

Wisconsin Guarantors Take a One-Two Punch

In two recent decisions, the Wisconsin Supreme Court and the United States Bankruptcy Court for the Eastern District of Wisconsin both held that guarantors defending against liability arising from a personal guaranty may not raise counterclaims or affirmative defenses that are derivative claims arising from alleged injuries to the borrower.

In *Park Bank v. Westburg*, 2013 WI 57, 832 N.W. 2d 539 (2013), the Wisconsin Supreme Court affirmed the decisions of the Court of Appeals and the Circuit Court that guarantors are precluded from derivatively raising defenses that belong to the borrower. In *Westburg*, the guarantors, Mr. and Mrs. Westburg, were the shareholders of a company that manufactured point-of-purchase displays and retail fixtures. The guarantors also owned another company that held the real estate upon which the business was operated. Both entities received loans from Park Bank secured by a lien on the assets of the operating company and a mortgage granted by the real estate company. As additional security, the two shareholders executed personal guaranties of both loans. The loans went into default and the debtor's entered into a forbearance agreement. When the debtors breached the terms of the forbearance agreement, the bank froze the Westburgs' personal bank account, which was their only source of cash. The bank agreed to allow the funds in the personal account to be used provided that the operating company filed a petition for a receiver, to which the Westburgs reluctantly agreed. The assets of the operating company were liquidated in the receivership and the bank foreclosed its mortgage on the real estate. The bank then sued the Westburgs on the guaranties for the \$1.2 million remaining due after the liquidation of the real and personal assets. In response, the guarantors filed numerous counterclaims and affirmative defenses alleging, among other things, that the bank breached its fiduciary duty, breached its duty of good faith and fair dealing and that the forbearance agreement was void because it was obtained under duress.

The Supreme Court majority opinion, authored by Justice Bradley, affirmed the lower courts' grant of summary judgment to the bank upon the basis that the guarantors' counterclaims and defenses were derivative of injuries to the borrower entities and the guarantors therefore lacked standing to assert them. Although the Supreme Court acknowledged that a single act can give rise to both direct and a derivative causes of action, the Westburgs' counterclaims and affirmative defenses were purely derivative and they therefore lacked standing to

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assert them.

The majority opinion further provided that while the Westburgs might have raised derivative claims as shareholders under Wisconsin Statutes § 180.0741, they failed to comply with the prerequisites of that statute. In a concurring opinion, Justice Roggensack agreed with the majority's holding that guarantors lack standing to assert derivative counterclaims and defenses belonging to the borrower. However, Justice Roggensack disagreed with the majority's implication that a shareholder's right to assert derivative claims can be equated to the obligations of a guarantor. A guarantor's rights and obligations are controlled solely by the guaranty contract. Justice Roggensack concluded that being a guarantor is never a sufficient status to bring a derivative claim.

Six days after the *Westburg* decision, United States Bankruptcy Judge Margaret Dee McGarity also addressed a guarantor's right to assert counterclaims under Wisconsin law. In *Layton State Bank v. Miller (In re Miller)*, No.12-32487, 2013 WL 3445996 (Bankr. E. D. Wis. July 9, 2013), Miller Ridge, LLC, a company controlled by the bankrupt debtor, Joseph Miller, entered into a construction loan agreement with Layton State Bank to permit the LLC to rehabilitate an apartment complex that was pledged to the bank as collateral. In connection with the loan, Miller executed a personal guaranty of the entity's obligations. In 2011, the borrower defaulted on its obligations. After the default, the debtor alleged that although the bank collected rents from the apartment complex, it failed to pay obligations associated with the project, including property insurance. On October 2011, a fire occurred at the complex resulting in over \$100,000 of uninsured damages. In Miller's bankruptcy proceeding, the bank asserted a claim for the full obligations owed based upon the personal guaranty. The debtor interposed counterclaims based upon a breach by the bank of its fiduciary duty, lender liability and breach of the duty of good faith.

In dismissing the counterclaim for breach of fiduciary duty, the court noted that the debtor waived its right assert counterclaims by the terms of the guaranty agreement. In addition, the court said a guaranty agreement between a lender and guarantor, without more, does not establish a fiduciary relationship. Regarding the claim of lender liability, the court noted that the bank had not loaned any money to the debtor/guarantor and therefore that claim must also be dismissed.

Addressing the duty of good faith, the court noted where a guarantor has taken an assignment of the borrower's claim; those claims may be asserted by the



guarantor as a setoff. However, such claims will not result in an affirmative recovery against the holder of the guaranty, even if they are in excess of the amounts due on the guaranty. The court found that there was no assignment of the borrower's claims against the bank to Miller and therefore the setoff defense was inapplicable.

In addition, citing *Westburg*, the court held that under Wisconsin law, guarantors cannot bring derivative actions, at least in their capacity as guarantors. The court went on to say that the duty of good faith implied in every contract is intended to protect against arbitrary or unreasonable conduct. The court concluded that once the loan was made, the bank had no further duty under the guaranty to act in any particular way or to render further performance to the guarantor. Holding the debtor to his bargain, said the court, does not constitute bad faith.

Both *Westburg* and *Miller* make clear that a guarantor has no standing to assert derivative claims of the borrower in an attempt to defeat the guaranty. These decisions should strengthen the hand of lenders attempting to recover on guaranties in Wisconsin and perhaps refute the old saw "Crime and guarantors don't pay."

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