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Welcome to another issue of the *Commercial Lending Bulletin*, a newsletter published monthly by the Commercial Lending Group at Lerch, Early & Brewer as a service to our clients. Here, you will find articles written by our attorneys covering a variety of current legal issues as they affect lending law. We publish the *Bulletin* as part of our ongoing efforts to provide our clients with responsive service and practical advice when needed.

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Consideration for Guaranty Comes from Underlying Contract

THE U.S. COURT FOR THE SOUTHERN DISTRICT OF NEW YORK RECENTLY HELD THAT A GUARANTOR SHARED THE SAME CONSIDERATION AS THE ORIGINAL OBLIGOR IN A SUIT SEEKING TO ENFORCE A GUARANTY PROVISION OF A PURCHASE AND MERGER AGREEMENT.



In June 2004 Thomas H. Lee Equity Fund V, L.P. agreed to invest nearly \$507 million in Refco Group Holdings Inc. As part of the transaction, all parties signed an equity purchase and merger agreement, which included a signed personal guaranty executed by current Refco president Phillip R. Bennett and Tone Grant, a former president of Refco. The guaranty stated that Bennett and Grant were each liable for 50% of Refco's obligations under the agreement. THL Equity alleged the investment was made based on intentional misrepresentations and fraudulent nondisclosures, resulting in Refco's declining stock prices and eventual bankruptcy filing in October 2005. Additionally, Bennett was arrested and indicted on charges of securities fraud. THL did not allege any intentional wrongdoing by Grant, but did seek to enforce his 50% guaranty of Refco's agreement. Grant sought to have the case dismissed against him, stating that (1) the guaranty portion of the purchase and



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merger agreement failed to include any consideration and (2) THL Equity was required to attempt to recover from Refco before seeking payment under the guaranty.

Under New York law, in order for a contract to be considered valid there must be consideration. The Court found that although Grant did not understand the nature of consideration in a guaranty agreement, since the Court found that the original obligor has provided consideration, that consideration is also considered valid for the guarantor. Additionally, the Court found that THL Equity was under no obligation to pursue Refco prior to seeking recovery from Grant. The Court stated that in order to recover from a guarantor, a party had to show 1) a debt was owed from a third party, 2) the guarantor made a guaranty of payment of the debt, and 3) that debt had not been paid by either the third party or the guarantor. Since the plain language of the agreement created an unconditional 50% guaranty, there was no reason THL Equity was required to enforce against Refco as a conditional precedent to seeking enforcement and payment of the guaranty. Therefore, the Court denied Grant's motion to dismiss.



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This case illustrates the importance of making sure a loan or underlying transaction has proper consideration because such consideration will affect the enforcement of not only the original contract, but also any underlying guaranty.

The case above is cited as *Thomas H. Lee Equity Fund V, L.P, et al. v. Bennett, et al.*, No. 05-9608 (S.D.N.Y. 03/28/07)

Acceptance of Post-Default Payment Does Not Necessarily Constitute a Waiver

A NEW YORK COURT HAS RULED THAT WHEN A BORROWER DEFAULTS ON A SCHEDULED PAYMENT, THE LENDER'S ACCEPTANCE AND DEPOSIT OF SUBSEQUENT PAYMENTS DOES NOT NECESSARILY WAIVE THE LENDER'S RIGHT TO ACCELERATE THE NOTE.



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Quatro Amici, Inc. purchased Gazzi Pizza & Restaurant, Inc. and a portion of the purchase price was paid by Quatro making a promissory note in the principal sum of \$525,000 payable to Gazzi. The note provided, among other things, that (i) any payment received more than seven days after the due date would bear interest at the lesser of 12% or such other amount allowed by law, and (ii) if a monthly installment was not received within 15 days of its due date, Gazzi could declare the entire unpaid balance of principal and interest immediately due and payable.

Quatro tendered payment for the January 1, 2004 installment 14 days late, and Gazzi endorsed the check "with reservation of rights, under protest, without prejudice."

Gazzi's attorney advised Quatro through three separate letters that it was in default for failure to pay the installment when due on January 1, 2004 and owed additional interest. Quatro did not pay the amount demanded, but it continued to make subsequent monthly payments due under the note. Gazzi received and deposited the checks for the February through April 2004 payments with the same endorsement as the January check. Gazzi also deposited the checks tendered for the May through October 2004 payments, but endorsed them without restriction. Quatro did subsequently tender a check to Gazzi in the sum of \$892.91 for the deficiency, which was less than the amount claimed by Gazzi but which Quatro claimed was the amount due.

After the third demand letter was delivered to Quatro, Gazzi commenced this action against Quatro.

Quatro argued that Gazzi's acceptance and deposit of the checks for subsequent payments due constituted a waiver of any right Gazzi had to receive default interest or penalty and to accelerate the payments due on the note.

The Court first ruled that a holder of a note "may waive the right of acceleration by inaction." However, the Court found that Gazzi had advised Quatro of its intent to accelerate by three separate letters after the default. The Court also found that since Gazzi and Quatro did not agree on the delinquencies due to Gazzi, the \$892.91 did not necessarily cure the default or terminate Gazzi's right to accelerate the note. Furthermore, the Court ruled that Gazzi's acceptance of payments after his acceleration of the note did not constitute a payment waiver of acceleration.

This case illustrates the value of promptly notifying a borrower when it defaults under its obligations under the loan documents to enforce the lender's rights. Had Gazzi "sat on its rights" through inaction the Court's decision may have been much different. Furthermore, any notice of default should include language which provides that subsequent tender of payment after acceleration will not



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cure the default and the note shall remain accelerated.

This case is cited as *Gazzi Pizza Restaurant, Inc. v. Quatro Amici, Inc. et al*, No. 19373_05 (NY Sup. Ct. 02/16).

Attorney's Fees Recoverable For Recouping Collateral For Satisfied Loans

BANKS AND OTHER LENDING INSTITUTIONS SHOULD BE AWARE THAT THE U.S. 8TH CIRCUIT COURT OF APPEALS HAS RULED THAT WHERE A LENDER DELAYED THE RELEASE OF COLLATERAL AFTER THE LOAN WAS SATISFIED, THE BORROWER CAN RECOVER ATTORNEY'S FEES INCURRED IN OBTAINING THE COLLATERAL'S RELEASE.

John and Beverly Stacks, the owners of Mountain Pure LLC, a business that bottled and sold water and juices, obtained a \$650,000 line of credit from Bank of America, N.A. secured by a stock pledge, as well as a \$1.85 million term loan with BofA. However, in February 2002, BofA declared Mountain Pure's line of credit loan in default and advised the Stacks to seek alternative financing.

In response, the Stacks promptly obtained a \$1.1 million loan from J.B. Hunt LLC, from which a portion of the proceeds were used to repay the line of credit. Nevertheless, rather than releasing the stock upon receipt of full payment, BofA refused to do so, claiming that the stock was also security for the outstanding term loan.

The Stacks were particularly concerned about the release of the stock since such release was a condition precedent for the Stacks being able to purchase new machinery with the proceeds of the Hunt loan. Thus, Hunt's attorney, on behalf of the Stacks, initiated action to procure the release of the stock, which was eventually released by BofA. Hunt's attorney's fees were paid by the Stacks.

The Stacks and Mountain Pure sued BofA in District Court in an effort to recover the cost of attorney's fees incurred due to the belated release of stock, but lost in summary judgment when the Court ruled that neither had suffered any damages.

On appeal, the U.S. 8th Circuit Court of Appeals analyzed the applicable Arkansas law which traditionally held that attorney's fees are not awarded unless "expressly provided for by the statute or rule". The Court noted, however, that notwithstanding the above, Arkansas did allow the recovery of attorney's fees in breach of contract claims, and more significantly for the purpose of the Stacks case, when legal fees are incurred in an effort to recover property. Thus, the Court concluded that the Stacks were entitled to recover attorney's fees because those fees were generated in the recovery of "property," namely, the stock held as collateral.

Parenthetically, it is interesting to note that although in this case the Stacks were unable to prove damages, the Court did indicate that it might also award damages beyond legal fees to plaintiffs in instances where a delay in the release of collateral causes monetary loss or other negative effects. If collateral secures numerous loans, a lender must make certain that each set of loan documents contains the necessary security interests before refusing to release collateral once one of the loans is paid in full.

This case is cited as *Mountain Pure, LLC, et al. v. Bank of America, N.A.*, 481 F.3d 573 (8th Cir. 03/12/07).

Tip of the Month: Multi-Jurisdictional Borrowers



We have encountered many situations where a borrowing entity is organized in one jurisdiction and is purchasing or refinancing property or collateral in another jurisdiction. When this is the case, it is important to remember that the entity's good standing should be verified in both jurisdictions, the state of organization and the state where the borrower is doing business. We have seen many transactions where the entity is in good standing in one jurisdiction but not the other. In fact, there are times where we have found the entity's charter has been revoked in the state of organization, while it remains in good standing in the state where it is doing business. However, since the charter no longer exists, the good standing in the other jurisdiction does not mean that the entity has the legal power to validly enter into the loan transaction.

Providing our clients with the necessary resources to deal constructively with problem loans and the implementation of creative loan work-out arrangements.

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Furthermore, lien searches should be ordered in the state of organization. Under Article 9 of the Uniform Commercial Code the appropriate filing jurisdiction on an all asset filing is the jurisdiction where it is organized, even though the loan is being used by the borrower to finance its operations in another jurisdiction. Fixture filings are still filed in the county where the collateral is located.

We Would Like To Hear From You

We publish this newsletter as a service to our clients as a means to make them aware of certain aspects of the law. As always, we would like to hear feedback from our readers regarding the content of the newsletter. If there are items or topics you would like to see covered in future issues, or you have a suggestion concerning the newsletter itself, you may send them to Ben Harris at BJHarris@lerchearly.com, or via phone at 301-961-6096.

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