PUBLICATION

Considering Guaranties

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This edition of Dispatches from the Trenches takes a look consideration issues applicable to guaranties, focusing on how related common law issues are summarized in The Restatement (Third) of Suretyship and Guaranty. It may surprise some that the analysis differs for guaranties as compared to other types of contracts.

Before proceeding, it is prudent to note that the Restatement is not binding law. Rather it is an attempt by the American Legal Institute to describe general principles of common law. However, it is a useful tool not infrequently cited by judges.

1. Standard Contract Law

Generally speaking, the law does not enforce unilateral promises. However, a promise exchanged for something of value is a binding contract under the protection of the Lady Justice. The foregoing concept is captured primarily by the legal concept of "consideration." It is one of the first "terms of art" that lawyers encounter in law school. In the simplest terms, consideration is something of value bargained for by the party claimed to be bound by the contract. The Restatement (Second) of Contracts summarizes this well defined concept as follows:

To constitute consideration, a performance or a return promise must be bargained for. A performance or return promise is bargained for if it is sought by the promissor in exchange for his promise and is given by the promisee in exchange for that promise. The performance may consist of: (a) an act other than a promise; (b) a forbearance; or (c) the creation, modification or destruction of a legal relation. The performance or return promise may be given *to the promisor or some other person.* It may be given by the promisee or by some other person.[1]

Of course, detrimental reliance can also serve as a substitute for consideration if such reliance is reasonable. The Restatement (Second) of Contracts captures this issue by noting that "[a] promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires." [2]

2. Guaranties and The Exceptions "that Swallow the Rule" (Restatement 3d- Section 9)

Since a guaranty is nothing more than a contract, standard logic would dictate applying the concept of consideration to guaranties. However, because a guaranty involves multiple parties (guarantor, borrower and lender), the analysis can be more complex.

In Downstream Guaranties (where an owner guarantees the obligations of its subsidiary) the benefit to the guarantor is clear: the value of its stock or other ownership interest in the borrower is increased by the infusion of capital into the borrower. However, the benefits are not as clear in Upstream Guaranties (where a subsidiary guarantees the obligations of its owner) or Cross-Stream Guaranties (where a brother-sister company relationship exists and one sibling guarantees the obligations of the other).

As occurs more frequently than many practitioners would like (but is undoubtedly welcomed in this instance), well-defined legal concepts can sometimes be subject to exceptions that swallow the rule. The Restatement (Third) of Suretyship and Guaranty provides such an exception in the context of traditional consideration analysis, stating that "***Except as provided [below]***, the requirement of consideration for [guaranties] is the same as for contracts generally." The exceptions specified read as follows:

A secondary obligation does not fail for lack of consideration if:

1. the underlying obligation is supported by consideration and the later creation of the secondary obligation was part of the exchange for which the obligee bargained; or
2. the promise of the secondary obligor is in writing and signed by the secondary obligor and recites a nominal purported consideration; or
3. the promise of the secondary obligor is made binding by statute; or
4. the secondary obligor should reasonably expect its promise to induce action or forbearance of a substantial character on the part of the obligee or a third person, and the promise does induce such action or forbearance.[3]

The exception in item (a) above addresses situations where "the existence of the [guaranty] is part of the exchange bargained for by the [lender or other] obligee to induce it to extend credit to, or otherwise contract with, the [borrower or other] principal obligor, but actual creation of the [guaranty] (not supported by separate consideration) is delayed until after the obligee contracts with the principal obligor." The Restatement acknowledges that "strictly speaking" the guaranty is not supported by consideration in the form of the loan made by the lender to the borrower because the loan already existed. However, the Restatement articulates an exception to the traditional rule noting:

Commercial realities often will cause [a lender or other obligee] to proceed with its transaction with the [borrower or other] principal obligor on the understanding that the [guaranty] will be forthcoming. No strong policy supports a rule that would render a [guaranty] undertaken in such circumstances unenforceable. Accordingly, this paragraph provides an exception to the requirement of consideration in such case.

The exception in item (b) above provides incentive to drafters to recite actual receipt of nominal consideration (as well as other good and valuable consideration). Some guaranties or other forms of suretyship are supported by a payment to the guarantor or other secondary obligor in exchange for its promise to perform the obligations of the borrower or other principal obligor. A classic example is a payment and performance bond offered by an insurance company in connection with a construction project. Many guaranties briefly include similar concepts by alleging payment of nominal or other good and valuable consideration.

As long as the borrower or other principal obligor performs its obligations to the lender or other obligee, the guarantor or other secondary obligor will not be called upon to perform the guarantied obligations. Even if it were to be required to do so, it would generally have recourse against the borrower or other principal obligor by way of its rights of subrogation. It may also have a right of contribution against other guarantors.

As such, any payment made to the guarantor or other secondary obligor is often only a small fraction of the value of the underlying obligation. As official comments in the Restatement note: "it would [therefore] often be difficult to say whether a nominal consideration (e.g., one dollar) is adequate in amount, and courts do not ordinarily inquire into that question. [The Restatement] goes further and precludes inquiry into whether the nominal consideration recited in a written contract establishing a secondary obligation was mere formality or pretense, or whether it was in fact given."

Drafters should be careful, however, to recite actual receipt of such consideration rather than making payment a condition to the effectiveness of the guaranty. As noted in the Restatement: “If, however, actual performance of consideration promised to the guarantor is a condition of the guarantor's duties under the guaranty, this section does not preclude the guarantor from asserting material failure of that performance as a nonoccurrence of that condition.”

The exception in item (c) above regarding promises made “binding by statute” generally relates to the laws in some jurisdictions regarding “contracts under seal.” In some jurisdictions, guaranty may be binding by virtue of a seal or a statutory substitute therefor.

The last exception, in item (d) above, is a modified application of the traditional concepts of detrimental reliance discussed above. The key difference is the removal of the concept that the remedy granted for breach may be limited as justice requires. In other words, if the criteria of item (d) above are satisfied, the “appropriate remedy is enforcement of the [guaranty] according to its terms. Difficult problems of measurement of the extent of the reliance are thereby avoided. . . .”[4]

3. Final Thoughts

Although local statutory and case law should always be consulted, the Restatement provides a nice summary of common law principles generally applicable to consideration analysis in the context of guaranties. There are also some useful take-aways. For example, drafters should be careful to recite the actual receipt of specified nominal consideration as well as other good and valuable consideration; and litigators may find it useful to be able to quote the Restatement exceptions when responding to certain failure of consideration claims.

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[1] Restatement (Second) of Contracts, Chapter 4, §71.

[2] Restatement (Second) of Contracts, Chapter 4, §90.

[3] Restatement (Third) of Suretyship and Guaranty, Chapter 2, §9.

[4] Restatement (Third) of Suretyship and Guaranty, Chapter 2, §9, Official Comment (e).