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CIRCUITS DISAGREE ABOUT FINANCING STATEMENTS THAT INDICATE THE COLLATERAL SOLELY BY REFERENCE TO UNFILED DOCUMENTS

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In September, the Seventh Circuit Court of Appeals issued a somewhat stunning decision. In *In re I80 Equipment, LLC*,[1] the court ruled that a financing statement's indication of the collateral as "[a]ll Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party" was sufficient despite the fact that the referenced security agreement was not also filed. As a result, a financing statement that gave no *public* indication of the collateral other than the word "[c]ollateral" – and hence no mention of any of the 26 categories of collateral identified in the security agreement[2] – was effective to perfect the security interest. The decision is contrary to a ruling by the First Circuit Court of Appeals earlier this year in *In re Financial Oversight and Management Board for Puerto Rico*.[3] Amazingly, the Seventh Circuit never even mentioned the First Circuit's decision.

While the Seventh Circuit's decision is questionable, it has some textual support. Section 9-502(a)(3) states that, to be effective, a financing statement must "indicate[] the collateral covered."[4] Section 9-504 then states that a description of collateral pursuant to § 9-108 suffices.[5] Section 9-108(b)(6) states that a description of collateral is sufficient "if the identity of the collateral is objectively determinable."[6] The Seventh Circuit reasoned that the reference in the financing statement to the security agreement made the indication of collateral in the financing statement "objectively determinable" even though that determination could not be made on the public record.[7]

Unfortunately, the court's decision somewhat undermines the notice function that financing statements are supposed to serve.[8] Financing statements are intended to provide a form of inquiry notice. A searcher who discovers a filed financing statement has no way to know from that document alone if the filer truly has a security interest, and so normally follows up by contacting the filer for more information. The drafters of Article 9 could have omitted the requirement that financing statements indicate the collateral. This would have impelled searchers to follow up with respect to all financing statements filed against their debtor. But the drafters instead expressly chose to require that financing statements indicate the collateral covered, at least in general terms, and presumably did this to lessen the burden of due diligence that searchers must bear. The Seventh Circuit's ruling therefore seems contrary to the drafters' implicit goal.

That said, searchers were already well advised not to rely on the indication of collateral in a filed financing statement. That is because, for at least three reasons,[9] a filed financing statement can be effective to perfect a security interest in collateral that is not included in the financing statement's indication of collateral:

- If the collateral is later sold, leased, licensed or otherwise disposed of in a manner that generates identifiable proceeds, the resulting security interest in those proceeds will be perfected as long as the place to file to perfect a security interest in the proceeds is the place where the financing statement was filed as to the original collateral.[10] Thus, for example, a security interest that attaches to accounts as proceeds of inventory will be perfected if the security interest in inventory was perfected by a filed financing statement indicating the collateral as "inventory." In short, a security interest in accounts can be perfected by a financing statement that indicates the collateral as "inventory."

- If a security interest in goods is perfected by a filed financing statement that indicates the goods, and the goods are later commingled with other goods into a product, the security interest will attach to the product and will be perfected, regardless of whether the financing statement indicates the product.[11] Consider, for example, eggs that are commingled with flour to

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make cakes. If, prior to commingling, a lender had a security interest in the eggs perfected by a filed financing statement that indicates the collateral as "eggs," the resulting security interest in the cakes will be perfected. In essence, a filed financing statement indicating the collateral as "eggs" would be effective to perfect a security interest in cakes.

• If, after a financing statement is filed, the debtor's use of the collateral changes, causing the classification of the collateral to change, the financing statement remains effective.[12] Consequently, if a secured party has a security interest in a debtor's inventory – consisting of, for example, microwave ovens – and that security interest is perfected by a filed financing statement that indicates the collateral as "inventory," and the debtor then moves some of the ovens to its employee break room, converting them to equipment, the security interest will remain perfected.[13] A filed financing statement covering "inventory" will be effective as to some equipment.[14]

Note, in each of these scenarios, the financing statement is somewhat misleading: it indicates the collateral but is nevertheless effective with respect to other property not indicated. The financing statement in *In re I80 Equipment* was not misleading, it merely lacked any information about what property was collateral. Giving efficacy to a financing statement that omits such information presents slightly less of a problem for searchers.

There is another reason to be concerned about the Seventh Circuit's decision. Although the court did not say so, its analysis suggests that a financing statement would be effective to perfect a security interest in personal property originally outside the collateral description in the security agreement but later added by amendment. That is problematic because there is nothing a searcher could do, short of entering into an intercreditor agreement with the filer, to protect itself from this risk. In essence, the searcher would have to assume that a financing statement such as the one filed in *In re I80 Equipment* covers all assets.

Despite all this, the advice to transactional lawyers is clear. Given the contrasting circuit court rulings, do not rely on the Seventh Circuit's decision when representing filers. If a financing statement indicates the collateral solely by reference to a security agreement, file the security agreement as an attachment. Better yet, do not indicate the collateral by reference at all. Instead, indicate the collateral in the financing statement. When representing searchers, on the other hand, advise them not to rely on property outside the scope of the collateral indicated in the filed financing statements they discover. Most financing statements filed against the debtor require further investigation to determine if they are effective with respect to other property.[15]

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Notes:

1. 938 F.3d 866 (7th Cir. 2019), *rehearing en banc denied* (7th Cir. Oct. 10, 2019).

2. *See id.* at 869 (stating that 26 categories were listed, "such as accounts, cash, equipment, instruments, goods [and] inventory," but apparently not recognizing that some of these categories overlap, such as "goods" and "inventory" and "goods" and "equipment").

3. 914 F.3d 694 (1st Cir. 2019), *petition for cert. filed* (May 3, 2019) (ruling that filed financing statements that described the collateral as "[t]he pledged property described in the Security Agreement attached as Exhibit A hereto," and which attached the security agreement, were ineffective to perfect because the attached security agreement did not define the pledged property even by type of collateral, but merely referenced a bond resolution that defined the term but which was not filed).

4. U.C.C. § 9-502(a)(3). In contrast, an authenticated security agreement must provide a "description of the collateral." *See* U.C.C. § 9-203(b)(3)(A). The drafters purposefully used different words – "description" for security agreements; "indicate" for financing statements – because both the documents and their statements of collateral serve different purposes. The security agreement is a document that transfers property rights in the collateral. Its description of the collateral is needed to identify the property in which rights are being transferred. The financing statement is a document that gives searchers inquiry notice of what property *might be* subject to a security interest. Thus, the standards for evaluating the sufficiency of a description and an indication are different.

5. U.C.C. § 9-504(1).

6. U.C.C. § 9-108(b)(6).

7. 938 F.3d at 871-72.

8. *See* Bruce A. Markell, *The Road to Perdition: I80 Equipment, Woodbridge and Liddle Pave the Way*, 39 Bankr. Law Letter 1, 3 (Nov. 2019) (describing the court's decision as "astounding" and as "neutering" the requirement that a financing statement indicate the collateral).

9. There might be other reasons. See In re Sterling United, Inc., 674 F. App'x 19 (2d Cir. 2016) and In re 8760 Service Group, LLC, 586 B.R. 44 (Bankr. W.D. Mo. 2018), each of

which ruled that a filed financing statement that misidentified the collateral's location was nevertheless effective. In each case, however, the language was ambiguous and the court ruled that a reasonably diligent searcher should have inquired further.

10. *See* U.C.C. § 9-315(c), (d)(1).

11. *See* U.C.C. § 9-336(c), (d).

12. *See* U.C.C. § 9-507(b).

13. This assumes the security interest remains attached to the ovens used as equipment. Whether it does or does not will depend on how the security agreement is worded and interpreted.

14. Similarly, if a filed financing statement initially included the collateral's location in the financing statement's indication of the collateral, and the collateral was later moved to a different location, the financing statement would remain effective to perfect.

15. If the indication of collateral in a filed financing statement is narrow – for example, a specific piece of equipment – and the debtor still owns the property indicated, then the searcher can reasonably conclude that the financing statement will not perfect a security interest in any other property.

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Too Clever by Half: The Validity of Choice-of-Forum Clauses

Stephen L. Sepinuck

Some contracting parties try to avoid an undesirable state statute or common-law rule – such as a prohibition on usury or champerty – by choosing the law of another jurisdiction to govern the transaction and the relationship of the parties. One problem with this approach is that it can run headfirst into the principle, expressed in Restatement (Second) of Conflict of Laws § 187 and which courts in most jurisdictions follow, that a contractual choice of law will not be followed if doing so would violate a fundamental policy of a state that has a materially greater interest in the determination of the issue and whose law would otherwise govern.[1] Courts in some jurisdictions are rather liberal in classifying legal rules as expressions of a fundamental state policy, with the result that they often invalidate the contractual choice of another state's law, even in commercial transactions.[2]

In a further effort to get their way, some contracting parties supplement their choice-of-law clause with a clause choosing the same state's courts as the exclusive forum to litigate disputes. In theory, courts in that state – the forum state – should refuse to enforce the choice of their own law if doing so would violate a fundamental policy of the state whose law would otherwise govern. However, courts in the forum state might be less willing to recognize the law of another state as expressing a fundamental policy of that state. Moreover, a statute in the forum state might expressly validate the choice of its own law, thereby making the Restatement rule inapplicable.[3] Thus, supplementing a choice-of-law clause with a similar choice-of-forum clause can work.

But transactional lawyers need to know that this approach is not a sure thing. In most jurisdictions, courts evaluate a choice-of-forum clause under the same standard they use to evaluate a contractual choice of law: if litigating in the chosen forum would violate a fundamental policy of the forum state, the choice will be disregarded.[4]

For example, in a case decided on October 31st of this year, the California Court of Appeals declined to enforce a New York choice-of-forum clause in an equipment lease, which also selected New York as the governing law and included a waiver of the right to a jury trial. The court concluded that enforcing the provision would diminish the plaintiff's substantive rights and violate a fundamental policy of the State of California, which prohibits pre-dispute, contractual waivers of the right to a jury trial.[5]

As another example, two years ago, the Minnesota Court of Appeals refused to enforce a clause in a litigation funding agreement choosing New York courts as the forum to resolve disputes because doing so would violate Minnesota's policy against champerty and maintenance.[6] Not only that, the court held that the trial court properly enjoined the lender from prosecuting a pending New York action, even though that suit was brought first.[7]

CONCLUSION

It is often desirable to include in a written agreement – particularly one for a transaction between parties in different states – a clause designating the exclusive forum to resolve disputes. Doing so can reduce litigation costs by reducing the likelihood that parties will fight about the proper forum or whether personal jurisdiction exists.[8] It can help ensure that one party will be able to litigate near where it is located, which can further reduce its costs and help ensure that it can be represented by the counsel of its choice. And, of course, for an entity that does business in many states or with counter-parties in many states, choosing the same state's law to govern all or most of its dealings promotes predictability and consistency in the applicable law.[9]

However, using such a clause to avoid a legal rule is risky. The clause cannot hurt, but it is not guaranteed to succeed either. For that reason, the transactional lawyer should advise the client of the risk. The safest approach might be to comply with – rather than seek to avoid – the legal rule, even if this means not doing the deal.

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Notes:

1. Restatement (Second) of Conflict of Laws § 187 (revised 1988). Pursuant to this provision, a contractual choice-of-law clause will be enforced: (i) with respect to any issue that the parties could have resolved by agreement; or (ii) any other issue if the chosen state has a substantial relationship to the parties or the transaction, or there is some other reasonable basis for the parties' choice, and doing so would not violate a fundamental policy of a state that has a materially greater interest than the chosen state in the determination of the issue and whose law would govern in the absence of the choice.

2. *See, e.g.*, Maslowski v. Prospect Funding Partners, LLC, 2019 WL 3000747 (Minn. Ct. App. 2019), *review granted*, (Minn. Sept. 25, 2019) (the clause in a litigation funding agreement choosing New York law to govern was not enforceable because it violated Minnesota's public policy against champerty and maintenance); BMO Harris Bank v. Richland Express, Inc., 2018 WL 8299883 (E.D. Ark. 2019) (agreements selecting Texas and Utah law and providing for a default rate of interest that would be usurious under Arkansas law violated a fundamental policy of Arkansas); Rincon EV Realty LLC v. CP III Rincon Towers, Inc., 213 Cal. Rptr. 3d 410 (Cal. Ct. App. 2017) (although a loan agreement selected New York law as the governing law, and its waiver of the right to a jury is enforceable in New York, the agreement's jury waiver clause was unenforceable in California litigation because it violates a fundamental policy of the state and California has a materially greater interest in the matter than does New York); Nutracea v. Langley Park Invs. PLC, 2007 WL 135699 (E.D. Cal. 2007) (clauses in stock purchase agreement selecting New York law as the governing law and New York as the forum for all litigation between the parties were unenforceable because of California's strong policy of preventing fraud on California corporations and New York's minimal interest in the litigation); Madden v. Midland Funding, LLC, 237 F. Supp. 3d 130 (S.D.N.Y. 2017) (application of Delaware law pursuant to a choice-of-law clause in the parties' credit card agreement would violate a fundamental public policy of New York because Delaware does not cap the interest rate that parties may agree to whereas New York has a criminal usury statute); In re Miller, 341 B.R. 764 (Bankr. E.D. Mo. 2006) (default rate of interest on business loan, though valid under Iowa law that the parties had chosen in their agreement, violated Missouri law, was contrary to a fundamental policy of Missouri, and was therefore unenforceable). *See also* William B. Emmal, *Evading Prohibitions on Usury Through Choice of Law*, 9 THE TRANSACTIONAL LAWYER 6 (Aug. 2019).

3. At least five states allow contracting parties to choose its own law regardless of whether the state bears a substantial or reasonable relationship to the parties or the transaction, provided the contract involves a set minimum amount of money. *See* Cal. Civ. Code § 1646.5 ($250,000); Del. Stat. tit. 6, § 2708 ($100,000); Fla. Stat. § 685.101 ($250,000); 735 Ill. Comp. Stat. 105/5-5 ($250,000); N.Y. Gen. Oblig. Law § 5-1401(1) ($250,000). Under such a statute, it is apparently not necessary to determine whether application of the state's law would violate a fundamental policy of the law of the state that would govern in the absence of the choice.

The New York statute expressly overrides the choice-of-law rule in former Article 1 of the Uniform Commercial Code. Unfortunately, the legislature did not update the reference when it enacted revised Article 1 of the U.C.C. in 2014. *See* 2014 N.Y. Sess. Law ch. 505 (enacting, among other things, U.C.C. § 1-301). It remains unclear, therefore, whether the New York statute applies in a transaction governed by the U.C.C.

4. A forum-selection clause will normally be invalidated if the clause results from fraud or overreaching, violates a strong public policy, or if enforcement of it would deprive a party of its day in court. *See, e.g.*, Krenkel v. Kerzner Int'l Hotels Ltd., 579 F.3d 1279, 1281 (11th Cir. 2009); Afram Carriers, Inc. v. Moeykens, 145 F.3d 298, 301 (5th Cir. 1998) (quoting Mitsui & Co. (USA), Inc. v. Mira M/V, 111 F.3d 33, 35 (5th Cir. 1997)).

5. Handoush v. Lease Finance Group, LLC, 2019 WL 5615674 (Cal. Ct. App. 2019).

6. Maslowski v. Prospect Funding Partners, LLC, 890 N.W.2d 756 (Minn. Ct. App. 2017).

7. *Id.* at 767-69.

8. A forum-selection clause is usually treated as a consent to personal jurisdiction. *See* Chan v. Society Expeditions, Inc., 39 F.3d 1398, 1406-07 (9th Cir. 1994); Heller Fin., Inc. v. Midwhey Powder Co., Inc., 883 F.2d 1286, 1292 (7th Cir. 1989).

9. An article in an upcoming issue of this newsletter will provide guidance on drafting an exclusive choice-of-forum clause.

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GUARANTIES OF UNENFORCEABLE OBLIGATIONS

Stephen L. Sepinuck

A guarantor, being a "favorite of the law,"[1] has an array of suretyship defenses that potentially discharge the guarantor's liability in whole or in part. These defenses – which are generally not available to the principal obligor – include almost any act by the creditor that either: (i) increases the guarantor's risk or cost of performance; or (ii) decreases the guarantor's potential ability to cause the principal obligor to bear the cost of performance.[2] As two articles in prior issues of this newsletter have discussed,[3] almost all of these defenses are waivable,[4] and indeed can be waived with a general statement that does not expressly list each defense.[5]

A related, but nevertheless distinct, issue arises when a guarantor seeks to assert a contract-law or statutory defense that is available to the principal obligor. Is the guarantor entitled to assert the defense and, if so, will an appropriately drafted waiver in the guaranty agreement be enforceable? One of the prior articles in this newsletter discussed these questions briefly.[6] But due to a recent decision by the Bankruptcy Court for the Southern District of New York,[7] a more comprehensive exploration of these issues is in order. Before discussing the case, however, it is necessary to provide some background on the law.

BACKGROUND

In general, the principal obligor's defenses fall into three distinct categories:

- defenses unavailable to a guarantor;
- defenses available to a guarantor (*i.e.*, defenses that cannot be waived in a guaranty agreement); and
- defenses that a guarantor may normally assert but which the guarantor can waive in the guaranty agreement.

Defenses Unavailable to a Guarantor

The Restatement (Third) of Suretyship and Guaranty identifies two defenses of the principal obligor that are never available to the guarantor: (i) the principal obligor's obligation has been discharged in bankruptcy; and (ii) the principal obligor's lack of capacity, whether due to infancy, mental incapacity, or lack of corporate authority.[8] The first, which is codified in the Bankruptcy Code,[9] is premised on the rationale that the principal obligor's financial inability to perform is precisely the risk that the guarantor has accepted, and allowing a guarantor to assert the principal obligor's bankruptcy discharge as a defense would seriously undermine the value of guaranties.[10] The second, which is apparently based on the same rationale – that this is a risk that the guarantor accepts,[11] is supported by some old treatises and judicial dicta,[12] but some more modern authorities seem to treat the defense as one that is waivable, rather than as one that is never available.[13]

Defenses Available to a Guarantor

The Restatement identifies no defenses that the guarantor cannot waive in the guaranty agreement and seems to imply that there are none.[14] But that does not mean there are none. Consider a situation in which A hires B, an assassin, to kill a specified individual, and C guaranties payment. Putting aside the fact that the guaranty is unlikely to be in writing or to go through the formalities of waiving defenses, it is simply inconceivable that a court would ever enforce the guaranty, no matter what defenses C purported to waive in the written agreement. Courts would, no doubt, treat similarly a guaranty of a buyer's promise to pay for contraband. In short, if the agreement creating the underlying obligation is illegal – not merely unenforceable, but illegal – the guaranty of that obligation will not be enforceable, and any effort by the guarantor to waive the defense will be ineffective.

Defenses Available to but Waivable by a Guarantor

The defenses of the principal obligor that are presumptively available to a guarantor but subject to waiver in the guaranty agreement include the following:

- the applicable statute of frauds;[15]
- breach by the creditor;[16] and
- fraudulent inducement of the underlying transaction.[17]

In the normal course of events, a guarantor is able to assert any defense of the principal obligor that would negate the obligation or reduce the amount owed. However, allowing the guarantor to waive these defenses in the guaranty agreement violates no significant public policy. If, for example, the principal obligation is unenforceable due to application of some statute of frauds, but the guaranty agreement satisfies the statute of frauds applicable to suretyship contracts, there would seem to be sufficient objective indicia of the obligation and the guaranty to enforce the guarantor's promise. Similarly, waiving in the guaranty agreement the effect of a breach by the creditor or a defense based on fraudulent inducement of the underlying transaction merely reflects the fact that the underlying transaction and the guaranty agreement are independent contracts. Moreover, a waiver of such a defense resembles a "hell or high water" term that some statutes expressly authorize,[18] and thus does not violate public policy.

There is an additional defense that might fall into the category of defenses that are presumptively available to but waivable by a guarantor: a defense of the principal obligor based on an anti-deficiency statute. Such a statute bars an action for a deficiency after a non-judicial foreclosure of a lien on real property. In some states, such a defense is available only to the principal obligor, and thus cannot be asserted by a guarantor.[19] In the jurisdictions where the defense is available to a guarantor, the defense can be waived.[20] This too makes some sense. After all, guarantors can normally waive a defense based on a release of the principal obligor.[21] Allowing a guarantor to waive the benefit of anti-deficiency statutes is merely an extension of that long-standing rule.

The Defenses Difficult to Classify

The proper categorization of other defenses of the principal obligor is less clear. Consider, for example, a waiver of a defense based on the creditor's failure to act in accordance with the duty of good faith or engaging in other inequitable conduct. Some courts will, apparently, enforce such a waiver.[22] Others suggest, at least in dicta, that a guarantor cannot waive in advance equitable defenses, such as unclean hands, because doing so would allow a creditor to profit by its own fraudulent conduct.[23]

Even more difficult to categorize is a defense based on lack of consideration. Absent reasonable and detrimental reliance, a promise to make a gift is normally unenforceable. It is far from clear that a guaranty of such an unenforceable promise should be enforceable merely because the guarantor purports to waive in the guaranty agreement lack of consideration as a defense. Allowing such a waiver to be effective would be a way to avoid the consideration requirement that contract law has embraced for centuries.

The same problem applies to a defense based on usury. Although courts in some states treat the defense as "personal" to the principal obligor, and hence something a guarantor apparently may never raise, regardless of whether the guaranty agreement contains a waiver,[24] in other states the defense is available to a guarantor and cannot be waived in the guaranty agreement, lest the lender use the guaranty to evade the prohibition on usury.[25]

THE RECENT CASE

This brings us to what might be the most difficult case: when all or part of the principal obligation is an unenforceable penalty.

In *In re Republic Airways Holdings Inc.*,[26] the Bankruptcy Court for the Southern District of New York ruled that, because the liquidated damages provisions in some aircraft leases were unenforceable penalties, they could not be enforced against the guarantors of the leases.[27] The court noted that, although guarantors are generally permitted to waive affirmative defenses, and the unenforceability of the principal obligation is an affirmative defense, the invalidity of a contract obligation based on illegality or public policy cannot be waived.[28]

The decision is in seeming conflict with *136 Field Point Holding Co. LLC v. Invar Int'l Holding, Inc.*, in which the Court of Appeals for the Second Circuit, applying New York law, declined to decide whether a liquidated damages clause in a real property lease was an unenforceable penalty because the guarantor had "absolutely, unconditionally and irrevocably guarantee[d] . . . full, complete and timely payment . . . without regard to the validity, regularity or enforceability of the lease."[29]

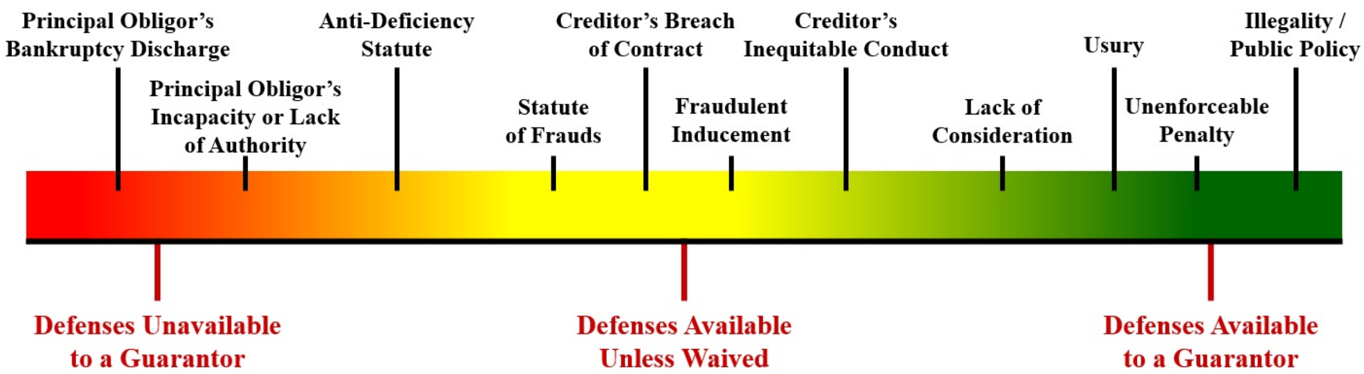
The *Republic Airways* court acknowledged the *136 Field Point* decision but refused to follow it for three reasons: (i) the decision was unpublished and therefore not precedential; (ii) neither the Second Circuit nor the District Court below had expressly addressed any argument based on public policy; and (iii) none of the cases the Second Circuit had relied on had dealt with an obligation invalidated on the basis of public policy.[30] Those reasons might be technically correct, but the clear import of the *136 Field Point* decision was that the defense had been waived, so that public policy was immaterial.

Still, there is much to be said for the portion of the *Republic Airways* case dealing with the guaranty. If a contractual obligation of a promisor is unenforceable due to public policy, enforcing a guaranty of that promise would, at least in some cases, violate the same policy. Moreover, it would be relatively simple in such cases to evade the law by using a front as the principal obligor and having the real party in interest provide a guaranty.[31]

CONCLUDING THOUGHTS

Transactional lawyers should be aware that there are some defenses of the principal obligor that a guarantor may never raise, some that the guarantor presumptively may raise but which the guarantor can waive in the guaranty agreement, and some that the guarantor can always raise. But because some defenses are difficult to categorize, and jurisdictions do not always agree into which category a particular defense falls or why, it might be useful to replace the concept of three distinct categories with a continuum – one in which the rights of the guarantor are determined by the policy underlying the defense. Some defenses are never available to a guarantor because a contrary rule would undermine the purpose and utility of guaranties and because the policy underlying the defense would not be served by allowing a guarantor to raise it. But for some other defenses, the underlying policy would be served by allowing guarantors to raise it. As that policy gets stronger, it overrides the basic principle of freedom of contract.

The following graphic displays one way of conceptualizing that continuum:



Readers who would order the defenses in a different sequence or who a have a different vision entirely of how the law does or should permit a guarantor to raise defenses of the principal, are encouraged to submit their thoughts by email.

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Notes:

1. *See, e.g.*, Williams v. Bank of Ozarks, 577 S.W.3d 434, 442 (Ark. Ct. App. 2019); Straits Fin. LLC v. Ten Sleep Cattle Co., 900 F.3d 359, 370 (7th Cir. 2018) (applying Illinois law); Palm Fin. LLC v. Griffin, 2018 WL 2056561, at *3 (Ga. Ct. App. 2018); In re Lamey, 2017 WL 3835797, at *5 (Bankr. D.N.M. 2017); First Fin. Bank v. Johnson, 2017 WL 1929743, at *2 (Ind. Ct. App. 2017); Badger v. Eighth Judicial Dist. Court, 373 P.3d 89, 94 (Nev. 2016); JRG Capital Investors I, LLC v. Doppelt, 580 F. App'x 242, 244 (5th Cir. 2014) (applying Texas law); Eginoire v. Market Foods Ltd., LLC, 2006 WL 2692852, at *3 (D. Kan. 2006); Chase Bank of Ohio v. Brookstone Ohio P'ship, 1990 WL 20104, at *3 (Ohio Ct. App. 1990); Nogg Bros. Paper Co. v. Bickels, 446 N.W.2d 729, 732 (Neb. 1989); Green Shoe Mfg. Co. v. Farber, 712 P.2d 1014, 1017 (Colo. 1986); Sinclair Mktg., Inc. v. Siepert, 695 P.2d 385, 387 (Idaho 1985). Among other things, this means that guaranty agreements are strictly construed in favor of the guarantor.

2. *See* RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 37. More specifically, these defenses include:
- releasing the principal obligor from a duty to pay money or other obligation;
- granting the principal obligor an extension of time to perform;
- agreeing to a modification of the duties of the principal obligor;
- impairing the value of an interest in collateral securing the underlying obligation;
- allowing the statute of limitations on the underlying obligation to expire;
- impairing the guarantor's rights of reimbursement or subrogation; and
- failing to inform a guarantor who has provided a continuing but terminable guaranty of a fact, known to the creditor, that materially increases the guarantor's risk.

See id. §§ 38-47; *see also* Cal. Civ. Code §§ 2819-2825.

Some defenses of a guarantor are available to the principal obligor. Releasing the principal obligor and allowing the statute of limitations to run on the principal obligation, for example, do give rise to a defense available to the principal obligor. The defense based on impairment of collateral includes several things that would not provide a defense or claim to the principal obligor, such as releasing collateral or failing to obtain or maintain perfection, as well some things that would potentially provide the principal obligor with a defense or claim, such as failing to preserve collateral in the creditor's possession or failing to comply with applicable law on disposing of or collecting on collateral. *See* RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 42(2); *see also* U.C.C. §§ 9-207(a), 9-607 *through* 9-612, 9-625 *through* 9-627.

A guarantor might have any of several other contract-law defenses that are not available to the principal obligor but which are not properly regarded as suretyship defenses because they are unrelated to the suretyship nature of the guaranty contract. These include defenses based on lack of consideration (for the guaranty), lack of capacity (of the guarantor), the statute of limitations (for actions on the guaranty), the statute of frauds (with respect to the guaranty), or fraud or duress (with respect to the guaranty). This article does not discuss any of these defenses or whether a waiver of them in the guaranty agreement would be effective.

3. *See* Stephen L. Sepinuck, *Suggestions for Drafting Guaranties*, 7 THE TRANSACTIONAL LAWYER 1 (Oct. 2017); Stephen L. Sepinuck, *Waiving Suretyship Defenses*, 5 THE TRANSACTIONAL LAWYER 2 (Apr. 2015).

4. The defenses that cannot be waived are some of the defenses arising from the creditor's breach of a duty imposed by U.C.C. Article 9. *See* U.C.C. § 9-602. However, at least one state – Washington – altered this rule when enacting Article 9 so as to permit guarantors to waive all their Article 9 rights. *See* Wash. Rev. Code § 62A.9A-602; *see also* Wash. Rev. Code § 62A.9A-624(a). Moreover, the duty to preserve collateral imposed by § 9-207(a) on a secured party in possession of the collateral is not included in the list of nonwaivable obligations in § 9-602, and thus guarantors can waive their rights under § 9-207. *See* Hartley v. Hynes, 2018 WL 5093975 (Pa. Super. Ct. 2018).

5. *See* Sepinuck, *Suggestions for Drafting Guaranties*, 7 THE TRANSACTIONAL LAWYER at 6 n.18; CertusBank v. Miller, 2015 WL 2084613 (N.D. Ga. 2015).

6. *See* Sepinuck, *Suggestions for Drafting Guaranties*, 7 THE TRANSACTIONAL LAWYER at 3-4.

7. In re Republic Airways Holdings Inc., 598 B.R. 118 (Bankr. S.D.N.Y. 2019).

8. *See* RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 34(1). In contrast, if the principal obligor is a governmental agency that lacks constitutional or statutory authority to incur the debt, a guaranty of the debt – particularly by another governmental agency – might also be unenforceable.

9. *See* 11 U.S.C. § 524(e) (providing a narrow exception for some community claims); In re Gentry, 807 F.3d 1222 (10th Cir. 2015) (even though a guaranty agreement signed by the sole shareholders of a corporation defined the indebtedness as all obligations of the corporation and any advances or transactions that "modify, refinance, consolidate or substitute" those debts, whether "voluntarily or involuntarily incurred," the obligation of the guarantors was not modified and reduced by the confirmed Chapter 11 plan of the corporation). *See also* U.C.C. § 3-305(d).

10. RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 34 cmt. b.

11. *Id.* at cmt. c.

12. *See* National Lumber Co. v. Fink, 2018 WL 1414487, at *3 (Mass. Ct. App. 2018); In re L & S Indus., 989 F.2d 929, 934 (7th Cir. 1993) (discussing Illinois law); Rhode Island Hosp. Trust Nat'l Bank v. Ohio Cas. Ins. Co., 789 F.2d 74, 79 n.6 (1st Cir. 1986). *See also* U.C.C. § 3-305(d).

13. *See, e.g.*, In re Lehman Bros. Holdings, Inc., 541 B.R. 551, 571-72 (S.D.N.Y. 2015) (a "hell or high water clause" in a guaranty that purports to waive all defenses based on the unenforceability of any loan document is effective to waive any defense based on lack of consideration or authority, even if the guaranty agreement was not the subject of extended negotiation).

14. RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 34 cmt. a ("the secondary obligor is free to contract to be liable on the secondary obligation even when the principal obligor has a defense to the underlying obligation."). *See also id.* § 6 (each rule in the Restatement may be varied by contract).

15. *See, e.g.*, Torin Associates, Inc. v. Perez, 2016 WL 6662271 (S.D.N.Y. 2016).

16. *See, e.g.*, Heartland Bank and Trust Co. v. Goers, 2012 WL 7005595 (Ill. Ct. App. 2012) (by waiving all defenses of the borrower, guarantors effectively waived any defense that the borrower could have asserted on the note based on the allegation that the lender caused the borrower to default; although a general waiver of defenses in a guaranty agreement does not waive defenses based upon a lender's breach of its duty to act in good faith, the lender did not act in bad faith).

17. *See, e.g.*, J. Remora Maintenance LLC v. Efromovich, 943 N.Y.S.2d 792 (N.Y. Sup. Ct. 2012). *Cf.* Faust Printing, Inc. v. MAN Capital Corp., 2007 WL 4442325 (N.D. Ill. 2007) (a fraudulent inducement claim might be a basis to avoid liability under a "hell or high water" clause of a finance lease).

18. *See, e.g.*, U.C.C. § 2A-407.

19. *See, e.g.*, JP Morgan Chase Bank v. Winthrop Properties, LLC, 94 A.3d 622 (Conn. 2014) (a Connecticut statute barring deficiency actions against persons who were or could have been parties to the foreclosure action did not prevent a mortgagee that had obtained a foreclosure judgment from seeking payment from guarantors); Bank Mutual v. S.J. Boyer Constr., Inc., 785 N.W.2d 462 (Wis. 2010) (a Wisconsin statute that insulates from liability for a deficiency on a mortgage loan "every party who is personally liable for the debt secured by the mortgage" does not apply to guarantors because a guarantor's liability arises not from the debt itself, but from a separate contract).

20. York v. RES-GA LJY, LLC, 799 S.E.2d 235 (Ga. 2017) (a mortgagee that judicially foreclosed on several parcels of real property but was denied judicial confirmation of the sales because it failed to prove that it obtained the fair market value of the properties sold was nevertheless entitled to judgment against the guarantors of the debt because the guarantors had waived the protection of the state confirmation statute); Moayedi v. Interstate 35/Chisam Road, L.P., 438 S.W.3d 1 (Tex. 2014) (a clause in guaranty could waive the guarantor's statutory right of offset – which reduces the deficiency to an amount based on the value of the collateral, rather than the amount of the foreclosure sale price – following the creditor's non-judicial foreclosure); Bank of Oklahoma v. Red Arrow Marina Sales & Serv., Inc., 224 P.3d 685 (Okla. 2009) (a guarantor can waive the protection of an Oklahoma statute that insulates the principal obligor from liability for a deficiency on a mortgage loan). *But cf.* United States v. Kumar, 2016 WL 7369863 (N.D. Cal. 2016) (the individuals who guaranteed an SBA loan to their limited liability company, secured by a deed

of trust, raised a potentially valid defense to a deficiency claim by alleging that the guaranty was a sham intended to evade the anti-deficiency statute).

21. *See supra* note 2.

22. *See, e.g.*, Cooperative Centrale Raiffeisen-Boerenleenbank, B.A. v. Navarro, 978 N.Y.S.2d 186 (App. Div. 2014) (a director who unconditionally guarantied a corporation's obligations to bank and waived all defenses could not escape liability because the bank's default judgment against the corporation was entered after the bank had effectively seized control over the corporation through appointment of a receiver and had the director removed from his position; collusion was a defense that the guarantor had waived and did not go to the existence of the bank's claim); Morris v. Comerica Bank, 2004 WL 1801034, at *5 (Mich. Ct. App. 2004) (applying Illinois law).

23. *See, e.g.*, Pacifica L 39 LLC v. Ramy, 2015 WL 394239, at *8 (Cal. Ct. App. 2015); California Bank & Trust v. DelPonti, 181 Cal. Rptr. 3d 216, 219-20 (Cal. Ct. App. 2014).

24. *See, e.g.*, JMT Capital Holdings, LLC v. Johnson, 2015 WL 3832674 (N.D. Cal. 2015) (based on Texas law, which regards a usury defense as personal to the debtor).

25. *See, e.g.*, Henry & Co. v. Fry, 137 N.Y.S. 894 (App. Div. 1912) (a guaranty of a usurious debt was not enforceable because enforcement would place the principal in a better position than the surety and leave the surety without the right to recover from their principal, and enable the usurer to evade the prohibitions of the statute).

26. 598 B.R. 118 (Bankr. S.D.N.Y. 2019).

27. This aspect of the court's decision has been criticized. *See, e.g.*, Richard J. Tannenbaum, Debra S. Verstandig & Robert M. Vilter, *Liquidated Damages Under Attack: In re Republic Airways Holdings, Inc.*, The Temple 10-Q (May 3, 2019).

28. 598 B.R. at 145-48.

29. 644 F. App'x 10 (2d Cir. 2016).

30. 598 B.R. at 147-48.

31. Deciding whether a public policy or statute that makes an obligation unenforceable also renders unenforceable a guaranty of the obligation is analogous to deciding whether a right of restitution exists if a contractual promise is unenforceable due to public policy or illegality. Relevant factors include the strength of the policy and the connection between the policy and enforcement of the guaranty. *See* Restatement (Third) of Restitution and Unjust Enrichment § 32, cmts. b & c; Restatement (Second) of Contract § 178, cmts. c & d.

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Recent Cases

SECURED TRANSACTIONS

In re Aluminum Extrusions, Inc.,
2019 WL 5677572 (Bankr. N.D. Miss. 2019)
Summary judgment could not be issued on whether a secured party's security interest in the debtor's inventory attached to steel dies and aluminum racks. The debtor used the dies to mold aluminum into finished products for sale and used the racks to store molded products waiting to be painted or shipped, but the evidence was conflicting about the useful life of the dies and the racks. Thus it could not be determined at this stage whether the dies and racks were used up or consumed in business, and thus inventory, or whether they had a longer useful life and were therefore equipment.

Gillette v. Service Intelligence LLC,
2019 WL 5268570 (E.D. Wis. 2019)
An arbitration clause in a car financing contract that covered "any controversy or claim" between the parties, but which expressly excepted any repossession of the vehicle or exercise of any power of sale over the vehicle as long as such action does not involve a request for monetary relief, covered the debtor's claims arising from the secured party's repossession of her car because the claims sought monetary relief.

Laurie v. Collateral Recovery Team LLC,
2019 WL 5538423 (S.D. Tex. 2019)
An arbitration clause in a car financing contract that covered any dispute between the parties, and defined "dispute" to include contract, tort, and statutory claims other than any repossession of the vehicle or any action by the debtor to prevent such a remedy, provided such claim does not involve a request for monetary relief, covered the debtor's claims arising from the secured party's repossession of her car because the claims sought monetary relief. Therefore, the debtor would be compelled to arbitrate her claims against the secured party and the repossession agents. No discussion of why the claim against the repossession agents was within the scope of the arbitration clause.

Ronnoco Coffee, LLC v. Westfeldt Brothers, Inc.,
2019 WL 4492665 (8th Cir. 2019)
A competitor that, through a newly formed subsidiary, bought substantially all of the debtor's assets at a commercially reasonable, private foreclosure sale was not liable for the debtor's outstanding obligations arising from inventory purchases. Although the competitor continued the debtor's operations at the same location, retained most of the debtor's employees, and for a few months employed both the debtor's president and the debtor's CFO, the competitor was not a mere continuation of the debtor given the arm's-length nature of the transaction and the absence of continuity of ownership or management.

BANKRUPTCY ISSUES

In re Denby-Peterson,
941 F.3d 115 (3d Cir. 2019)
A secured party that repossessed collateral prepetition does not violate the stay by failing to return the property to the debtor postpetition despite a demand therefor. Instead, it is incumbent on the debtor to bring a turnover action under § 542.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Handoush v. Lease Finance Group, LLC,
2019 WL 5615674 (Cal. Ct. App. 2019)
Enforcement of a New York choice-of-forum clause in an equipment lease, which also selected New York as the governing law and waived the right to a jury trial, would diminish the plaintiff's substantive rights and violate fundamental policy of the State of California – which prohibits pre-dispute, contractual waivers of the right to a jury trial – and was therefore unenforceable. It did not matter that the plaintiff's claims were not based on a statute with an anti-waiver provision.

Magic Carpet Ride LLC v. Rugger Investment Group, L.L.C.,
2019 WL 5485327 (Cal Ct. App. 2019)
Even though an aircraft purchase agreement stated that "time shall be of the essence," that clause will not be enforced if doing so will result in a forfeiture. Hence, the seller's eight-day delay in providing a lien release statement would not warrant the buyer's refusal to release the remaining $90,000 of the purchase price, which had been held in escrow, absent proof that the seller failed to substantially perform.

Gannett Fleming, Inc. v. Corman Construction, Inc.,
2019 WL 6207616 (Md. Ct. App. 2019)
The trial court did not err in ordering arbitration even though the claim was barred by the applicable statute of limitations because the contract clause did not expressly state that claims outside the limitations period were not subject to arbitration. Of course, the arbitrator remains free to decide that the claim is not arbitrable or that the claim is untimely even if the demand for arbitration was not.

CitiMortgage, Inc. v. Equity Bank,
2019 WL 5778343 (8th Cir. 2019)
Because the seller of mortgage loans had breached representations and warranties regarding some loans, the seller was contractually obligated to repurchase the loans that still existed. It did not matter that the loan buyer failed to include the repurchase amount in the repurchase request. However, the seller was not obligated to repurchase the loans which, prior to the repurchase request, had been liquidated through foreclosure, and thus no longer existed.

Wang v. Hull,
2019 WL 5862964 (W.D. Wash. 2019)
A creditor with a contractually subordinated loan was not entitled to an order enjoining the senior lender from extending the maturity date of its loan, even though that would have the effect of delaying payment on the subordinated loan. The Subordination and Intercreditor Agreement contained no termination date – instead it terminated only upon full, indefeasible payment to the senior lender – and the duty of good faith did not require the senior lender to demand payment on its loan quickly.

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