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Guaranteeing Your Guaranty—Ensuring Enforceability of Personal Guarantees Upon Subsequent Modification of the Guaranteed Obligation

Guarantees are an important source of additional security for companies or banks extending loans. However, guarantees are often executed along with the closing of a loan transaction, put in the loan file, and not considered again until years later, after the loan is amended several times, when the loan becomes due or in danger of default. Lenders may fail to realize that under Wisconsin law, a loan amendment or modification can render an underlying guaranty unenforceable if the amendment increases the risk to the guarantor.

Under Wisconsin law, a modification of a loan agreement has the effect of discharging the underlying guaranty if the modification is (i) material and (ii) injures the interest of the guarantor by increasing the risk to the guarantor. *Lakeshore Commercial Finance Corp. v. Drobac*, 319 N.W.2d 839 (Wis. 1982). To be material, the change must be "substantial" and not simply varied in "the least particular." *Stephens v. Elver*, 77 N.W. 737 (Wis. 1898).

To prevent the discharge of a guaranty, a lender must receive the guarantor's consent to modify the guaranteed indebtedness. However, if a loan is distressed and needs to be modified, the lender may not be able to find the guarantor to get consent for the modification. Even worse, if the guarantor knows that the lender does not want the borrower to default (and knows that the modification of the loan could result in a discharge), the guarantor might refuse to modify the loan in the hopes that business considerations will force the lender to modify the loan and thereby discharge the guaranty.

Fortunately, Wisconsin courts have held that a lender can avoid dealing with the guarantor at the time of the loan modification by gaining the guarantor's consent to future modification in the language of the original guaranty. ,em>Cicardo v. Van Der Molen, 2009 U.S. Dist. LEXIS 23064, *18-20 (W.D. Wis. Mar. 19, 2009) (citing *John Deere Co. v. Babcock*, 278 N.W.2d 885 (1979)). One of the most important terms in a guaranty agreement is therefore the guarantor's explicit agreement to waive the right to consent to modifications of the original loan agreement.

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Where a guarantor has not agreed in advance to consent to modification of the loan, it is important to get the guarantor's consent for almost any modification of the loan, even if it appears that the modification is intended to help the borrower.

Consider the following scenario. Lender makes a term loan to Borrower to expand Borrower's business. In order to get better terms on the loan, Borrower's wealthy uncle, Guarantor, agrees to guarantee Borrower's obligations. Borrower makes all of its payments under the loan. As the maturity date approaches, Borrower requests an extension of the loan and the Lender consents. Borrower executes a new promissory note under the exact same terms as the first promissory note, and continues making payments. Several years later, Borrower's business declines and Borrower files for bankruptcy. Not wanting to take a loss on the loan, Lender sues Guarantor to recover on the guaranty of Borrower's obligations. In court, Guarantor argues that the loan was modified without his consent, which caused the guaranty to be discharged. In response, Lender argues that the loan modification did not harm the interests of Guarantor. Lender points out that the only modification was to extend the maturity date of the loan and argues that the extension of the loan actually helped Borrower by giving Borrower more time to repay the principal.

In the above scenario, Wisconsin precedent is on the side of the Guarantor. Courts have held that the extension of the maturity date of a loan materially increases the risk to the guarantor because it extends the time during which the borrower could suffer adversity and be forced to default. *Federal Deposit Ins. Corp. v. Manion*, 712 F.2d 295, 297 (7th Cir. 1983). Other modifications that Wisconsin courts are likely to view as material modifications include increasing the interest rate of the loan, adding covenants to the loan and releasing any collateral securing the loan. Each such modification requires the consent of the guarantor to prevent the discharge of the guarantor's obligations.

The best way to ensure that a loan guaranty will be enforceable is to plan ahead and consider the effect of any loan modification on the underlying guaranty. If possible, be sure to get the guarantor's consent to future modifications in the language of the guaranty itself. Failing that, be sure that each modification either does not increase the risk to the guarantor or is made with the written consent of the guarantor.

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