

Guarantor Liability

Courts Strictly Enforce Waiver of Defense Clauses

Carefully drafted loan guarantees customarily contain clauses waiving defenses such as fraud, breach of fiduciary duty, breach of contract, negligent misrepresentation, failure of consideration and economic duress. Despite the ingenuity of counsel for borrowers, these waiver of defense clauses are uniformly enforced. An example can be found in a recent, as yet unpublished, decision of the Supreme Court, New York County (Cahn, J.), in *Wells Fargo Bank Minnesota N.A. v. Cohn*, Index No. 0604347/02 (Dec. 3, 2004), in which our firm represented plaintiff.

Waiver of Defense Clauses

The forerunner to *Wells Fargo* is *Citibank N.A. v. Plapinger*.¹ In *Plapinger*, the Court of Appeals held that a waiver of defenses clause in the guarantee at issue foreclosed the guarantors' defense of fraud in the inducement of the guaranty where the guaranty was "absolute and unconditional." The guarantors were officers and directors of the borrower who had personally guaranteed a line of credit for the corporation. The Court of Appeals recognized that the clause at issue was contained in a "multimillion dollar personal guarantee proclaimed by defendants to be 'absolute and unconditional' " and was the result of "extended negotiations between sophisticated business people." Furthermore, the guaranty contained provisions waiving any defenses

Kenneth M. Block and **Jeffrey B. Steiner** are members of *Brown Raysman Millstein Felder & Steiner*. **Olivia Milonas**, an associate of the firm, assisted with the preparation of this article.

to its own validity and "any other circumstance which might otherwise constitute a defense to the guaranty."

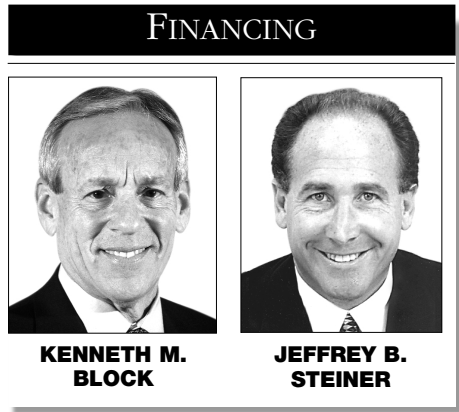
Based on the holding in *Plapinger*, New York federal and state courts have repeatedly enforced waiver of defense clauses

summary judgment in favor of the lender and dismissed the guarantors' affirmative defenses, in part, based on enforcement of the waiver of defenses clause at issue.

In or around December 2002, Wells Fargo, as trustee for the registered holders of Credit Suisse First Boston Mortgage Securities Corp., commercial mortgage pass-through certificates, commenced an action in New York Supreme Court against several defendant guarantors seeking recovery on a guaranty agreement (the "agreement of principals") held by the lender. The guaranty enabled Hemmingsway Hotel, the borrower, to obtain a loan in excess of \$5 million, which was secured by two properties located in New Mexico and Maine. The guarantors were all principals of the borrower. The loan was subsequently assigned to Wells Fargo.

Pursuant to the agreement of principals, the guarantors agreed to become jointly and severally personally liable for the payment of unpaid principal, interest, and any other sums payable under the loan upon the occurrence of any one of certain events, including the filing of a petition in bankruptcy by the borrower. The guarantors also expressly waived the right to assert certain defenses, including defenses based on the lender's acts or omissions, which could vary, increase or decrease the principals' risk, and the lender's failure to first proceed against the borrower or the collateral.

The borrower ultimately defaulted on its obligations under the loan documents. After providing notice of the default and an opportunity to cure, the lender commenced actions to foreclose on the New Mexico property and to appoint a receiver over the Maine property. Shortly thereafter, the borrower filed a petition for relief under



contained in guarantees executed by sophisticated guarantors. See, e.g., *Nat'l Westminster Bank PLC v. Empire Energy Management Sys. Inc.*, 1998 WL 47830 (S.D.N.Y. Feb. 5, 1998) (dismissing defenses alleging fraudulent inducement based on application of *Plapinger* principles); *Banco Do Estado De Sao Paulo, S.A. v. Mendes Jr. Intern. Co.*, 249 A.D.2d 137, 672 N.Y.S.2d 28 (1st Dep't 1998) (citing *Plapinger* and finding the express terms of the guarantee at issue barred the guarantor's defense); *Preferred Equities Corp. v. Ziegelman*, 190 A.D.2d 784, 593 N.Y.S.2d 548 (2d Dep't 1993) (dismissing fraud in the inducement defense based on application of *Plapinger* principles); *General Trading Co., Inc., v. A&D Food Corp.*, 292 A.D.2d 328, 741 N.Y.S.2d 845 (1st Dep't 2002) (citing *Plapinger* and holding guarantors waived defenses of fraudulent inducement and failure of consideration).

In *Wells Fargo*, Justice Cahn granted

Chapter 11, which had the effect of both staying the foreclosure proceedings and triggering the guarantors' personal liability for payment of the obligations under the loan. The bankruptcy case was ultimately dismissed and the automatic stay vacated on the basis that the borrower had no realistic reorganization plan.

In the New York action, the guarantors moved to dismiss the complaint on the grounds that Real Property Action and Proceedings Law §1301(3) (proscribing lender from simultaneously bringing a foreclosure action and an action on a note or guaranty) prevented the lender from proceeding with the action. The guarantors also claimed their express waiver of the right to assert an election of remedies defense under the agreement of principals constituted an impermissible waiver of a statutory provision.

By decision affirmed by the Appellate Division, First Department, the Supreme Court denied the motion and held that §1301(3) did not apply and that the lender could proceed with the action.² The court also held that the waiver of defenses clause was enforceable due to the fact that the guarantors did not allege fraud, novation or modification, and in fact, could not claim fraud, since the underlying transaction was complex and involved sophisticated business people.

The guarantors then filed an answer asserting defenses of equitable estoppel, failure to satisfy a condition precedent, breach of the implied covenant of good faith and fair dealing, and claimed that Wells Fargo unjustifiably declared a default against the borrower under the loan documents. The lender subsequently moved for summary judgment for the amount due on the underlying loan transaction.

The Supreme Court granted summary judgment to the lender and ordered judgment as to the outstanding principal, interest and costs. The court held that the guarantors were precluded from asserting defenses based on the lender's alleged breach of express or implied terms of the loan agreement, inasmuch as the guarantors had expressly waived the right to assert defenses based on the lender's conduct. Citing *Plapinger*, the court stated: "It is well-

established that a contractual waiver-of-defense provision is enforceable, absent fraud, novation, or modification."³ The guarantors did not allege that the waiver clause was induced by fraud or was modified after execution of the guaranty. The court went on to hold that the guarantors could not make out a tenable claim for fraud in light of the fact that the underlying transaction was a "complex multi-state real estate transaction between sophisticated business people dealing at arms' length."⁴

The court also found that the record conclusively demonstrated that the borrower's decision to file for Chapter 11 protection was not motivated solely by Wells Fargo's declaration of default and acceleration of the principal and that bankruptcy was inevitable. Essentially, the borrower simply lacked the financial strength to perform as required under the loan.

Defense Barred

Further, the court held that the defenses were barred by the doctrine of res judicata, which includes not only those matters which are actually litigated before a court but also those relevant issues which could have been litigated. The court noted, citing other authority, "it is fundamental [to the doctrine] that a judgment in a prior action is binding not only on the parties to that action, but on those in privity with them, i.e., those with interests that were represented in the prior proceeding, or who controlled the conduct of the prior action to further their own interests."⁵ As controlling principals, the guarantors were clearly in privity with the borrower. However, neither the guarantors nor the borrower raised any of the defenses or claims asserted against the lender in the state action in the bankruptcy or foreclosure proceedings, despite having had the opportunity to do so.

In a similar case, involving the same defendants and an identical waiver of defenses clause, the Southern District of New York granted summary judgment in favor of the lender, dismissing the guarantors' various assertions of lender liability. There, *Credit Suisse First Boston Mortgage*

*Capital LLC v. Cohn*⁶ the guarantors alleged that because the lender's representatives failed to object when informed of the decision to file for bankruptcy, the guaranty was thereby modified to exclude the bankruptcy trigger (i.e., the same trigger contained in the agreement of principals in *Wells Fargo*). In other words, the failure to object to the bankruptcy filing by the lender could be viewed as a modification of the loan documents.

The Southern District rejected the guarantors' defenses and held that whether or not there was a modification (which in the court's view there was not) was of no consequence. Due to the borrower's "severe financial difficulties," bankruptcy was inevitable and therefore "no reasonable jury could conclude that [the borrower's] bankruptcy filing was unequivocally referable to the modification."⁷ Additionally, citing to the decision in *Wells Fargo* denying the motion to dismiss, the Southern District held that any such defense was waived pursuant to the waiver of defenses provision of the guaranty, which the guarantors did not challenge on the basis of fraud or modification.

Conclusion

Under prevailing law, waiver of defense clauses continue to present a formidable obstacle to guarantors seeking to defeat motions for summary judgment, absent a showing of fraud, novation and/or modification.

1. 495 N.Y.S.2d 309, 66 N.Y.2d 90 (1985).

2. *Wells Fargo Bank Minnesota N.A. v. Cohen*, Index No. 0604347/02 (July 15, 2003), aff'd, 4 A.D.3d 189, 771 N.Y.S.2d 649 (1st Dep't 2004).

3. *Wells Fargo*, slip op. at 8.

4. Id. at 9.

5. Id. at 10.

6. No. 03 Civ. 6146 (DC), 2004 U.S. Dist. LEXIS 16577 (S.D.N.Y. Aug. 19, 2004).

7. Id. at *21.

This article is reprinted with permission from the January 19, 2005 edition of the NEW YORK LAW JOURNAL. © 2005 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact American Lawyer Media, Reprint Department at 800-888-8300 x6111. #070-01-05-0017