

CO-BORROWERS OR SURETIES

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INTRODUCTION. Lenders often structure a transaction with multiple borrowers rather than utilize a borrower and guarantor or surety structure. This multiple borrower structure is based on the sometimes erroneous belief that adding credit-enhancing parties as borrowers, rather than as guarantors, provides a better source of repayment. Lenders must be cautious when entering into such multiple borrower transactions. If specific drafting techniques are not employed, a co-borrower's obligation may be inadvertently discharged. This article explores the suretyship discharge issues involved in multiple obligor structures and suggests methods for avoiding their inherent pitfalls.

LEGAL IMPLICATIONS OF SURETYSHIP. Commonly, lenders rely not only on the credit of a borrower but also on the credit of another party, whose support enhances the creditworthiness of a loan transaction. Many lenders consider the role of a surety or guarantor to be rather straightforward. However, even if not designated as a guarantor or surety, a co-borrower who provides credit support for the principal obligation but does not benefit from the obligation may trigger certain suretyship issues.

In order to properly structure a multiple-obligor credit, a lender must consider the legal classification of each party, its related rights and obligations and the use of the transaction's proceeds. Often in a "plain vanilla" loan transaction, a subsidiary of a borrower will agree to guarantee the loan, a so-called upstream guarantee. It is not always clear whether any of the proceeds of the loan will be downstreamed to the subsidiary for the subsidiary's use. However, a lender will usually rely on the subsidiary's assets in making its credit decision.

This type of transaction could be documented in two different ways. The subsidiary could be a co-borrower and sign the note. Alternatively, the subsidiary could sign a separate guarantee. Different legal rules will govern the subsidiary's rights and obligations, depending on which approach is used. The proper structural choice hinges on the intended use of the loan proceeds and who will benefit from such use. In either case, from a lender's perspective, the documents must contain language to ensure that the subsidiary will not be able to avoid its obligation to the lender.

Sureties have several defenses that can be raised to avoid liability based upon an extensive body of case law. The rules are dependent upon the specific jurisdiction and vary, whether based on common law or the Uniform Commercial Code (UCC). Regardless of the jurisdiction or source, however,

suretyship defenses are based on the underlying premise that a note cannot be unilaterally modified after execution.

The other main premise of suretyship defenses is the preservation of the surety's rights against the primary obligor for reimbursement, restitution and subrogation. Sureties may be discharged from their obligations in situations where the lender and primary obligor, or the lender alone, take actions that would alter the risks to the surety or otherwise put the surety in a position that it had not bargained for. Examples of situations that might warrant a discharge of a surety include an increase in the amount of the loan, extension of maturity of the loan or release of collateral.

Each of these changes could make it more difficult for the surety to seek reimbursement from the primary obligor if the surety is called upon to perform; therefore, in the absence of obtaining the consent of the surety, the taking of any of these actions could result in the surety's full or partial discharge. If the position of the surety has been impaired, but it is difficult to determine the degree of impairment, case law generally presumes that the impairment is equal to the full amount of the surety's obligations, thereby shifting the burden to the lender to prove otherwise.

CONTRACTUAL RELIEF. Felicitously for lenders, the law recognizes the freedom of parties to contract with one another and thereby provide for a waiver of suretyship defenses in advance. The general practice of lenders is to require guarantors to sign lengthy and detailed waivers. Any well crafted guaranty contains such waivers.

On the other hand, multi-party notes, even long-form notes, are often drafted without suretyship law in mind. Consequently, many notes do not contain language necessary to waive a co-borrower's suretyship defenses. Since it is clear that properly drafted waivers are effective to prevent discharge, it is of paramount importance for a lender to ensure that its documents have the appropriate language when co-borrowers are actually in a surety relationship.

A lender can require a subsidiary to sign a note as a co-borrower or sign a separate guaranty. Shorter documentation or fewer documents is not always the wisest choice. It may seem more palatable to use less paper and have the borrower and the subsidiary sign the same note, but this is only satisfactory if the note contains appropriate language dealing with the subsidiary in its capacity as a surety. If the subsidiary signs the note but does not receive any of the proceeds or other direct benefit from the loan, the subsidiary is, in actuality, a surety regardless of its execution of the note as a co-borrower, in which case the lender must include appropriate waiver language in the note.

In order to avoid the unintended discharge of a co-borrower which is, in reality, a surety, multi-party notes should contain suretyship defense waivers. Since it may not be clear whether a co-borrower is, in fact, a surety, it would be prudent to draft all notes executed by co-borrowers to include such waivers.

The alternative structure is to require a subsidiary to sign a guaranty. In such a case, the subsidiary's role is clearly defined and the note will not require suretyship defense waivers.

Documentation can be drafted in either of these alternative ways. Lenders should be cognizant of the implications of having more than one party on a note and the extra language required if all the obligors sign one note. Included below is sample language that drafters of multi-party notes may want to include to avoid discharge of a co-borrower.

SAMPLE NOTE LANGUAGE

SECTION 8. Joint and Several Obligations; Dealings with Multiple Borrowers. *If more than one person or entity is named as Borrower hereunder, all Obligations, representations, warranties, covenants, waivers and indemnities set forth in the Loan Documents to which such person or entity is a party shall be joint and several. Big Bank shall have the right to deal with any officer of any Borrower with regard to all matters concerning the rights and obligations of Big Bank and Borrower hereunder, and pursuant to applicable law with regard to the transactions contemplated under the Loan Documents. All actions or inactions of the officers, managers, members and/or agents of any Borrower with regard to the transactions contemplated under the Loan Documents shall be deemed with full authority and binding upon all Borrowers hereunder. Each Borrower hereby appoints each other Borrower as its true and lawful attorney-in-fact, with full right and power, for purposes of exercising all rights of such person hereunder and under applicable law with regard to the transactions contemplated under the Loan Documents. The foregoing is a material inducement to the agreement of Big Bank to enter into this Agreement and to consummate the transactions contemplated hereby. The Borrower represents that for purposes of this transaction, they are operated as part of one consolidated business entity and are directly dependent upon each other for and in connection with their respective business activities financial resources. Each Borrower will receive a direct economic and financial benefit from the Obligations incurred under this Agreement and the incurrence of such Obligations is in the best interests of each Borrower.*

USE OF SAMPLE NOTE LANGUAGE

You can use a sample provision, such as the above note language, in two ways. First, you can use it in a specific transaction with appropriate modifications. Second, you can use it to compare against another similar note provision. In

either case, do not use this sample language without appropriate legal advice.

CONCLUSION. There is no foolproof method that can insure the enforcement of a surety's or guarantor's obligations. However, when structuring loans to multi-tiered entities, the suretyship principles and waivers discussed above, and the fraudulent transfer principles discussed in our article entitled, "Corporate Group Joint Borrower and Fraudulent Conveyances", should all be considered to avoid, or at least minimize, the risk of inadvertent discharge of a credit-enhancing party.

*This article is not intended to provide legal advice for a specific transaction. If you require further information on any matter contained in this article or would like to discuss a specific transaction, please feel free to contact either **Mr. Goetz or Mr. Hoffmann at (516) 296-7000.***