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DISPATCHES FROM THE TRENCHES

Are you SURE you want Co-Borrowers/Co-Lesseees? A little something about Suretyship

Although the use of co-borrowers and co-lessees sometimes makes sense, some lenders and lessors unfortunately use a co-borrower/co-lessee structure in situations where the more traditional guarantor structure should be used. Co-lessee structures vary somewhat from co-borrower structures and some of those differences are discussed towards the end of this edition of Dispatches from the Trenches. However, many of the problems with both co-borrower and co-lessee structures are similar. Although most of this article discusses co-borrowers generally, the same analysis applies in co-lessee situations.

A co-borrower structure makes sense when both entities are receiving some of the funds being advanced. However, when only one party (the "Borrower") receives money and the other party is merely acting as a credit enhancer, that other party should be treated as a "Surety" irrespective of whether or not it is designated as a guarantor or a co-borrower in the applicable loan documentation. Suretyship has been defined as "the contractual relation whereby one person, the surety, agrees to answer for the debt, default, or miscarriage of another, the principal, with the surety generally being primarily and jointly liable with the principal debtor." State v. Federal Ins. Co., 10th Dist. No. 04AP-1350, 2005-Ohio-6807, ¶9.

Over the years, an extensive body of case law and statutory law has developed which grants sureties myriad defenses allowing them to avoid liability. Although the rules vary from jurisdiction to jurisdiction, many of these suretyship defenses stem from the premise that a Surety has rights against the primary obligor (in this case, the Borrower) that should be preserved. Basically, if the Surety is forced to pay the lender because the Borrower fails to perform its obligations, the Surety is subrogated to the rights of the Lender. In other words, the Surety can turn around and ask for reimbursement or restitution from the Borrower or may sometimes step into the lender's shoes to enforce the underlying obligations that the Borrower originally owed.

In order to preserve these rights, laws have developed which protect the Surety from actions that would alter these rights and put the Surety in a position that it did not originally believe to be part of its bargain. For example, an increase in the loan amount may require the Surety to pay more than it originally contemplated. Similarly, an impairment of collateral may put the Surety in a disadvantageous position. Such

impairment could include a voluntary release of collateral by the lender or a failure by the lender to perfect the type of security interest in the collateral, first priority or otherwise, that was originally anticipated.

An extension of the loan may also have adverse consequences. For example, if the Borrower and the lender extend the maturity date without the consent of the Surety and the financial condition of the Borrower deteriorates after the extension agreement has been executed, the Surety's liability to the lender may be reduced by the amount of the decline in the Borrower's net worth.

Most strong form guaranties contain carefully crafted language intended to waive these suretyship defenses and to protect lenders when dealing with the Borrower. That is one reason that many guaranties border on being unreadable to non-lawyers and why many lawyers resist changes to such documents.

If a Surety does not sign a guarantee, but rather signs a note as co-borrower, it is still entitled to all the suretyship defenses. Although some strong promissory notes contain similar waivers, intended in part to cover the risk of a co-borrower who is really merely a surety, there is a much greater chance that the "form note" being used by the lender is less protective in this regard than the form guaranty. Consider, for example, the potential suretyship defense discussed above that would be available in the event of an extension of the maturity date. Many lawyers would expect a strong form guaranty to provide that the guarantor remains liable notwithstanding any extension of the maturity date that may be accomplished by a written amendment of the loan documents executed by the Borrower and the lender. Such a provision would be more awkward in a promissory note and would have to say that a written amendment of the promissory note by one co-borrower was automatically binding on the other co-borrower.

In addition, there can be a debate in some states as to whether the types of issues addressed by suretyship waivers are enforceable within the context of a promissory note. Some courts believe that such waivers address legitimate concerns of lenders that are willing to accept a guaranty but that such waivers are too broad to be included in a promissory note. Of course, one would hope that courts which disfavor the effectiveness of such waivers in a note, would only do so on the basis that a primary obligor cannot make such waivers. If the co-borrower is a Surety rather than a primary obligor, it *should* be able to grant such waivers. Alternatively, if the co-borrower is a primary obligor, such waivers should not be necessary because suretyship defenses should not be available. However, by muddying the waters and designating a Surety as a co-borrower, a lender is relying on these courts to delve into the foregoing analysis. It would not be surprising for a court or legislature to instead favor a bright line which says suretyship waivers are not enforceable in promissory notes, period, and not proceed with the more detailed analysis contemplated by this paragraph.

There are other issues to consider when using a co-borrower structure. If the co-borrower signs the promissory note, will it also be signing the security agreement or related documents? If not, it may not be responsible for indemnities, maintenance and other obligations.

Matters can be even trickier when a Surety signs an equipment lease as co-lessee. What happens if one of the co-lessees declares bankruptcy? What if the co-lessees squabble

over the use and possession of the equipment or their respective obligations to pay taxes, remove liens or maintain the equipment? In short, a co-lessee situation is inherently more complex since it involves the right to use and possess equipment as well as the obligation to pay for its use. The same can be said for certain co-borrower situations such as an equipment finance agreement or a lease with a one-dollar purchase option. Quite simply, when rights in equipment are inextricably linked with payment obligations (whether under a lease, a lease intended as security or an equipment finance agreement) it is easier for co-lessees and co-borrowers to involve the lender in a dispute regarding the equipment in the same way that they cannot in many straight loan situations.

The key point is that even if you call a duck a monkey, it is still a duck. Lenders should proceed with caution before using a co-borrower structure when the underlying transaction really involves a borrower and a guarantor. The same guaranty risks are still at issue and using an improper structure may exacerbate the situation.

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