Insights

Waiver of Suretyship Defenses - Not a Sure Thing?

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A "surety" is generally known as one who agrees to be liable for the debts or contractual obligations of another. Lenders and borrowers often rely on sureties to act as guarantors to assure or guaranty that a borrower will fulfill its obligations to the lender. Sureties may be required to pledge assets to secure the guaranty obligations. If a borrower defaults, a lender may generally pursue remedies directly against the guarantor and satisfy the borrower's debts by foreclosing on the collateral pledged by such surety. In these transactions, a lender may include a waiver of "suretyship defenses" within its loan documentation to allow the lender to modify the underlying loan documents from time to time without the concern that such modification will absolve or discharge the surety from its obligations to the lender.

Although inclusion of a waiver of suretyship defenses provision is common in Indiana loan documentation, a 2015 decision from the Indiana Court of Appeals calls reliance on such waivers of suretyship defenses into question. In **First Federal Bank of the Midwest v. Karen S. Greenwalt and Farm Credit Services of Mid-America, FLCA**, No. 21A01-1408-MF-344 (Ind. Ct. App. July 28, 2015), the Indiana Court of Appeals quotes with approval a 2008 Montana Supreme Court decision for the proposition that "even where the surety authorized the bank to 'alter, compromise, renew, extend, accelerate, or otherwise change . . . the time for payment or other terms of the indebtedness,' evidence of the conversion of a revolving line-of-credit to an installment loan with fifty-nine monthly payments with a final balloon payment was sufficient to exonerate the surety." This commentary in the court's reported decision, in what hopefully can be regarded as dicta, flies in the face of the Indiana Uniform Commercial Code ("UCC"), specifically Ind. Code § 26-1-3.1-605(f), which states that "[a] secondary obligor is not discharged under this section if the secondary obligor consents to the event or conduct that is the basis of the discharge, or the instrument or a separate agreement of the party provides for a waiver of discharge under this section specifically or by general language indicating that parties waive defenses based on suretyship or impairment of collateral."

The **Greenwalt** decision involved circumstances where a corporation ("Corp") obtained a revolving line of credit ("LOC"), husband (Corp president) guaranteed it, and husband and wife granted bank ("Bank") a mortgage on two parcels of real estate to secure Corp's obligation. Husband and wife later divorced, with wife keeping parcel 1 and husband keeping parcel 2. The LOC was interest-only for many years, and Corp and Bank agreed to increase the

LOC over time; eventually, Bank modified the LOC to a "closed-end" line, resulting in the payments no longer being interest-only. Corp defaulted, husband filed Chapter 7 bankruptcy, Bank foreclosed on parcel 2, and then Bank sought to foreclose on wife's parcel 1. Wife defended, claiming that she was a surety of Corp's debt to Bank, and the change in terms of the LOC released her from any repayment obligation and removed parcel 1 from the collateral pool available to Bank. The trial court agreed, and the Indiana Court of Appeals, in a decision devoid of any discussion of the relevant provisions of the UCC, affirmed. While the Court of Appeals' case law analysis is straightforward, the Court's last cite to the Montana Supreme Court decision noted above, First Citizens Bank v. Sullivan, suggests that the waivers of suretyship defenses routinely included in commercial guaranties pursuant to Ind. Code § 26-1-3.1-605(f) are unenforceable.

As a result of the **Greenwalt** decision, ambiguity exists as to whether suretyship defenses waiver language in existing guarantees and/or loan documentation will be enforced by Indiana courts. Indiana lenders should consider altering loan modification practices to require guarantors to reaffirm and ratify the guaranty obligations concurrently with each modification of the related credit facilities.