-604, but that section 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 §36-3-603(a) (Law Co-op. 2009 Supp.). The principles of law applicable to simple contracts 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 direction and provided guarantors with hope that they may have defenses against unreasonable and unjustified actions by the creditor.

#### **4. The 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 §6. 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.<sup>7</sup> Further, some general defenses are so

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<sup>7</sup> The comments to the Restatement make it clear that the “rules concerning unconscionability place limits on the parties’ freedom to contract, and rules concerning good faith and fair dealing place limits on the parties’ freedom to act within the confines of the contract.” Restatement §48, Comment a.

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.<sup>8</sup>

Generally, the Restatement provides the following 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).

These section will be briefly discussed in the following sections of this article but, Section 37 of the restatement is a collection of rules that provide for a two level approach to these defenses. Simply, the Restatement’s rules are different depending on whether the creditor’s acts fundamentally alter the risks imposed on the surety (Section 37(2)) where “the secondary obligor is discharged from any unperformed portion of the secondary obligation” or whether the creditor’s acts simply impair the

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<sup>8</sup> For example, Restatement Sections 37(b)(2) and 41(b)(ii) provide the guarantor is discharged when the creditor enters into agreements with the principal obligor that impose risks on the guarantor fundamentally different from those imposed on the guarantor at the time of the contract. *See* Restatement §37(2)(b) (providing for the discharge if from any unperformed portion of the obligation if the creditor modifies the duties of the principal obligor that “imposes risks fundamentally different from those imposed on the secondary obligor prior to the modification”); Restatement 41(b)(ii) (same). Restatement 48(1) providing a list of those defenses that may be waived in the “contract creating the secondary obligation” and specifically does not including the defenses provided for in §37(2)(b) or §41(b)(ii). The concept that a defense that cannot be waived is similar to UCC’s prohibition on the waiver of certain defenses in Article 9. *See* S.C. Code Ann. §36-9-602 (Law Co-op 2003) (adopted in South Carolina pursuant to 2001 Act No. 67.

surety's recovery against the principal obligor (Section 37(3)) where "the secondary obligor is discharge from its duties ... to the extent [necessary] to prevent the impairment of recourse from causing the secondary obligor a loss." Restatement §37.

### **3.1 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. But, in commercial transactions sometimes it is reasonable to release the primary obligor and preserve the creditor's rights against the guarantor. The possibility of preserving the creditor's rights against the secondary obligor are provided for in Section 38 of the Restatement, but this preservation does not occur simply by the creditor seeking to preserve its rights. Specifically, the Restatement rejects the reservation of rights doctrine<sup>9</sup> and instead requires the creditor to preserve the "secondary obligor'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. Without this preservation, Section 39 provides that a release of the principal obligor by the creditor also acts as a release of the primary obligor's duties to the guarantor. See Restatement §39. Thus, the Restatement prevents the inequitable result that would occur if a creditor released

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<sup>9</sup> Under the reservation of rights doctrine, the creditor could preserve his rights against the secondary obligor through a mere declaration that it was "reserving rights." In some cases, the declaration did not even need to be provided to the secondary obligor. The Restatement adopts the position that "the traditional reservation of rights doctrine has outlived whatever usefulness it may have had." Restatement §38 Comment a.

the primary obligor and yet continued to pursue the guarantor.

### **3.2. 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 basically 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 “cause(s) the secondary obligor a loss”, the guarantor is discharged to the extent of that loss. Restatement §40(b). Further, the guarantor may have a “claim against the obligee to the extent provided in §37(4).” Restatement §40(d). Thus, caution should be taken in given extensions in deepening insolvency situations without the consent of guarantors.

### **3.3 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 the form guarantees. Obviously, to the extent the modification alters the performance requirements, so too are the guarantors duties “correspondingly modified.” Restatement §41(a). But, “if the modification creates a substituted contract or imposes risks on the secondary obligor fundamentally different from those imposed pursuant to the transaction prior to the modification” 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 secondary obligor 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).

### **3.4. Impairment of Collateral (Section 42)**

The Restatement provides the following non-exhaustive list of things that a secured creditor could do that are seen as impairing 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 security interest, the guarantor may be “discharged to the extent” of such impairment. Restatement §42(1); *see also* S.C. Code Section 36-9-610(b); 36-9-611, 36-9-613 and 36-9-614 (dealing with the discharge of the principal obligor because of the impairment of collateral through a commercially unreasonable sale, without notice). In this situation, the Comments explain,

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

Restatement §42 Comment a. Such impairment argument would be fact intensive. As discussed

earlier, Article 9 puts the burden of proof on the creditor if it acts in a commercially unreasonable manner. It is unclear who bears the burden of proof for the extent of the loss under the Restatement.

### **3.5. Allowing the Statute of Limitations to Run on the Underlying Obligation (Section 43)**

The Restatement specifically addresses the situation where 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 “discharged from duties to the obligee.” Restatement §43.

### **3.6. Other conduct impairing the ability of the guarantor to recover from the principal (Section 44)**

In addition to issues relating to impairment of collateral, the creditor may engage in other conduct that could impair the rights of the guarantor against the primary obligor. Section 44 provides:

If otherwise than described in §§39-43 the obligee impairs the principal obligor’s duty of performance (§21), the principal obligor’s duty to reimburse (§§22-25), or the secondary obligor’s right of restitution (§26) or subrogation (§§27-31), the secondary obligor is discharged from its duties pursuant to the secondary obligation to the extent that such impairment would otherwise cause the secondary obligor a loss.

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 effect of that loss.

### **3.7. 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 secondary obligor a loss.” Restatement §46(2). A tender is “a valid and sufficient offer of performance” and the terms of the performance can be determined by the underlying agreement between the parties. See Restatement §46 Comment 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, revised Articles 3 and 4 in 2008 and the specific references to the general law of suretyship and guaranty, perhaps some of the defenses previously not available will allow a defense against some of the more egregious conduct engaged in by creditors.