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Attempt To Restructure Debt May Relieve Parties From Obligations Under The Note and Guaranty

The Tennessee Court of Appeals recently held that a co-maker of a note was relieved of any obligation he had under the note or his personal guaranty when the lender refinanced the original note pursuant to a Bankruptcy Court order.

In March 1996, William G. Dickerson purchased fifty percent of G & S Implement Co., Inc. from Eddie Kingrey. On May 7, 1996 G & S Implement renewed a year old note for $268,036.28 with Cumberland Bank. At the time, Dickerson and Kingrey signed the note as officers and separate, personal guaranties. Mr. Dickerson's guaranty included two provisions: 1) his guaranty was limited to a maximum amount of $267,936.28, and 2) his guaranty contained a revocation provision which, once invoked, prevented him from becoming liable for advances or new indebtedness extended or created after the notice of revocation.

In December 1996, Dickerson sought to sever all ties with G & S and on December 16, 1996 notified the Bank in writing that he was revoking his guaranty. Cumberland continued to advance funds to G & S after receipt of the notice and even after Kingrey and his wife filed for Chapter 11 bankruptcy. In 2000, in order to satisfy an order of the Bankruptcy Court to refinance the 1996 note, the Kingreys and Cumberland executed a new promissory note for $170,835. This 2000 note provided that the Kingreys were the sole borrowers. The 2000 Note also included a provision that it was a renewal of the 1996 Note and provided for final payment of the indebtedness in 2005. In February 2003 Cumberland filed suit in circuit court against G & S, Kingrey and Dickerson alleging that the 1996 Note was in default. Since G & S was no longer in existence and Kingrey could not be pursued due to the bankruptcy proceeding, Cumberland proceeded solely against Dickerson. In September 2004 the trial court found for Cumberland and granted a judgment against Dickerson for $162,246.37, plus attorney's fees.

On appeal the Court found that Cumberland was inconsistent in its arguments for the continued liability of Dickerson. On the one hand, Cumberland argued that the 1996 Note became due in 2001 and they were pursuing Dickerson based upon default of that obligation. However, Cumberland also stated that the 2000 Note was a renewal of the 1996 obligation. The Court concluded that no one could be in default of the 2000 Note, as it was not due and payable until 2005. Further, the Court found that when the Bankruptcy Court ordered the restructure of the 1996 Note, the Court required a refinance of the debt and not a restructure or reaffirmation of the original indebtedness. Since the refinance did not include Dickerson as either co-maker or guarantor, and the 2000 Note paid off and replaced the 1996 Note, the Court held that Dickerson was not liable under the 2000 Note.

This case emphasizes that if a lender intends to restate and restructure prior indebtedness, it must include all parties to the original indebtedness to ensure continued liability of all parties.

The case above is cited as *Cumberland Bank v. G & S Implement Co., Inc., No. M204-02650-COA-R3-CV, 2006 Tenn. App. LEXIS 528.*

Bank's Waiver of Claims Against Borrower Does Not Relieve Guarantor's Liability For Debt

The Michigan Court of Appeals recently ruled that a lender's waiver of claims against a borrower does not relieve the liability of personal guarantors for the remaining amount of debt owed under the borrower's loan.

Charter One Bank N.A. made loans to ELO LLC and OSB Inc. The business owners, Edwin Osbourn and James Osbourn, personally guaranteed the repayment of the loans. The borrowers defaulted on the promissory notes and subsequently became insolvent. Upon default, Charter One sued the borrowers and, in settling the suit, agreed to release the borrowers from further liability in exchange for their remaining assets.

After receiving the borrowers' assets, Charter One sued on the Osbourns' guaranty for the remainder of the outstanding debt. At trial, the Osbourns argued that the agreement with the borrower applied to their own continued personal liability for the debt as well as the liability of the borrowers and presented an affidavit from the borrowers' attorney stating that Charter One intended to waive all future claims against the businesses. On that basis, the trial court ruled that the waiver applied to the Osbourns.

On appeal, the Court ruled that the stipulation did not apply to Charter One's claims against the Osbourns because Charter One did not pursue its rights against the Osbourns in the underlying case. The Court noted, "[T]here is nothing in the agreement or subsequent order…to suggest that [the owners], individually, were parties to the proceedings." While the Court ruled the affidavit by the borrowers' attorney was admissible to show that a potential ambiguity existed and to clarify the meaning of the agreement, the Court observed that the affidavit merely showed that Charter One intended to waive its claims against the borrowers' entire estate. Accordingly, the Court concluded that Charter One did not waive its claims against the Osbourns by joining the stipulation.

This case highlights the importance of drafting clear and unambiguous waivers setting forth which parties are being released and which parties remain liable for the debt.

This case is cited as *Charter One Bank, N.A. v. Osbourn, et al., No. 260497 (Mich. Ct. App. 08/10/06, unpublished).*

Change of Business Form Extinguishes Guarantor's Obligations

An Arkansas court has determined that a guarantor is not liable for the debt of a partnership consisting of a former sole proprietor after the initial debt has been paid.

In this case, Helena Chemical Company extended Jerry Caery, Jr. credit for farming supplies in 1988. His father signed an unconditional guaranty for Caery's credit, together with any of Caery's future indebtedness, The guaranty also indicated that it would remain in effect until revoked by the father in writing. In subsequent years, Helena continued to provide Caery with various amounts of credit, including $40,000 in 1995. In 1996, Caery formed a partnership named JLC Farms. In 1998, Caery received credit from Helena in the amount of $250,000, but Helena used the original individual credit application with Caery dating back to 1995. Caery subsequently defaulted on the loan, and in 1999 Helena filed a suit against both Caery and his father for the credit extended to JLC, which was eventually dismissed in January 2000. In February, 2002, Helena filed another suit for the remaining outstanding balance of $167,000, alleging that Caery and his father were jointly and severally liable. The father admitted to signing the continuing guaranty, but claimed he was not liable for the credit extended to JLC because he had not guaranteed that debt when he signed the original guaranty. The trial court agreed with the father stating that he had not guaranteed JLC's debt, and Helena appealed.

Although the father never revoked the guaranty, as required by its terms, the Appellate Court also agreed that the father was not liable for JLC's indebtedness. Discussing the role of a guarantor generally, the Court stated that a guarantor's liability is to be strictly construed and "cannot be extended by implication beyond the expressed terms of the agreement." The Court went on to say that material changes in the obligations secured by the guaranty, such as requiring the guarantor to do more than originally intended, discharges the guarantor if made without the guarantor's consent. Specifically, the Court looked to other states' laws, where guarantors have been discharged from liability when the principal debtor changed the form of their business "from a sole proprietorship to a partnership and credit is extended to that partnership without the knowledge or consent of the guarantor." In addition, the Court noted that the substantially increased risk undertaken by Helena in extending JLC a much larger amount of credit than they had extended Caery was also a material alteration of the debt.

This case reminds us that any change in the form or structure of a borrower should be documented and acknowledged by all parties to the original indebtedness if the lender intends all parties to remain liable on the debt.

This case is cited as *Helena Chemical Company v. Caery, Jr., 93 Ark.App. 447, 2004 WL 3619829 (Ark.App.)*

Lender's Choice of Law Contributes to Rejection of Guarantor's Defenses To Non-payment

The U.S. District Court for the Western District of Louisiana found in favor of an assignee of a U.S. Small Business Administration loan after rejecting affirmative defenses by the guarantor. This was due in part to the guarantor's attempt to assert state law defenses in a matter governed by Federal Law.

In 1997, the borrower, Stewart A. Cathey & Sons, Inc., executed a promissory note in the amount of $223,000 in favor of Northeast Louisiana Industries, Inc. Stewart Cathey personally guaranteed the loan and provided an assignment of life insurance. Northeast assigned the note, the guaranty, and the life insurance policy to the SBA. In 1998, the Borrower filed for Chapter 11 Bankruptcy. In August, 2000, the SBA assigned its rights in the note, guaranty, and life insurance to LPP Mortgage, Ltd. Prior to the assignment, the SBA had lost the note, but had executed a lost note affidavit and published it in two local periodicals.

On September 30, 2004, LPP filed suit against the Cathey to recover the balance due under the note. Cathey filed for summary judgment on grounds that the six year statute of limitations had run barring LPP's recovery, LPP had not adequately proven its ownership right to enforce the note, and neither LPP nor the SBA complied with Louisiana law to enforce lost promissory notes.

The Court held that federal law provides that the six-year statute of limitations is interrupted when a person provides written acknowledgment of the debt. When the Borrower listed the debt in its disclosure statement or schedule of debts in the bankruptcy proceeding, it acknowledged the debt and the statute of limitations began to run anew. The Court also ruled that LPP had a right to enforce the note even though it was not in possession of the note due to loss under Louisiana law, and that publishing the loss of the note in two public newspapers was sufficient. The Court noted that federal law governs questions involving rights of the United States arising under nationwide federal programs, as provided in the Note. Since the loan at issue was an SBA guaranteed loan, Cathey could not assert state law defenses because federal law controlled all contractual rights under the loan documents, as elected by the lender.

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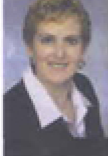

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Choice of law provisions contained within an instrument will determine the laws to be applied in any action to recover debt in most cases. Thus, such a choice should be made carefully and with the assistance of counsel.

This case is cited as *LPP Mortgage, Ltd. V. Cathey, 2006 U.S. Dist. LEXIS 32560 (W.D. La. May 23, 2006).*

Upcoming Seminars

On Wednesday, December 6 in our Bethesda office, and again on Wednesday, December 13 in our office in McLean, Virginia, Larry Lerman will be presenting a seminar for lenders and real estate professionals entitled "Understanding Insurance Coverages and Controlling Insurance Proceeds: A Primer for Lenders and Landlords." Additional information will be posted on our website, and invitations will be sent out soon. If you have additional questions, please contact Benjamin Harris at bjharris@lerchearly.com, or at 301-961-6096.

If you do not wish to receive the Bulletin in the future or you would like to receive this Bulletin only by e-mail, please call Ben Harris at (301) 961-6096 or e-mail him at *BJHarris@lerchearly.com.*

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