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DISPATCHES FROM THE TRENCHES

Guaranties: How Certain Is Your Security?

By Kenneth P. Weinberg

Some leasing companies obtain personal guaranties in all transactions. Others obtain them when they are readily available or only when absolutely necessary. In any event, guaranties are certainly the engines that drive many transactions. However, lessors relying on guaranties should be aware of some limitations on their enforceability. In addition, lessors in small ticket and middle market transactions should make sure they have strong forms and should be careful not to negotiate them. The remainder of this issue of dispatches from the trenches focuses first on the risk of "upstream" and "cross-stream" guaranties and then concludes with some other general advice on guaranties.

Courts generally favor only the classic "downstream" guaranty where a corporate parent guaranties the obligations of its subsidiaries or an owner guaranties the obligations of his, her or its corporation or other business entity. In upstream guaranties, a subsidiary is guarantying the obligations of its parent. When the leasing company tries to enforce the guaranty, the guarantor may raise a defense of lack of consideration. In other words, the guarantor will argue that the lease with the parent does not directly benefit the subsidiary and that the guarantor is therefore unenforceable. A lessor can always argue that it detrimentally relied on the guaranty when entering into the transaction, an argument that may or may not be successful.

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 tangible benefits, the lessor may want to require the lessee to pay a "guaranty fee" to the guarantor in consideration for its providing the guaranty.

So-called "cross-stream" guaranties fall somewhere between the downstream and upstream guarantees. In these situations, 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.

Another issue important for lessors who frequently utilize guaranties involves work-outs, amendments and defaults. The rule is simple: always treat the guarantor identically with the lessee for purposes of notices and amendments regardless of whether the form guaranty states that the guarantor waives its rights to any notice of such changes. The guarantor should be given notice of a proposed amendment to the lease or change in the payment structure to facilitate a work-out and should consent to the amendment or work-out in writing. The guarantor should always be given notice of default and, if remedies are to be exercised, of the remedies at hand. Changes to the version of Article 9 of the UCC implemented in 2001 clarify this as the definitive rule with respect to leases intended as security.

The reason for treating guarantors the same as lessees generally is that courts go to great lengths to find prejudice against guarantor's rights where the guarantor is not kept in the loop. Despite language contained in proper guaranties waiving notices and stating that the guarantor's obligations are unconditional, many cases have held that the guarantor took on more of a risk than he, she or it bargained for.

For example, in *Ace Leasing, Inc. v. Boustead*, 55 P.3d 371 (Mt., 2002), the lessor failed to file a financing statement covering the leased equipment. When lessee defaulted and the lessor tried to recover from the guarantor under the terms of the guaranty, the guarantor claimed that the original obligation of the lessee had been materially altered in a manner that increased her risk and that she was therefore exonerated from liability pursuant to §28-11-211 of the Montana Code. The Court

agreed, holding that the lessor's failure to properly perfect a security interest in the leased equipment materially altered the risk born by guarantor.

Sometimes, language in the guaranty will save the lessor and this is one reason that guaranties should generally be considered non-negotiable by small ticket and middle market lessors. For example, in *Comi v. DSC Finance Corporation*, 994 F. Supp. 121 (N.D.N.Y. 1998), the lessor reached a settlement with the lessee with regard to the lease and sought to enforce its rights against the guarantor under the terms of the guaranty. The guarantor claimed it should have no liability under their guaranty. The court agreed with the guarantor that the general rule is for any release of the primary obligor (i.e. the lessee) to automatically release the guarantor. However, the court focused on language in the guaranty which specifically authorized the lessor to release the lessee without impairing the ability to seek payment from the guarantor and, as a result of that language, the court upheld the guaranty.

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, 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. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit www.leaselawyer.com or contact Weinberg at 205-251-8307.



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