Guarantor Liability

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In tough economic times, it becomes more common to see borrowers default on loans. Business ventures that previously held infinite promise during an economic boom become sources of liability when the economy takes a downturn. As individuals and businesses stop making payments on their loans, lenders seek payment through other means. For guarantors, the default of a principal debtor may result in massive liability. This article discusses the potential liability of guarantors under Nebraska law, and demonstrates that guarantors are often less protected than they may assume.

The Nebraska Supreme Court has defined a guaranty as "a contract . . . to answer for the payment of a debt or the performance of some contract or duty in case of the default of another person who is liable for such payment or performance in the first instance." Guaranty contracts are strictly construed in Nebraska, and the liability of guarantors is governed by the precise terms of the contract. Although it is generally true that a guarantor's liability does not arise until the principal debtor defaults, some people wrongly assume that a guarantor's liability only covers the amount outstanding after the principal debtor's assets have been liquidated. Any confusion on what a guarantor is liable for – and when that liability is determined – may arise from a misunderstanding of Nebraska law.

In Nebraska, a "surety" includes a guarantor, which means that guarantors are protected by the suretyship provisions of the Nebraska Revised Statutes. In particular, Neb. Rev. Stat. § 25-1544 provides that "[i]n all cases the property, both personal and real, of the principal debtor, within the jurisdiction of the court, shall be exhausted before any of the property of the surety or bail shall be taken in execution." Based upon this statutory language, some guarantors may believe that a lender

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must exhaust all sources of collateral from a principal debtor before seeking payment on a guaranty contract. However, the provisions of this statute are "fallback rules" and only become effective if the guaranty contract is silent on that issue. In other words, the terms of a guaranty contract can trump the statutory protections that a guarantor could otherwise rely upon.

Guarantors can (and usually do) waive certain statutory rights in a guaranty contract. Indeed, most lenders, landlords, or other creditors include express waiver provisions to limit the defenses available to guarantors. With such waivers in place, creditors can then extend the full liability of a debtor to the guarantor immediately upon any default by the debtor (subject to any exceptions in the guaranty contract). Because guaranty contracts are strictly construed in Nebraska, an express waiver often means that a creditor may proceed directly against the guarantors in the event of a default by a principal debtor.

Recent case law from the Nebraska Supreme Court suggests that no exception will be made for guarantors looking to overcome the rule of strict construction. In *Builders Supply Co., Inc. v. Czerwinski* (2008), an officer of a real estate development company ("Debtor") signed a guaranty stating that she would "absolutely and unconditionally guarantee . . . prompt repayment when due of all amounts advanced in the past . . . and of all amounts advanced in the future." The Debtor had previously signed an agreement (to which the guarantor was not a party) with the creditor stating that the maximum line of credit extended to Debtor would be $525,000; however, the creditor subsequently extended more than $525,000 of credit to Debtor. When Debtor filed for bankruptcy in 2006, it owed in excess of $1,400,000 to the creditor. The guarantor attempted to rely on Debtor's prior agreement with creditor to limit her liability to $525,000, but the Nebraska Supreme Court noted that "in the absence of a limit in a guaranty, the presence of a credit limit in a separate credit agreement does not create a limit in the corresponding guaranty." The Court also stated: "It is the guaranty agreement that contains the express condition on the guarantor's liability and that defines the obligations and rights of both guarantor and guarantee."

The Eighth Circuit Court of Appeals has also recently upheld the rule of strict construction of guaranty contracts. In *Henning v. Mainstreet Bank* (2008), the owner and officer of a landscaping company personally guaranteed $600,000 of his company's debt to a bank and secured his guaranty with a mortgage on his home. The guaranty contract stipulated that the bank would release the mortgage after $200,000 of the company's principal balance was paid, and the guaranty itself would be released after an additional $200,000 was paid. After paying approximately $124,000 on the debt, the company defaulted on its loan and the bank recovered an additional $196,000 from a liquidation of certain company assets. The bank then sought to enforce the guaranty contract to recover the outstanding balance from the guarantor. The guarantor subsequently filed for bankruptcy and argued that the bank was required to release the mortgage after the bank had recovered more than $200,000 from the company. However, the Eighth Circuit Court of Appeals determined that the guarantor's definition of "paid" was contrary to the intention of the parties and, therefore, the mortgage was not released because the company had not paid at least $200,000 before going into default.

Although Nebraska statutes offer guarantors some protection against being held liable for the full amount of a primary debtor's liabilities until after the debtor's assets have first been applied against the debt, most guarantors are probably less protected than they think. The statutory defenses available to guarantors may be waived, and lenders, landlords, or other creditors generally include express waivers in their standard form guaranty contracts so that guarantors can be held liable for the full amount of a debtor's liabilities immediately upon a default. As recent case law demonstrates, guaranty contracts are strictly construed and a guarantor's waiver of statutory protections are enforceable. Accordingly, guarantors and the party receiving the benefit of the guaranty should each have an understanding of when the guarantor's liability will arise (or be released) and draft the guaranty contract to reflect that understanding. By working through any unique issues that need to be considered in a guaranty contract, the guarantor and party receiving the benefit of such guaranty can avoid disputes in the future in the event that a primary debtor defaults on liabilities or obligations covered by the guaranty contract.

By Thomas F. Ackley