

## **Loan Guarantees During Tough Times**

As the real estate market wends its way through *epocha horribilis*, loan guarantors are for good reason wary of liability stemming from their written guarantees -- that is, their assumed responsibility for paying the debts of another, whether it be a person or an entity.

If say a corporation or limited liability company borrows money to purchase real property, a lender will typically insist that an individual or individuals (or another well capitalized company with a solid credit history) guarantee that the debt will be repaid. Not all lenders, mind you, will require this but certainly the ones who aren't fool hardy enough to rely on an entity that may be under-capitalized or an entity that initially had sufficient assets but became insolvent. (You'd be surprised however how many creditors fail to seek to back-stop their risk. Then again, we advise our debtor clients to avoid guarantee agreements at all costs and advise our creditor clients they would be wildly remiss not to have one.)

If you've signed a guarantee, the question you have to consider is whether there are defenses to invoke if the primary debtor is in default and the creditor looks to you.

The fact of the matter is, anti-deficiency judgment statutes which preclude a lender from seeking to recover from a borrower the difference between the loan balance and the amount recouped at foreclosure, extant in some states, don't necessarily apply to guarantors. (Typically, a lender has a limited period of time after the foreclosure sale to initiate a deficiency action; after that, it's barred.) The point being, if the underlying security, i.e., the real property, is worth substantially less than the loan balance -- exceedingly common these days -- a creditor could forego the right to foreclose and simply file suit on the guarantee for the full amount of debt or, more likely, foreclose and sue you concurrently.

What's more, while the "one-action rule" applies in the context of a guarantee, it's common for the rule to be waived by the guarantor in the written agreement. In some states though, for instance Nevada, by virtue of statutory law, the provision may not be waived by a guarantor if the lien secures an indebtedness for which the principal balance of the obligation was never greater than \$500,000. NRS 40.495.

The rule stands for the proposition that "but one action" may be had for the recovery of debt or for the enforcement of any right secured by real estate. Notwithstanding what it implies -- it's not actually an either/or design -- the one-action rule requires a lender to exhaust the security before recovering from the debtor personally. If the rule is violated, the lender could lose its right to foreclose on the real estate. A guarantor, however, without the protection of the one-action rule, is not afforded the benefit of time it takes to foreclose before the creditor may file suit against him.

The crux of a compelling defense to enforcement of a guarantee is establishing that it was required simply to avoid application of the one-action rule or anti-deficiency limitations which are statutory and generally cannot be waived by a borrower. For example, if a lender requires the sole shareholder of an S corporation or the sole member of an LLC to execute

a guarantee, it could very well be deemed an ill-conceived hedge. Which makes sense: if an individual does business through an entity merely to shield himself from personal liability and doesn't follow corporate formalities or commingles personal and company accounts, under the "alter ego" theory the corporate veil may be pierced resulting in personal, unlimited liability. If, then, an entity is truly autonomous, sufficiently capitalized and adheres to corporate conventions, why should a creditor be allowed to hold shareholders or LLC members personally accountable by way of pretext?

Historically, there were other bases to attempt to defeat enforcement of a guarantee but they've gradually been worn away. The tried and true defenses of failure of consideration, unconscionability, mistake, etc., will invariably have to be waived by the guarantor, as will the requirement that the creditor exhaust its remedies against the "primary" debtor and foreclose on the property first.

When the terms of the underlying obligation are changed without the knowledge and consent of the guarantor, certainly leverage against the creditor may be brought to bear. Then too, a guarantor should not be held liable for a greater amount than the underlying obligation of the primary debtor. Although a well-drawn guarantee can dispel some defenses, they are certainly arguments a guarantor should pursue.

You may be at this point contemplating what, then, is the difference between a guarantor and a co-signer and, at bottom, your suspicion that there's not much anymore is correct. Just as with a co-signor, a guarantor's credit record will reflect the obligation and affect credit worthiness.

"A mortgage casts a shadow on the sunniest field," so be smart.

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