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A Difference That Could Matter: Borrower versus Guarantor

Opening remarks on liability.

I enforce many unconditional and unlimited guaranty documents signed by the owners or officers of entity commercial borrowers and tenants. Those guaranties regularly require the guarantor to pay every obligation (debt principal, interest, costs, legal fees, etc.) if the borrower or other guaranteed obligor (like a tenant) does not pay as promised regardless of the lender or landlord's efforts to collect from the primary obligee or realize on the collateral. This unlimited and unconditional guaranty is called a "guaranty of payment" as contrasted to a less onerous (as to the guarantor) "guaranty of collection." *Preferred Investment Co. v. Westbrook*, 174 N.W.2d 391 (1970).^[1]

From the perspective of the lender or landlord who benefits from the guaranty, the guarantor who executes a payment guaranty is an equally liable co-maker of the promissory note, the tenant, or other primary obligated entity. The purpose of these provisions is to make the guarantor's liability effectively the same as the liability of the borrower or tenant. This type of guaranty gives lender's litigation counsel several options because the obligee may proceed against the easiest collection source. See [Joinder of Claims in Commercial Foreclosure Litigation is a Choice](#) (6/6/18) .

This post will explore some of the more common concerns related to guaranties.

Drafters of contracts of guaranty should first ensure that the language is compliant with any governing states' statute, if any, as the failure to follow statutory mandates may result in the contract's invalidity. Also, guaranty contracts need to be explicit and clear because "[a] guarantor, like a surety, is bound only by the precise words of his contract. Other words cannot be added by construction or implication, but the meaning of the words actually used is to be ascertained in the same manner as the meaning of

similar words used in other contracts.” *Wells Fargo Bank v. Daniels*, 2011–Ohio 6555 (Hamilton Cty. App. Dec. 21, 2011). That rule, however, is not a license or gift to guarantors because the “rule that a guarantor is held only by the express words of his promise does not entitle him to demand an unfair and strained interpretation of those words, in order that he may be released from the obligation which he has assumed.” *Id.*, citing and quoting *LaSalle Bank Natl. Assn. v. Belle Meadows Suites, LP*, 2010–Ohio–3773 (Montgomery Cty. App. Aug. 13, 2010) and *G.F. Business Equip., Inc. v. Liston*, 7 Ohio App.3d 223 (Franklin Cty. App. 1982).

Makers of note undertakings have defenses that guarantors do not, and vice versa. Traditionally, guarantors (like sureties) are vested with certain common law surety defenses. By definition, a guarantor or surety’s obligation is secondary to that of the borrower and that secondary obligation exists only as long as the principal debtor owes performance of the underlying obligation. Many traditional guarantor defenses relate to this definition and the requirement that an obligee first collect from the primary obligor and any collateral before asking the guarantor to pay. In general, when the obligation of the principal debtor is extinguished for less than payment in full, the obligation of the surety is also extinguished, unless the surety consents to continued liability or the creditor expressly preserves the surety’s right of recourse against the principal debtor.^[2]

In addition to defenses arising from how the lender deals with the borrower and collateral, at common law a guarantor is typically entitled to raise the nonpersonal defenses of the borrower.^[3]

If that were not true, a lender could avoid those nonpersonal defenses by forcing the guarantor to pay and the guarantor could then collect from the primary obligee. Or, as one court said: “[o]therwise, the principal would be indirectly deprived of the benefit of a valid defense against the creditor, by being compelled, in effect, to respond through his sureties; or the sureties could be deprived of their right to reimbursement from the principal, and thus one or the other be compelled to lose the rights which the law had secured to them.” *Mutual Finance Co. Politzer*, 21 Ohio St.2d 177

(1970) quoting *State ex rel. v. Blake*, 2 Ohio St. 147 (1853) cited in the *O'Brien* case below.

The existence of these nonpersonal defenses and the litigation work required to defeat them is why lenders negotiate for the waiver of defenses when they have that ability – a common provision in a payment guaranty discussed above. A waiver of defenses in a commercial guaranty is enforceable. *O'Brien v. Ravenswood Apartments, Ltd.*, 169 Ohio App.3d 233 (Hamilton Cty. App. 2006) (“The guarantors entered into an agreement with O’Brien unconditionally guaranteeing the performance of Ravenswood, the principal debtor. This agreement gave them suretyship status and the rights associated with that status, to the extent that these rights were not altered by contract.”)

The *O'Brien* case has several quotations from the successfully enforced unlimited and unconditional guaranty of payment that enforceably waived the guarantor’s common-law defenses. Transaction counsel might consult this case for suggestions as they draft guaranty contracts for lenders.

The above description applies to unconditional and unlimited guaranties. A few words on other types of guaranty contracts is appropriate.

- Springing recourse guaranties are contracts where the guarantors only became liable if certain specified events occurred usually including a payment default by the borrower. For a good example of such a contract, see *Wells Fargo Bank v. Daniels*, 2011-Ohio 6555 (Hamilton Cty. App. Dec. 21, 2011).
- Commonly called “bad boy guaranties,” this subset of springing recourse guaranties have their activation conditions limited to what lenders consider bad acts. The most common acts that implicate a bad boy guaranty are: (i) causing the filing of a bankruptcy case by the borrower; (ii) diverting cash generated by the borrower from payment of the borrower’s obligations while the borrower is in payment default to the lender; (iii) lies on the loan application; and (iv) transfer of the borrower’s assets to non-creditors while the guaranteed debt is outstanding – including excessive

management fees paid to (or for the benefit of) the guarantor.

- Limited guaranties are just that and they come in many varieties. A limited guaranty might cover only a certain dollar amount of the debt, a percentage of the debt, a portion of the lease term, or any other fraction of the obligation created by the guaranteed contract. Limited guaranties need to be clear. The lack of clarity in limited guaranty contracts has generated much work for commercial litigators including several cases I have handled.

One example of a problematic limited guaranty will suffice: in *Chapel Real Estate Company v. Burris*, 64 N.E.3d 1096 (Lake Cty., Ohio App. 2016) the guarantor of a multi-year lease executed a guaranty that said “[g]uarantors hereby, jointly and severally, personally guarantee to Landlord, and Landlord’s successors and assigns, the prompt payment of rent and other sums of money and the full performance of the covenants and agreements to be made and performed by Tenant under the lease *for the term of one (1) year only*.” The tenant defaulted after the first year of the lease agreement. When the landlord sued the guarantor, the question became: (a) was the “one (1) year only” phrase a temporal limitation that expired when the tenant did not default during the first year of the multi-year lease; or (b) did that clause merely limit the dollar amount of the guarantor’s liability to a year’s rent? Construing the contract as a whole, the court held the limitation was monetary not temporal – the guarantor had to pay,

I once litigated whether a document titled “50% Guaranty” signed in conjunction with a \$1,000,000 loan was a guaranty with a maximum value of: (a) \$500,000; (b) 50% of the deficiency after the collateral was liquidated; (c) 50% of the total owed including interest and late fees before any other payment sources reduced the amount owed; or (d) 50% of the total owed including interest and late fees after other payment sources reduced the amount owed.

A few closing thoughts re guaranty contracts.

Much has been written about IRS forms 1099-C and we know that receipt of that form is unwelcome. See, [When a Lender Must File](#)

[and Send a Form 1099-C to Report Debt Forgiveness](#) (4/26/19). For purposes of this blog post, the relevant point is that a Form 1099-C need not be issued to guarantors (as opposed to borrowers) when debt is forgiven.^[4] This is one benefit to being a guarantor not a primary obligor.

A second similar benefit relates to reporting of the outstanding debt. As compared to a borrower who obviously must show debt as a liability on its financial statement, a guarantor (generally speaking) need only recognize the guarantee's existence as a liability when required by the industry standard that has been adopted by regulatory authorities.^[5]

It [FASB Summary of Interpretation No. 45] also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. This Interpretation does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee.

Hopefully for all concerned, if a guaranty is signed at the loan origination, the "fair value" of the guarantor's obligation is zero. Frankly, otherwise, the loan is undercollateralized and the borrower unqualified from the very beginning. Both of those are conditions that the lender's loan underwriters and other obligees try to avoid.

A guaranty is a contract with significant common law history. Several traditional common law defenses available to guarantors unless the guaranty contract waives the application of those defenses. If your guaranty contract is not explicit, that history can protect guarantors in unanticipated ways.

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^[1] "If defendant's guarantee is one of payment, the obligation is an absolute undertaking with the imposition of liability on the guarantor immediately upon default of the principal debtor, and

regardless of whether any legal proceedings or steps are taken to enforce liability of the principal debtor, or whether notice of default is given to the guarantor, and regardless of the solvency or insolvency of the principal debtor. Schaffer v. Acklin, 205 Iowa 567, 570, 218 N.W. 286, 287, and citations; Miller v. Geerlings, 256 Iowa, 569, 580, 128 N.W.2d 207, 214. If a guarantee of collection, there is no liability until after, by use of due diligence, the guarantee has become unable to collect the debt from the principal debtor. Schaffer v. Acklin, supra, 205 Iowa at 571, 218 N.W. at 287. See also in this regard Amick v. Baugh, 66 Wash.2d 298, 303-308, 402 P.2d 342, 345-348; 38 C.J.S. Guaranty s 46."

[2] A guarantor can defend against enforcement of a guaranty where the creditor has impaired the guarantor's suretyship status. See, See Restatement of the Law 3d, Suretyship and Guaranty (1996), Section 37.

[3] Personal defenses are those that relate to the nature of the contracting party. The most obvious examples are contracting capacity due to age or mental condition.

[4] The IRS statement is clear on this point: "Guarantor or surety. You are not required to file Form 1099-C for a guarantor or surety. A guarantor is not a debtor for purposes of filing Form 1099-C even if demand for payment is made to the guarantor." From <https://www.irs.gov/instructions/i1099ac#idm139804541463024>.

[5] Financial Accounting Standards Board's Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* was enhanced, enlarged, explained and in some situations superseded by other pronouncements including FASB's Accounting Standards Codification (an ASC) topic 460 titled *Guarantees*. Interpretation 45 remains, however, a clear and concise statement of the general rule. A good discussion of accounting for guarantees and the currently applicable standards is available from the FASB's website and beyond the scope of this blog post.

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