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Legal Update
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Illinois Supreme Court Holds Guarantor Not a Surety Under Illinois Sureties Act

The Illinois Supreme Court recently decided a case that may affect the enforceability of guaranties in Illinois. In *J.P. Morgan Chase Bank, N.A. v. Earth Foods, Inc.,*[1] the Illinois Supreme Court examined whether the guarantor of a note was a "surety" for purposes of the Illinois Sureties Act[2] (the "Sureties Act").

The Sureties Act was originally enacted in 1819. If found to be applicable to a guaranty relationship, it potentially affords certain affirmative defenses to a guarantor. In *Earth Foods,* the court held that not all guarantors were "sureties" within the meaning of the Sureties Act and reversed the judgment of a lower court that had held that all guarantors were within the scope of the definition of "surety" for purposes of the Sureties Act. The court remanded the case so that a lower court could make a determination of whether the guarantor in this case was such a surety.

As will be noted below, another court has held that the protections afforded by the Sureties Act may be waived contractually. We believe that a number of issues posed by the potential applicability of this statute may be avoided by having the guarantor waive the benefits of the Sureties Act in the body of the guaranty it signs.

Background

In 2001, JPMorgan Chase Bank (the "Bank") extended a line of credit to Earth Foods, Inc., and obtained personal guaranties from its three co-owners. Earth Foods then ran into financial difficulty. Before the Bank sent Earth Foods a notice of default, one of the guarantors, Leonard DeFranco, sent the Bank a letter that warned that Earth Foods was depleting its inventory (which was collateral) and demanded that the Bank take action.[3] Earth Foods subsequently failed to repay the loans and the Bank attempted to enforce the personal guaranties.

At trial, Mr. DeFranco claimed an affirmative defense on the ground that he was protected under section 1 of the Sureties Act. That section provides as follows:

> When any person is bound, in writing, as surety for another for the payment of money, or the performance of any other contract, apprehends that his principal is likely to become insolvent or to remove himself from the state, without discharging the contract, if a right of action has accrued on the contract, he may, in writing, require the creditor to sue forthwith upon the same; and unless such creditor within a reasonable time and with due diligence, commences an action thereon, and prosecutes the same to final judgment and proceeds with the enforcement thereof, the surety shall be discharged; but such discharge shall not in any case affect the rights of the creditor against the principal debtor.

The Sureties Act thus imposes a duty of diligence on a lender to "commence" a suit upon its borrower following a demand by its surety, "prosecute" the same to final judgment and

"proceed" with the enforcement thereof or else the surety will be discharged.

The trial court entered summary judgment for the Bank on the ground that DeFranco was a guarantor, not a surety. On appeal, the Bank argued that the Sureties Act did not apply to guarantors, only to sureties. The appellate court disagreed, finding that the Sureties Act applied to all sureties and guarantors, and remanded the case to the trial court to determine whether the guarantor had satisfied the requirements of the Sureties Act that would discharge his obligations under his guaranty.

The Illinois Supreme Court reversed the decision of the appellate court, holding that a surety was technically different from a guarantor, a decision reached in part by examining legal dictionaries and treatises from the era when the legislature enacted the Sureties Act, as well as prior decisions from the Illinois Supreme Court, the US Supreme Court and courts from other states construing similar statutes.

Among the salient differences between a surety and a guarantor under the common law was that a holder of an instrument had no obligation to use diligence to enforce payment against the maker of an instrument with respect to a surety, whereas the holder was obligated to use such diligence in order to preserve the holder's rights against a guarantor.[4] The Illinois Supreme Court concluded that "a suretyship differs from a guaranty in that a suretyship is a primary obligation to see that the debt is paid, while a guaranty is a collateral undertaking, an obligation in the alternative to pay the debt if the principal does not." The Illinois Supreme Court held that the legislature did not intend to include guarantors within the scope of the Sureties Act.

Analysis

The statutory defense available under section 1 of the Sureties Act is arguably inconsistent with the common law rule that delays by the lender to enforce a primary obligation only discharge the surety in very few circumstances,[5] a fact the court seemed to recognize by construing the Sureties Act under a principle of statutory construction applicable to statutes "in derogation of the common law." The statutory requirement to exercise diligence is therefore troublesome for a lender.

While the holding of the Illinois Supreme Court that the Sureties Act is only applicable to sureties, rather than guarantors, is a welcome development for lenders, the court's remanding of the case for a determination of whether Mr. DeFranco was a guarantor or a surety illustrates a potential continuing difficulty posed by the Sureties Act.

In light of the Illinois Supreme Court's holding that sureties and guarantors are not synonymous for purposes of the Sureties Act—and because, in our experience, many form guaranties as used by financial institutions unambiguously provide that the guarantor is acting as a guarantor and not as surety—we expect that many secondary obligors of bank loans will in fact be guarantors, as opposed to sureties, for purposes of the Sureties Act. However, where the language of the guaranty at issue is not unambiguous, the Supreme Court recognized that it might be appropriate for the trial court to consider parol evidence in order to determine the intent of the parties.

In order to cut off inquiries as to whether the guarantor is a surety or a guarantor, it is possible that a guaranty could be drafted so as to waive the requirements imposed by section 1 of the Sureties Act in a manner similar to waivers of common law suretyship defenses.[6] *In City Nat'l Bank of Murphysboro v. Reiman*,[7] an Illinois appellate court held that the protection of the Sureties Act "may be waived by the language in the contract of guaranty."

It is also possible that language commonly included in guaranties may suffice to serve as a waiver of the Sureties Act. The guaranty in *Reiman* contained a specific waiver of "diligence"

and permitted the lender to make extensions of the maturity date without notice to the guarantor.[8] The guaranty in *Continental & Commercial National Bank, Chicago v. Cobb*[9] contained language permitting the lender to extend the time of payment and alter the underlying obligation without affecting the guarantor's liability.

In light of the *Earth Foods* decision, if a guarantor is located in Illinois, or if a guaranty is by its terms governed by Illinois law, lenders may wish to confirm that their guaranties contain appropriate waivers, including waivers of diligence and the ability to extend or modify the terms of the underlying obligation without notice to, or consent of, the guarantor. A waiver by a secondary obligor of the benefits of the Sureties Act should help a lender avoid the risks of noncompliance with the Sureties Act and the potential uncertainty posed by having to establish whether the secondary obligor is a guarantor or a surety for purposes of the Sureties Act.

Endnotes

[1] Available at http://www.state.il.us/court/opinions/supremecourt/2010/october/107682.pdf.

[2] 740 ILCS 155/1.

[3] It is unclear from the opinion whether this circumstance constituted an event of default under the transaction documents.

[4] The Supreme Court cited *Ross v. Jones, Brown & Co.*, 89 U.S. (Wall) 576 (1875), which held that the indorser of a note was not a "person bound as security" for purposes of an Arkansas statute similar to the Sureties Act.

[5] *See, e.g.*, section 50 of the Restatement (Third) of Suretyship and Guaranty, which provides as follows: "(1) Delay by the obligee in taking action against the principal obligor with respect to the underlying obligation, or failure of the obligee to take such action, does not discharge the secondary obligor with respect to the secondary obligation except as provided: (a) by applicable statute; (b) by agreement of the parties; (c) in § 43 of this Restatement [which releases the guarantor if the lender does not pursue the guarantor until the statute of limitations has lapsed for a suit against the primary obligor]; or (d) in subsection (2) of this section.

"(2) If the failure of efforts by the obligee to obtain satisfaction of the underlying obligation is a condition of the secondary obligor's duty pursuant to the secondary obligation, the secondary obligor is discharged to the extent that the obligee's failure to act with reasonable promptness against the principal obligor is the cause of the obligee's inability to collect from the principal obligor."

Of course, one of the exceptions in section 50(1) is clause (a), which refers to applicable statute.

[6] Section 3-605(f) of the Illinois UCC, which applies to negotiable instruments, allows the waiver of suretyship defenses by the surety either specifically "or by general language indicating that the parties waive defenses based on suretyship or impairment of collateral." *Cf.* Restatement (3d) of Suretyship and Guaranty, section 48.

[7] 601 N.E.2d 316 (App. Ct. Ill., 5th Dist. 1992).

[8] The guaranty in *Reiman* contained the following language:

"All diligence in collection, and all presentment for payment, demand, protest, notice of protest and notice of non-payment, dishonor and default, and of the acceptance of this guaranty, and of any and all extensions of credit hereunder, are hereby expressly waived.

"The granting of credit from time to time by said Bank to said Debtor in excess of the amount of this guaranty and without notice to the undersigned, is hereby authorized and shall in no way affect or impair this guaranty. We hereby subordinate any sums now or hereafter due us from said Debtor to the payment of any sums now or hereafter due you.

"Authority and consent are hereby expressly given said Bank from time to time, and without any notice to the undersigned, to give and make such extensions, renewals, indulgences, settlements and compromises as it may deem proper with respect to any of the indebtedness, liabilities and obligations covered by this guaranty, including the taking or releasing of security and surrendering of documents."

[9] 200 F. 511 (1st Cir. 1912).

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