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From the Bankruptcy Courts: Releasing Guarantor By Failing To Give Notice-The Danger of Relying on Predefault Waivers

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RELEASING GUARANTOR BY FAILING TO GIVE NOTICE—THE DANGER OF RELYING ON PREDEFAULT WAIVERS

Commercial credit agreements are often secured by the debtor's property and also supported by one or more guarantors. The security interest in the debtor's property benefits the guarantor as well as the lender because it increases the likelihood that the lender will be compensated from funds realized by the sale of the collateral. Therefore, in the event of default and foreclosure, the guarantor could be adversely affected by an improper sale of collateral that results in an unreasonably low price.

In order to avoid disputes and defenses regarding adequate notice of the collateral sale, it is common for the guaranty agreement to contain the guarantor's waiver of the right to all notices. If a debtor defaults and the secured lender forecloses and sells the collateral, does the guarantor have a statutory right to notice of the collateral sale despite the waiver of such notice in the guaranty agreement? This question was addressed recently by the Court of Appeals for the Ninth Circuit in *In re Kirkland.*[1]

Facts of the Case

On September 16, 1980, Security Pacific National Bank had entered into a credit agreement with Cascade Oil Co., of which Mr. Kirkland was president and a majority stockholder. The credit agreement provided for a revolving note and established a $1.25 million unsecured line of credit and an additional $200,000 line of credit. Mr. and Mrs. Kirkland also gave Security Pacific an unsecured general continuing guaranty of Cascade's credit line. The guaranty waived all notices and gave Security Pacific the power to substitute, release, decrease, or alter any collateral.

Cascade Oil defaulted on March 31, 1981, and on May 20, 1981, as part of a workout agreement, Cascade Oil gave Security Pacific a security interest in certain of its real and personal property. Security Pacific waived the default through

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[1] 915 F.2d 1236 (9th Cir. 1990).

May 29, 1981. By a letter agreement dated May 18, 1981, the Kirklands as guarantors consented to the collateralization of Cascade Oil's loan. The letter agreement provided that the collateralization of Cascade Oil's loan "does not affect or diminish" the Kirklands' obligation under the continuing guaranty of September 16, 1980.[2] However, the repayment proposed under this workout agreement was not accepted by Security National, and the Cascade Oil obligation reverted to default status.

In a second workout arrangement, Security Pacific agreed to a six-month moratorium on Cascade Oil's obligation and obtained security for the Kirklands' previously unsecured guaranty consisting of a deed of trust on the Kirklands' California ranches and a security interest in Mr. Kirkland's partnership interest in an apartment complex. The agreement also provided that the September 16, 1980, continuing guaranty "shall also remain in full force and effect."[3]

The six months' moratorium passed, and Cascade Oil again failed to make payment. On May 7, 1982, Cascade filed a chapter 11 petition. Subsequently, Mr. Kirkland resigned as president. The new Cascade president, in August and September 1983, sold two pieces of equipment, one for $4,500 and the other for $55,000, either with the consent or at the direction of Security Pacific. The Kansas bankruptcy court found these sales to be commercially reasonable, but the Kirklands were not given notice of the sales and first learned about them after they took place.

The Kirklands filed for chapter 11 relief in 1985, and Security Pacific filed its proof of claim based on the guaranty. The Kirklands objected to the claim on the grounds that Security Pacific had not given the Kirklands notice of the sale of the collateral and that, therefore, the Kirklands' liability on the guaranty for any deficiency had become unenforceable.

Guarantors Are "Debtors"

The bankruptcy court granted the Kirklands' motion for summary judgment, holding that guarantors are "debtors" for the purpose of applying the notice requirements of the California version of the Uniform Commercial Code (UCC). Section 9105(1)(d) of the California Commercial Code provides:

> "Debtor" means the person who owes payment or other performance of the obligation secured, whether or not he or she owns or has rights in the collateral, and includes the seller of accounts or chattel paper. Where

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[2] The court stated: "The Kirklands note that this letter agreement did not use the words 'waiver,' 'renunciation,' or 'notice' and makes no other reference to the September 16, 1980, guaranty agreement."

Id. at 1237 n.2.

[3] The court stated: "Again, the Kirklands note that the letter agreement did not contain the words 'waiver,' 'renunciation,' or 'notice.' "

Id. at 1238 n.3.

> the debtor and the owner of the collateral are not the same person, "debtor" means the owner of the collateral in any provision of [Article 9 of the California Code] dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires.

As "debtors," the Kirklands were entitled to the notice requirements of Section 9504(3) of the California Commercial Code, which provides, in part, that "[u]nless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, the secured party must give to the debtor, if he has not signed *after default* a statement renouncing or modifying his right to notification of sale, . . . a notice in writing of the time and place of any public sale or of the time on or after which any private sale or other intended disposition is to be made." The section then goes on to provide with particularity the requirements regarding the time and manner of the notice.

Accordingly, the bankruptcy court held that, as a matter of law, the Kirklands could not have waived their rights to notice prior to default. "The [bankruptcy] court also determined that there was no post-default waiver because the letter agreements subsequent to the initial default constituted a novation of the Kirklands' original obligation."[4] Since notice of the sale was not given subsequent to default, the bankruptcy court disallowed the deficiency claim which exceeded $1.3 million.

The bankruptcy court's decision was upheld by the bankruptcy appellate panel[5] and was affirmed by the court of appeals.[6] The court of appeals agreed with the conclusion of the bankruptcy appellate panel that "even if the letter agreements incorporated the terms of the continuing guaranty by reference, Cascade's repeated failure to make payments constituted separate defaults, not one continuous default. Therefore, the waivers of notice, if any, occurred prior to, not after, the last default."[7]

Standard of Review

The court of appeals noted that the standard to review a lower court's decision granting summary judgment is reviewed de novo. Similarly, the court of appeals observed that an interpretation of state law was likewise reviewed de novo. Since there was no decision by the state's highest court, the court of appeals held:

> [A] federal court must predict how the highest state court would decide the issue using intermediate appellate court decisions, decisions from other jurisdictions, statutes, treatises, and restatements as guidance. . . . However, "in the absence of convincing

[4] *Id.* at 1238.

[5] *In re* Kirkland, 91 Bankr. 551 (Bankr. 9th Cir. 1988).

[6] 915 F.2d at 1236.

[7] *Id.* at 1238.

> evidence that the highest court of the state would decide differently, . . ." a federal court is obligated to follow the decisions of the state's intermediate courts.[8]

The court of appeals turned to the Supreme Court of California for an answer to the issue of whether a guarantor was a debtor, but no such decision could be found. The court of appeals then turned to the decisions of the Court of Appeals of California. Three of the most recent decisions of the highest state court that decided this issue had held that the guarantor was a debtor for the purposes of Section 9105(1)(d) of the California Commercial Code and was entitled to the protection of Section 9504(3)[9]; a fourth decision, *Rutan v. Summit Sports, Inc.*,[10] reached the opposite conclusion.

In construing California law, the court of appeals felt bound by the interpretation adopted by the majority of California state appellate courts. Accordingly, the Ninth Circuit upheld the bankruptcy court's determination that, for purposes of Section 9105(1)(d), a guarantor was a debtor and was afforded the protection provided in Section 9504(3).

Although the court admitted that predicting the way that the Supreme Court of California would decide this issue was not an exact science, two facts bolstered its conclusion. First, the majority of California courts had repudiated the course initially set by *Rutan*, and in light of the most recent cases, "*Rutan* would be a slim reed upon which to rest a contrary decision."[11] Second, the more recent cases had "brought California within the majority of states which had determined that a guarantor is a debtor for the purpose of section 9105(1)(d) [of the Uniform Commercial Code] and afforded the notice protection of section 9504(3)."[12]

The court of appeals, having decided that a guarantor is entitled to notice of the manner in which the collateral will be sold, turned to the final issue of whether the Kirklands did in fact waive their right to such notice after default as required by Section 9504(3).[13] Security Pacific

[8] *Id.* at 1239.

[9] See American Nat'l Bank. v. Perma-Tile Roof Co., 200 Cal. App. 3d 889, 246 Cal. Rptr. 381 (1988); C.I.T. Corp. v. Anwright Corp., 191 Cal. App. 3d 1420, 237 Cal. Rptr. 108 (1987); Connolly v. Bank of Sonoma County, 184 Cal. App. 3d 1119, 229 Cal. Rptr. 396 (1986).

[10] 173 Cal. App. 3d 965, 219 Cal. Rptr. 381 (1985).

[11] *In re* Kirkland, 915 F.2d at 1240.

[12] *Id.* In footnote 6 (citations omitted), the court of appeals rejected another interesting argument:

> Security Pacific contends that in adopting a stricter version of § 9504(3) the California legislature could have, but did not, include guarantors within that statute's provisions: California's adoption of a stricter version of § 9504(3) is of no consequence to our decision. In adopting a stricter version of § 9504(3), the California legislature's apparent concern was not who was to be given notice, but the way in which notice should be given.

Id. at 1240 n.6 (citations omitted).

[13] The court stated: "Both parties assume, as do we, that a default by the debtor is the event used to determine whether a waiver of notice by the guarantor is post-default."

Id. at 1241 n.8.

argued that "the Kirklands did, in fact, waive their right to notice after Cascade's default in both their May 18, 1981 and June 8, 1981 letter agreements because both letter agreements incorporated the terms of the Kirklands' original guaranty."[14] Security Pacific took the position that Section 9504(3) requires that notice be waived "after default" but not that the debtor has to be "in default" when notice is waived. Accordingly, Security Pacific argued that, since the guarantors waived their right to notice after March 31, 1981, the date of the debtor's *initial* default, Section 9504(3) had been satisfied.

The court responded to this argument by observing that the debtor defaulted at three separate times: in March 1981, in May 1981, and in September 1981:

> After each of these defaults, with the exception of September 15, 1981, Security Pacific waived the default and had executed in its favor additional security from both Cascade and the Kirklands. Therefore, even if we assume that the letter agreements of May and June 1981 incorporated the terms of the Kirklands' original guaranty and that § 9504(3) requires only that a debtor waive notice "after default" and not while "in default," Security Pacific violated § 9504(3).
>
> Prior to September 15, 1981, in effect, Cascade had not defaulted because Security Pacific waived default for additional security. As a result, the only waiver of notice that would have been effective would have been one executed after September 15, 1981, the date of the only relevant default. No such waiver existed.[15]

A Costly Mistake

The court of appeals observed that California courts traditionally disallowed deficiency claims when a creditor failed to adhere to the notice requirements of Section 9504(3). Security Pacific argued that the court should not apply the absolute bar rule, which is "meant to prevent unreasonable, not commercially reasonable, dispositions of collateral, particularly when, as here, the guarantors incur no damage."[16] The court of appeals rejected this argument, noting that the California courts had consistently adhered to a simple maxim: "[I]f the secured creditor wishes a deficiency judgment he must obey the law. If he does not obey the law, he may not have his deficiency judgment, . . . regardless of the commercial reasonableness of the creditor's conduct."[17]

The court also pointed out that California courts do not allow a secured creditor's substantial compliance or good faith to mitigate the severity of disallowance of the entire deficiency claim. California courts do not require the debtor to show injury; instead, the burden of proving compliance with the notice

[14] *Id.* at 1241.

[15] *Id.*

[16] *Id.*

[17] *Id.* at 1242.

requirements of the UCC is placed on the secured creditor.

Conclusion

The *Kirkland* decision serves as an important reminder to secured creditors to comply strictly with the requirements of Article 9 of the UCC and especially to treat guarantors as "debtors" for notice purposes. Although guaranties often contain various waivers, including a waiver of notice of the sale of collateral, the practitioner should not blindly rely on the validity or unrestricted application of those waivers. The decision also illustrates how the requirement that a waiver of notice of a collateral sale be executed after default can be misleading in the common scenario involving several successive defaults and restructurings.