

MARKS & WEINBERG, P.C.

GUARANTIES: For Your Consideration

By Barry Marks & Ken Weinberg

It is not unfair to say that courts are not kind to guaranties. Important as they are to credit decisions, particularly in small business transactions, guaranties have been subjected to more judicially-created defenses than any other leasing document. Judges have required a variety of notices to guarantors, permitted guarantors to wriggle out of their obligations due to changes in the underlying transaction, required lawsuits be maintained against the primary obligor first and thrown up a fusillade of assorted hoary-headed legal requirements from Dickensian England and earlier.

One particularly nasty defense, however, is something that any lessor should be able to avoid and one for which we can only blame ourselves if it trips us up: *consideration*. Every lawyer and most leasing professionals are well aware that a binding contract requires consideration, value to the obligor.

What is the consideration for a guaranty? In the classic "downstream" guaranty where a parent guaranties the obligations of its subsidiaries or an owner guaranties the obligations of his or her corporation or other business entity, the consideration is obvious: the value of the stock or interest of the parent/owner is increased by the credit infusion.

In an upstream guaranty, on the other hand, a subsidiary is guarantying the obligations of its parent. When the leasing company tries to enforce the guaranty, the guarantor may argue that the lease with the parent does not directly benefit the subsidiary and that the guarantor is therefore unenforceable for lack of consideration.

A smart lessor will try to mitigate the risk of losing to such a defense by the guarantor by documenting the consideration that the guarantor receives. For example, if the guarantor receives the right to use the equipment or the parent's use of the equipment will somehow result in increased revenues to the subsidiary, the lessor can describe those benefits in the guaranty. At the very least, a memorandum should be placed in the file explaining how the guarantor benefits.

If the guaranty is particularly important to the credit decision and it is difficult to show the guarantor as receiving any significant benefit, the lessor may want to require the lessee to pay a "guaranty fee" to the guarantor in consideration for its providing the guaranty. How much depends on the circumstances, but it must be enough to be meaningful in light of the risk and not a mere token payment. More on this later.

Another type of guaranty is the "cross-stream" guaranty in which a brother-sister company relationship exists, such as two corporations owned by the same parent or individual. There is a similar question of consideration and a similar lack of a clear answer. Again, the lessor should be prepared to show how the guarantor benefits from the lease to the lessee or may choose to use a guaranty fee. While these guaranties are less clearly defective than upstreams, they are subject to attack and far from safe.

Many clients ask how much value must be given to the guarantor to establish adequate consideration. Clearly, a token payment or insignificant benefit is not enough. Generally, however, the value does not have to equal or even closely approximate the potential loss if the guaranty must be paid. There is, however, one major exception:

Where the guarantor is insolvent as an accounting matter, such as where the book value of its assets is so low that the contingent liability of the guaranty or other obligations can cause it to be technically insolvent, the consideration must be "reasonably equivalent value" or the transaction will be deemed a "fraudulent transfer" under most states' laws. This situation should be unusual in leasing transactions but subleases and guaranties executed in connection with stock sales can result in surprise fraudulent transfers.

What to do? In addition to documenting value to the guarantor or requiring the lessee to pay a guarantor fee, sometimes it makes sense to lease to the subsidiary and let it sublease to the parent. Consider whether a pledge of stock or membership interests by the parent will give the practical benefits of the guaranty by the subsidiary. Sometimes multiple parties can join in the lease as lessee or establish that all will have access to the equipment from time to time.

This last suggestion requires care and raises its own issues as joint lessees and pooling arrangements must be considered a last-ditch means to avoid upstream or cross stream guaranties. All such arrangements must include agreements by the lessees that only one of them is required to execute any amendment or consent and that a default by any one terminates the others rights, especially any right of quiet enjoyment.

Given the importance of guaranties in many transactions, it never hurts to pay attention to these details.

MORE ON EQUIPMENT LEASE GUARANTIES

Thanks to everyone who responded to our recent article on guaranties executed in equipment finance transactions. In answer to many of the questions, and further to the issues raised in the article:

1. The most common question that was raised was whether intra-family guaranties escaped the consideration issue. The usual case in point is that papa has all the money and is providing a guaranty for Junior's new business.

The courts have been very creative in this situation about accepting "love and affection", a duty to provide support in the future (long-term care) and such as consideration for the guaranty. Generally speaking, when we are dealing with individuals we can be a little less stringent on the rules, particularly where a family or other personal relationship is involved. We still like to consider the issue and have some documentation in the file as to why the parties think there is good consideration.

2. This brings about a very important point that we want to reiterate: We are not saying that upstream, cross-stream or other guaranties that do not clearly show significant consideration are *worthless*. We are saying that they are *vulnerable* to attack and their value should be considered.

3. It is also important to bear in mind that the court is going to look carefully at any guarantor trying to get out of a guaranty by claiming failure of consideration. The worst problem is where a third party creditor is involved. This will most commonly arise in a *secured* guaranty.

Obviously, if the guaranty is going to have any value, the guarantor's credit must be strong. The likelihood of the guarantor going bankrupt should be far less than that of the lessee defaulting. The exception to the rule is where a secured guaranty is involved and the guarantor is providing collateral for someone else's lease or loan.

The consideration issue is most important in those situations. The possibility exists that the guarantor might, in fact, follow the lessee into bankruptcy and the Trustee for the guarantor or a third party creditor, might attack the lessor/lender's security interest in the collateral pledged as security for the guaranty.

Once again, no one is saying that the guaranty is worthless or that the security interest unenforceable. The point is that, going into any guaranty situation, we advise readers to take a moment and consider what the consideration to the guarantor is and whether it represents what a reasonable person would consider "reasonable", "adequate", "sufficient" or the like in common parlance.

4. The Model Business Corporation Code, which has been enacted in most states, includes a statute granting broad authority for boards of directors to approve corporate guaranties. We are not aware of any case that has construed this to do away with the consideration requirement or to address the other issues we raised in our article. Nevertheless, it may be helpful in convincing banks and other funders to accept corporate guaranties if there is a question about the corporation's legal authority to execute the guaranty.

Unfortunately, the subject addressed by the statute raises another issue: Does the execution of a guaranty always require the approval of a board of directors? We generally take a conservative view on this subject when representing the bank, but sometimes the argument can be made that the execution of the guaranty, like the lease or loan itself, is in the "ordinary course of business" of the corporation and therefore

something that the president or perhaps a vice president can approve in the course of the company's business.

This issue merits its own article, but we suggest you consider whether the equipment being used is essential to the subsidiary's or other affiliated company's business and whether the party providing the guaranty is actually an entity clearly formed for the purpose of providing the guaranty.

Barry Marks and Kenneth P. Weinberg are founding partners of Marks & Weinberg, PC. They have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. If you would like more cases or articles on leasing, or have any questions or comments about this Article or other leasing issues, please visit www.lease lawyer.com or contact Barry at 205-251-8303 or Ken at 205-251-8307.

