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DISPATCHES FROM THE TRENCHES

Guaranties: For your Consideration
By: Barry Marks and 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 finance 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. These defenses are a primary reason why many form guaranties are so full of legalese that they are hardly readable and whey many lawyers and others in the industry are reluctant to make any changes at all in their form guaranty. For example, a seemingly simple change which causes a guaranty to be a õguaranty of collectionö can have disastrous consequences, making the guarantorøs obligations secondary instead of primary.

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 õconsiderationö. Consideration is simply the legal term meaning that something of value is received by the party claimed to be bound by the contract.

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.

When it comes to intra-family guaranties (such as when papa has all the money and is providing a guaranty for Juniorøs new business), this issue is a little vaguer. There, the courts have been very creative about accepting õlove and affectionö, a duty to provide support in the future (long-term care) and similar intangible benefits as sufficient consideration for the guaranty.

Returning the discussion to corporate or other guaranties executed by companiesô if you do not have a parent guarantying the debt of a subsidiary, you may be faced with either an õupstream guarantyö or a õcross stream guarantyö. In an õupstream guarantyö, 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. Such an argument could also be made by *other creditors* seeking to preserve more of a given guarantorøs liquidity for their own account. The likelihood increases further in the case of a secured guaranty in a bankruptcy proceeding since defeating the guaranty will result in more assets for unsecured creditors and, frequently, a larger pay check for the Bankruptcy Trustee.

A smart lessor will try to mitigate the risk of losing to a õfailure of considerationö defense 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. Consider for example where the guarantor company sells products manufactured by its parent companyô whose lease or loan obligations are being guarantied. If the subsidiaryøs guaranty allows the parent company to acquire a new machine which will increase the amount of product it is able to produce, this benefits the guarantor by providing it more product to sell and a means of generating more revenue.

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 upstream guaranties, they are subject to attack and far from safe.

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. Although a token payment or insignificant benefit is not enough, the value generally does not have to equal or even closely approximate the potential loss if the guaranty must be paid. One thing that might help is to consider the amount a company would have to pay for a bank to issue a standby letter of credit. This test does not provide a bright-line rule since a bank letter of credit should be considered more valuable than an affiliate guaranty. However, it can provide some guidance.

There is, however, one major area where there is more pressure for a higher fee to be required: 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 õreasonably equivalent valueö or the transaction will be deemed a õfraudulent transferö under most statesø laws. Its hard to describe such any test with words like õreasonably equivalentö This situation should be unusual in leasing transactions but subleases and guaranties executed in connection with stock sales can result in surprise fraudulent transfers.

If a lessor is unable to become sufficiently comfortable by documenting value to the guarantor or requiring the lessee to pay a guarantor fee, it can consider leasing to the subsidiary or brother-company pursuant to a slightly more complex transaction where the equipment is eventually subleased to the originally intended lessee. Such a transaction creates additional wrinkles but if properly structured can result in lessorøs comfortably having both companies õon the hookö.

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

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