Secure Transactions

Careful Drafting Can Keep Guaranties If Loans Are Modified

As many commercial loans are being restructured, the question arises whether changing the terms of the loan necessitates obtaining reconfirmations of existing guaranties. Persuading a guarantor to agree to new terms may be difficult, and more difficult still is a situation with multiple guarantors, each of whom must be persuaded and each of whom may potentially hold up the process. An analysis of New York case law suggests that, with careful drafting of the guaranty and of the amended loan documents, it is possible to ensure that guarantors will remain obligated, without reaffirming their obligation under their guaranties, even when there are material changes to the terms of the loan such as significant increases in interest rate or extensions of the payment schedule.

Generally, if the terms of the underlying loan subject to the guaranty are substantially modified without the guarantor's consent, the guarantor is released from liability. In other words, the guarantor's undertaking cannot be altered to cover a different obligation than the one he originally signed on for because the doctrine of strictissim juris dictates that the guarantor will only be held liable for what he explicitly agreed to. However, commercial loan guaranties often contain anticipatory waiver provisions whereby the guarantor consents in advance to changes in the terms of the loan, and, sometimes, even waives the right to be notified of such alterations. Such waivers are valid and enforceable under New York law. Whether the waiver will ensure that the guarantor will remain liable despite the loan restructuring, making a reaffirmation of the guaranty unnecessary, depends on: (1) whether the scope of the guarantor's consent is broad enough to encompass the modification at issue, and (2) whether the change in the terms of the loan goes beyond modification and, in fact, effects a novation. For example, in Leeward Isles Resorts, Ltd. v. Hickox, the Appellate Division ruled that the guaranty was unenforceable because the changes to the terms of the loan “did not merely modify the [original] agreement…but constituted a novation thereof.” This article will examine how New York courts have analyzed anticipatory waiver provisions in guaranties and where New York courts have delineated the boundary between modifications and novations. This article will also make drafting suggestions, for both the guaranty and the amended loan documents, to ensure that the guarantor will not be released from liability notwithstanding any restructuring of the loan, thus avoiding the potentially onerous process of obtaining guaranty reaffirmations.

Did the Guarantor Consent?

As is the case with all contract interpretation, courts look to the language of the waiver to determine what the guarantor agreed to. “The question for the Court…[is] whether the scope of the consent given is sufficiently broad to encompass the change [in the terms of the loan] at issue.” Some waivers enumerate specific modifications in the terms of the loan that the guarantor consents to in advance. For example, in White Rose Food v. Saleh, the waiver stated that the “Guarantors…agree and consent that the time for payment may be extended” and so the court upheld the lender’s right to reduce the weekly payments and grant more time for payment of the debt. On the other hand, many waivers are worded broadly, such as the waiver in Bank of New York v. CMS Funding, which provided that “[the loan] may from time to time, in whole or in part, be renewed, extended, modified, accelerated…all without any notice to, or further assent by, or any reservation of rights against, Guarantor and without in any way affecting or releasing the liability of the Guarantor hereunder.” New York courts have found such broad consent language sufficient to cover such material modifications as increasing the interest rate from 10 percent per annum to 15.5 percent per annum (Manufacturers and Traders Trust Co. v. Thielman10), changing the currency (In re Boco Enterprises11), and various changes to the payment schedule (First American Bank of NY v. Builders Funding12; Crossland Fed. Savings v. Suna13; American Bank & Trust Co. v. Koplak14; Regency Equities Corp. v. Reiss15).
Was There a Novation?

Guarantors often argue that, although they consented to modifications through a prospective waiver, the change in loan terms at issue is not in fact a modification, but rather a novation of the original loan agreement, creating an entirely new loan agreement.

“In a novation, the existing obligation is extinguished by the acceptance of a new promise in satisfaction of the original obligation.” 16

Because a guaranty applies only to the specific obligation, the extinguishment of that obligation releases the guarantor from liability.

Whether an agreement has been extinguished is a matter of the parties’ intent. 17 Again, courts look to the contract language to deduce the intention of the parties; specifically, the courts consider whether the amended loan documents provide that they “supersede” or are “in lieu of and shall supersede” any prior agreement between the parties, or that the new agreement effects a “revocation and cancellation” of any prior agreements. 17

These are examples of language that has led courts to hold that a novation had occurred, with the result that the guarantor is released from liability. 18 For example, in Northville Industries Corp. v. Fort Neck Oil Terminals Corp., 19 the amended agreement “clearly and unequivocally provided that it [was] to be in ‘lieu of’ and would ‘supersede’ any other agreements existing as of that date between the parties.” The Second Department stated:

“It is well settled that ‘where the parties have clearly expressed or manifested their intention that a subsequent agreement supersedes or substitutes for an old agreement, the subsequent agreement extinguishes the old one.’” 20

On the other hand, a provision in an amended loan agreement that read: “[i]n this contract shall replace all prior agreements between [the parties]” was found by the First Department insufficient to effect a novation. The court found that “in the absence of more definitive language,” there was no extinguishment of the prior agreement. 21 Likewise, where the amended loan agreement explicitly provides that the amended agreement does not extinguish or terminate the original agreement, courts have held that a novation has not occurred. 22 For example, in Citibank v. Outdoor Resorts, the parties amended and restated the original loan agreement four times, yet the court held that no novation occurred and the guarantors remained liable because each of the amendments “clearly and unambiguously states that it does not discharge any outstanding obligations under the ‘prior notes,’” a provision that the court found to be a clear expression of the “parties’ intent to preserve the Personal Guarantees.” 23

Waiver Language

The drafting lesson for lenders’ counsel, gleaned from a review of New York case law, is that waiver language in guaranties should be as broad and absolute as possible to ensure that guarantors will remain liable notwithstanding any loan restructuring that may take place. The following are some suggestions:

• The waiver and consent should state they are “absolute, irrevocable and unconditional under any and all circumstances.”

• A blanket waiver of all suretyship defenses should be included; for example: “The Guarantors waive and surrender all defenses to their respective liabilities hereunder based upon any acts, omissions, agreements, waivers or any of them and all other rights and remedies accorded by applicable law to guarantors and sureties.”

• Broad language should be used to describe the types of modifications in loan terms that the guarantor is consenting to and, as a matter of convenience, the guarantor should waive the right to receive notice of any changes or modifications in the terms of the loan. For example: “The Guarantors agree that their respective liabilities hereunder will be unaffected, regardless of whether notice is given or their further consent is obtained by any amendment, supplement, extension, renewal, modification or other change in the provisions of the Note, the Loan Agreement, or any other instrument made to or with the lender by the borrower.”

Amendment Language

A further lesson is that lenders’ counsel should be extremely careful to word amendments to loan agreements in such a way as to make unambiguous and clear that it is an amendment of the original loan agreement, not a new agreement. The following are some suggestions:

• It is prudent to state explicitly that the original loan agreement will remain in full force and effect, and that the present agreement does not terminate the original loan agreement or any of the obligations thereunder.

• Language such as “supersedes,” “in lieu of” or “revoke and cancel” should be absolutely avoided because that is precisely the language that New York courts have found extinguishes a prior agreement and creates a new one (in other words, effects a novation).

Conclusion

When restructuring a loan, it is important to be mindful of the language of the anticipatory waiver contained in the guaranty of the original loan, and of the language used in the amended loan documents in order to avoid the extra complication of having to obtain reaffirmations of existing guaranties. New York courts have found that broad waiver language in guaranties, consenting to subsequent modifications in the terms of the loan, may ensure that guarantors remain liable notwithstanding any restructuring of the loan, as long as the amended loan documents are not worded so as to effect a novation of the original loan agreement.

3. Id.
6. Id.
14. See Koplik, supra, 87 A.D.2d 351.
21. Globe Food Services, supra, 184 A.D.2d at 279.