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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.

This newsletter is sent via email in HTML format. If you wish to print a copy of the newsletter, you may access a .pdf version by following the "Printer-Friendly version" link below.

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**In This Issue:****Guaranty Discharged by Modification of Primary Debt**

The U.S. District Court in New York determined that a guarantor is no longer liable for a guaranteed debt because the terms of the debt were substantially altered without the guarantor's consent and reaffirmation.

**Defective Notice May Be Determined Ineffective**

A Florida court determined that if required notice is not addressed to the specific person and address given in a contract, such notice may be ineffective.

**Dealership Allowed to Pursue Fraud Claims Against GMAC**

The Ninth Circuit Court of Appeals determined that a car dealership can sue its lender under floorplan financing documents for fraud and conversion, but not for breach of fiduciary duty.

**Tip Of The Month**

On November 14, 2008, an SBA procedural notice 1000 - 1081 was published and became effective relating to the use of LIBOR, in addition to the Wall Street Journal Prime Rate and Optional Peg Rate as a variable interest rate option for SBA 7(a) loans.

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**Guaranty Discharged by Modification of Primary Debt**

**THE U.S. DISTRICT COURT IN NEW YORK DETERMINED THAT A GUARANTOR IS NO LONGER LIABLE FOR A GUARANTEED DEBT BECAUSE THE TERMS OF THE DEBT WERE SUBSTANTIALLY ALTERED WITHOUT THE GUARANTOR'S CONSENT AND REAFFIRMATION.**

In *United Natural Foods, Inc., v. Burgess*, Helene Burgess owned 3 grocery stores, each of which were individually incorporated and separately responsible for their own obligations. In May, 1998, Burgess's employee completed credit applications with United for the purchase of foods and related products for two stores. The applications were completed with Burgess's name, social security number, address and phone number. An employee signed Burgess's name, as was routinely instructed or authorized by Burgess. In December, 2001 the store manager, Bushar Omar, completed and signed his name to an application for the third (Broadway Street) store. The credit applications

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had two paragraphs immediately preceding the signature line. The second paragraph was a guaranty that read, in part, "the undersigned jointly and severally guarantee payment on each invoice and the performance of all terms and conditions of this Credit Application. This is a continuing guaranty and shall remain in full force until written notice of revocation is received and acknowledged...." The paragraph ended with a blank which the guarantor was supposed to complete with the date, but which remained incomplete on each application. United provided food and other products to the three stores through 2003. The stores frequently failed to pay or made late payments and by mid-2003 collectively owed United over two million dollars. In November, 2003, Burgess sold all of her shares in the three stores to Omar. Shortly thereafter, Omar closed the Broadway store because of negative cash flow. In December, 2003, United briefly stopped sending goods to the remaining two stores but resumed shipments on the condition that it receive a certified check before delivery of goods. United sought a personal guaranty from Burgess but she repeatedly refused to guaranty the debt. In January, 2004, Omar, the three stores and United entered into a settlement agreement for all three stores. The settlement agreement consolidated the debts of all three stores into a single note and extended payments over more than ten years, with the first payments being used to pay off the Broadway store's portion of the debt. All three stores were jointly and severally liable under the note. The other two stores closed shortly thereafter with only a small fraction of the debt having been repaid. In June, 2005 United sued Burgess to recover under the initial guaranties in the credit application. Burgess moved for summary judgment claiming that i) neither she nor her authorized agent signed the guaranties, ii) the guaranties were not signed in a personal capacity, and iii) the guaranties were discharged by an agreement which modified the stores' obligations.

The court agreed with Burgess. First, the court considered the authenticity of the signature and determined that there was a genuine issue of fact as to whether the signature was authentic and authorized. Next, the court looked at New York agency law which states that an agent will not be individually bound unless there is "clear and explicit evidence" of the agent's intention to be personally liable. The court enumerated factors to consider: length of the contact, location of the liability provisions in respect of the signature, nature of the negotiations and signatory's role in the corporation. Here, the court found that there was also a genuine issue of material fact as to whether Burgess intended to be individually bound. The court opined that it would have been better for the contract to have included two signature lines, one for the corporation and one for the guarantor. Without that, it was not willing to find an intent to be personally bound. Third, rendering the above issues irrelevant, the court looked at New York surety law which states that an alteration of a contract without the guarantor's consent will release the guarantor from his obligations. The court cited case law which stated that the "test is whether there is a new contract which will be enforced...." Here, the court stated that the contracts underlying the initial guaranty, if there was an initial guaranty, were the invoices between United and each individual store. When the parties signed the settlement agreement, the obligations of the stores to United were fundamentally altered. Yet, Burgess never consented to the terms of the settlement agreement or the note. The court found that the note replaced the invoices as the "operative debt instrument" and that "Burgess's guaranties of the original invoice debts did not survive the modification of the obligations of the guaranteed stores."

Further, the court refused to enforce United's provision in the settlement agreement which expressly preserved its right to proceed against Burgess under the guaranties. The court stated that Burgess's obligations under the initial guaranties were discharged regardless, because otherwise United could theoretically have proceeded against her under both the original guaranties and under the new obligations. Last, United argued that the guaranties were "continuing" guaranties, such that they would apply to all obligations of Burgess to United, whether arising under invoices or not. However, the court disagreed, stating that United's language limiting the guaranty to "payment on each invoice" was not broad enough to be a continuing guaranty, which should cover all obligations "of every kind and character." In a final blow, the court stated that United could easily have included the proper continuing guaranty language within its credit applications, but did not.

This case reminds creditors that, in order for a guaranty to survive a modification of the underlying debt, it must obtain specific consent, agreement and affirmation by the guarantor to the modifications.

The case is cited as *United Natural Foods v. Burgess*, 488 F.Supp.2d 384 (S.D. New York).

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### **Defective Notice May Be Determined Ineffective**

**A FLORIDA COURT DETERMINED THAT IF REQUIRED NOTICE IS NOT ADDRESSED TO THE SPECIFIC PERSON AND ADDRESS GIVEN IN A CONTRACT, SUCH NOTICE MAY BE INEFFECTIVE.**

In 2000, Presidential Financial Corporation made a loan to Stanley Freight which was secured by an



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assignment to Presidential of all of Stanley's accounts receivable. Some time later, Building Materials Corporation (d/b/a GAF Materials Corporation) entered into a warehousing agreement with Stanley which resulted in accounts receivable for Stanley. Presidential sent a letter to GAF's office in Tampa, Florida notifying GAF of the financing arrangement between Presidential and Stanley and requesting all payments GAF owed to Stanley to be paid directly to Presidential. The letter was acknowledged by a GAF employee in the Tampa office, Mr. Whitlock, and returned to Presidential. GAF made some payments to Stanley and made other payments to Presidential. Presidential sued GAF for breach of contract, open account and unjust enrichment. In its defense, GAF produced an affidavit of its Executive Director of Real Estate stating that all notices under GAF's warehousing agreement with Stanley were required to be sent to GAF's Wayne, NJ office to the attention of "Executive Director, Real Estate." The affidavit further stated that GAF's Tampa office had no accounting personnel and that the person who had acknowledged the letter from Presidential held the position of "logistics manager" and had only been in his position for two weeks when he signed the acknowledgement. GAF claimed that it had established procedures with Stanley whereby Stanley would send GAF certain invoices for which payment was to be made to Presidential and others for which payment was to be made to Stanley directly and that GAF had complied with such procedures. GAF claimed that it was unaware of the letter sent to Tampa and signed by Mr. Whitlock until the lawsuit was filed.

The lower court granted summary judgment to Presidential on the basis of the acknowledgement by Mr. Whitlock of the assignment letter. On appeal, GAF argued that the notice given via the assignment letter signed by Whitlock was inadequate. The appellate court agreed that under Florida law an organization who receives actual notice of an assignment may be held liable to the assignee if it makes payment to the debtor instead of the assignee. However, it went further than the trial court and looked into Florida law regarding what constitutes effective notice. The statute provides that notice is effective if it is "brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his or her attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information..." The statute goes on to say that "due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his or her regular duties or unless the individual has reason to know of the transaction and that the transaction would be materially affected by the information." Here, the appellate court determined that genuine issues of material fact remain as to whether the notice given by Presidential and acknowledged by Mr. Whitlock was proper, binding notice. GAF provided evidence that it had designated a specific office and a specific individual other than Mr. Whitlock in the Tampa office for receipt of notices under the warehousing agreement. Further, Mr. Whitlock's receipt and acknowledgment of the notice were not part of his regular duties and he would not necessarily have understood the significance of the notice or acknowledgement. Although GAF had made some payments consistent with the notice, evidence was presented that this was due to separate procedures established between GAF and Stanley. Accordingly, the appellate court determined that the lower court had improperly granted summary judgment in favor of Presidential.

The case is a reminder to parties to strictly comply with notice provisions contained within their contracts.

The case is cited as *Building Materials Corporation of America v. Presidential Financial Corporation*, 972 So.2d 1090 (Fla. Ct. App. 2008).

**Dealership Allowed to Pursue Fraud Claims Against GMAC**

**THE NINTH CIRCUIT COURT OF APPEALS DETERMINED THAT A CAR DEALERSHIP CAN SUE ITS LENDER UNDER FLOORPLAN FINANCING DOCUMENTS FOR FRAUD AND CONVERSION, BUT NOT FOR BREACH OF FIDUCIARY DUTY.**

In *Giles v. General Motors Acceptance Corporation*, Mr. and Mrs. Giles owned and operated two car dealerships in Yerington, Nevada: Yerington Ford and Giles Chevrolet. Both dealerships obtained financing for their inventory of vehicles through General Motors Acceptance Corporation (GMAC) and both signed a "continuing cross-guarantee" under which each dealership guaranteed the obligations of the other to GMAC. The Gileses also personally guaranteed the dealerships' obligations to GMAC. During GMAC's routine audit in October, 2001, GMAC discovered that Yerington Ford had sold or leased a number of vehicles without repaying GMAC the portion of financing (approximately \$291,000) owed on those vehicles in accordance with their financing arrangement. During investigation, the Gileses discovered that an employee had embezzled hundreds of thousands of dollars from the dealership. Although the money attributable to those vehicles was repaid to GMAC within two weeks of the audit, the Gileses signed documents i) assigning to GMAC all of the proceeds from the sale or lease of vehicles by both dealerships, ii) placing a \$4,300,000 lien on separate property owned by the Gileses, and iii) a forbearance agreement giving GMAC authority to monitor

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Yerington Ford during all hours of operation, take possession of all Yerington Ford vehicles' keys and titles, and agreeing to reimburse GMAC for expenses incurred in such efforts.

Further, GMAC began holding all amounts due to the dealerships by car manufacturers and promised to release the hold as soon as Yerington Ford paid the past-due amounts. Contrary to its promise, the hold remained until Yerington Ford went out of business in May 2003 and until the Giles Chevrolet complaint was filed in October 2004. Further still, GMAC did not obtain assignments from the Gileses authorizing such hold until several months after the holds were placed, when GMAC "tricked" them into signing and backdating the documents by misrepresenting the purpose and use of the assignments. The Gileses filed suit regarding the Yerington Ford dealership in March, 2003 claiming fraudulent and negligent misrepresentation, conversion, breach of fiduciary and confidential relationship duty, constructive fraud, undue influence, intentional infliction of emotional distress and breach of contract. In October, 2004, the Gileses filed suit on behalf of Giles Chevrolet on claims almost identical to those of Yerington Ford and based on the same factual allegations. The lower court granted summary judgment to GMAC in the Yerington Ford case and then in the Giles Chevrolet case, stating that the claims in that case were barred because they had been previously determined in the Yerington Ford case.

The Ninth Circuit Court of Appeals found that the lower court had misapplied the law and that most of the Gileses claims should have been allowed to proceed on their merits. First, the Ninth Circuit determined that Nevada courts had never before addressed whether the economic loss doctrine (which states that purely monetary damages, as opposed to damages involving physical harm to person or property, are only remediable in contract) applied to fraud and conversion claims and that such claims were not barred. Second, the Court found that GMAC had actually committed fraud by holding the dealerships' funds without authority to do so and then by misrepresenting documents it demanded the Gileses sign, which it then back-dated to a date prior to the date the holds were placed on dealership funds. Finally, regarding conversion, the Court stated that GMAC had a duty under Nevada law not to take dealership property without proper authority that was completely independent of any contractual duty. Accordingly, the Ninth Circuit determined that the claims against GMAC for fraud and conversion should have been allowed to proceed on their merits.

The Ninth Circuit agreed with the lower court that summary judgment in favor of GMAC was appropriate regarding the breach of fiduciary duty issue. The Gileses had claimed that they had a confidential or special relationship with their GMAC representative that went beyond the typical arms-length business relationship. They relied on this relationship by signing the forbearance documents without reading them, despite the fact that other documents between GMAC and the dealerships specifically disavowed any fiduciary relationship. However, the Ninth Circuit found that the Gileses failed to establish such a confidential or special relationship, concluding that signing contracts without reading them and other testimony were insufficient to turn a friendly, arms-length business relationship into a fiduciary relationship.

This case stands as a reminder to lenders dealing with distressed borrowers that they must act within the contractual boundaries established with their clients in good faith and in the context of a work-out or similar type transaction.

This case is cited as *Giles v. General Motors Acceptance Corp.*, 494 F.3d 865 (9th Cir. 2007).



## Tip Of The Month

**ON NOVEMBER 14, 2008, AN SBA PROCEDURAL NOTICE 1000 - 1081 WAS PUBLISHED AND BECAME EFFECTIVE RELATING TO THE USE OF LIBOR, IN ADDITION TO THE WALL STREET JOURNAL PRIME RATE AND OPTIONAL PEG RATE AS A VARIABLE INTEREST RATE OPTION FOR SBA 7(A) LOANS.**

Previously, lenders were only allowed to use the Wall Street Journal Prime Rate or Optional Peg Rate in pricing variable rate 7(a) loans. Lenders will now be able to use the 30-day LIBOR rate plus 3 percentage points as the "Base Rate" in its 7(a) variable rate loans.

This notice was issued in order to assist lenders in selling their loans on the secondary market by ensuring "continued availability of capital to small businesses and to improve liquidity in and efficiency of the secondary market."

The maximum allowable spread on variable rate loans will not change. The LIBOR based note initial interest rate cannot exceed the equivalent of Wall Street Journal Prime Rate plus 2.25% for loans with an original maturity of less than 7 years or Wall Street Journal Prime Rate plus 2.75% for loans with an original maturity of 7 years or longer.

Also, the SBA has revised the Loan Authorization Boilerplate (Version 2009). This version is now available on the SBA website. Use of this version will be mandatory as of December 1, 2008 (although the SBA strongly encourages preferred lenders to begin using the new version as soon as possible).

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### **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 Bill Melchior at [wgmelchior@lercheearly.com](mailto:wgmelchior@lercheearly.com).

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