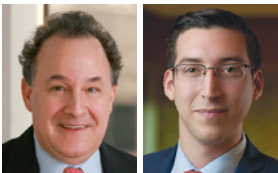


You Can't Judge a Guaranty by Its Title: A 'Conditional Guaranty' May Be an Unconditional Guaranty of Payment



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When extending credit to financially distressed customers, creditors may request a personal guaranty—frequently from the customer's principal or owner—as a backstop for full payment of the creditor's claim against the customer. Best practice is for the creditor to obtain a guaranty of payment (sometimes referred to an *unconditional* guaranty), where the creditor can seek payment directly from the guarantor without first seeking to collect from the primary obligor. This contrasts with the far less preferable guaranty of collection (sometimes referred to as a *conditional* guaranty), where the creditor is required to exhaust its remedies against the primary obligor before seeking to collect from the guarantor.

A recent decision from the U.S. District Court for the Southern District of New York (District Court), in *KLS Diversified Master Fund, L.P. v. McDevitt (KLS)*, made clear that the terms of a guaranty, and not its title, control whether the guaranty is an unconditional guaranty of payment or a conditional guaranty of collection. Calling a guaranty

an unconditional guaranty or a conditional guaranty has no bearing on whether the creditor has a guaranty of payment; rather, whether a creditor may first seek to collect from a guarantor depends on the language of the guaranty. The old saying "You cannot judge a book by its cover" clearly applies to judging the enforceability of a guaranty by its title and whether and to what extent a creditor may ultimately be able to collect from a guarantor.

Background of the KLS Case

The *KLS* case involves disputes regarding liability and damages under a conditional guaranty. The primary obligor, Sensei, Inc. (Sensei) had described itself as "the leading digital and entertainment platform and mobile application that enables insurers, health systems and employers to communicate with their members/employees, engage and educate across various benefits and wellbeing enhancement topics." However, by late 2016, Sensei was a company "struggling for survival" in the words of the District Court, as the company was losing money and running out of cash.

On Jan. 9, 2017, Sensei obtained financing from KLS Diversified Master Fund, L.P. (KLS) via a secured convertible promissory note (Note) in KLS's favor and granted KLS a security interest in all of Sensei's personal property to secure payment of the Note. That same day, Sean McDevitt (McDevitt)—Sensei's majority owner and chief executive officer—signed a document titled, "Conditional Guaranty" (Guaranty), under which McDevitt guaranteed Sensei's obligations under the Note. Specifically, McDevitt agreed that he would "be fully and personally liable for the payment and performance of any then remaining obligations of [Sensei] set forth in the Note"—the "condition" merely being that McDevitt's obligations as guarantor arose only upon the occurrence of any one of six recourse events contained in the Note.

Sensei failed to pay to KLS the approximately \$3.3 million principal amount of the Note by the maturity date of Jan. 9, 2019. Accordingly, KLS foreclosed on and took possession of its collateral that secured Sensei's obligations under the Note. However, KLS recovered nothing of value from the collateral, despite its efforts to market and sell the foreclosed assets. KLS merely ended up with title to Sensei's collateral.

On April 26, 2019, KLS commenced an action in the District Court to recover \$3.6 million from McDevitt pursuant to the Guaranty, which KLS alleged was the payment due under the Note, including accrued interest. On June 5, 2020, KLS and McDevitt filed competing motions for summary judgment to determine whether or not McDevitt was liable under the Guaranty. On Dec. 15, 2020, the District Court granted summary judgment in favor of KLS, holding that several recourse events under the Note had occurred and McDevitt was liable to KLS under the Guaranty.

In holding McDevitt liable for the indebtedness owing to KLS, the District Court rejected McDevitt's argument that KLS's foreclosure on Sensei's collateral precluded KLS from recovering from McDevitt under the Guaranty (regardless of whether a recourse event had occurred) because Sensei had no remaining obligations under the Note for which McDevitt could be held liable under the Guaranty. The District Court

held that KLS's remedies against Sensei in the event of a default under the Note were in addition to, not in lieu of, KLS's remedies against McDevitt under the Guaranty because it was a guaranty of payment. As such, McDevitt was fully and personally liable for the payment of all of Sensei's obligations to KLS under the Note. The court also noted that KLS's exercise of its rights against Sensei, such as foreclosing on KLS's collateral, did not compromise or otherwise release or adversely affect KLS's rights against McDevitt, or release or limit the liability of McDevitt under the Guaranty. McDevitt was required to pay all of Sensei's obligations under the Note because KLS did not realize any recovery on its collateral.

KLS then moved for summary judgment with respect to the amount owed by McDevitt to KLS under the Guaranty. KLS asserted that McDevitt was liable for the full principal amount of the Note, plus interest, for a total judgment amount of approximately \$3.9 million, together with KLS's attorneys' fees and costs. In opposition, McDevitt argued, among other things, that the amount of the judgment should be reduced by the value of the collateral in KLS's possession.

McDevitt claimed KLS's collateral was worth \$2.6 million based on a prior appraisal of Sensei's liquidation value and sought a trial for the court to determine the value of KLS's collateral. McDevitt argued that KLS's judgment against him should be reduced by such value, regardless of the fact that KLS had not actually realized any recovery from the collateral.

The District Court's Decision

The District Court held that McDevitt was liable for the full principal amount of the Note, plus interest and certain attorneys' fees,¹ because the Guaranty was an unconditional guaranty of payment, despite being called a conditional guaranty. The court relied on the Guaranty's clear language stating that it was a continuing guaranty of payment and performance and not of collectability. According to New York law, which governed the Guaranty, when a party guarantees payment of a debt, as opposed to collection of a debt, the guaranty is absolute and unconditional. Therefore, regardless of being called a conditional guaranty,

the Guaranty was an unconditional guaranty of payment and not collection.

The District Court pointed to numerous other provisions of the Guaranty that supported its characterization as an unconditional guaranty of payment. For example, the Guaranty stated that "[KLS] may bring a separate action against Guarantor without proceeding against [Sensei] or . . . any security held by [KLS], and without pursuing any other remedy." The Guaranty also gave KLS the right to fail to perfect, terminate, compromise or release the collateral without obtaining McDevitt's approval. Additionally, pursuant to the Guaranty, McDevitt waived the right to require KLS to proceed against Sensei or KLS's collateral; designate the order of application of any sums or property that KLS had received; or pursue any other remedy. And, finally, while the Guaranty gave KLS the right to exercise any remedy against Sensei or KLS's collateral upon Sensei's default, the Guaranty also stated that no such action by KLS would release or limit McDevitt's liability under the Guaranty. As a result, KLS had no duty to collect from Sensei or sell KLS's collateral before seeking to collect from McDevitt under the Guaranty.

The District Court noted that its conclusion was consistent with the New York Uniform Commercial Code (UCC). For example, according to New York UCC Section 9-620(a), a secured party "may accept collateral in full or partial satisfaction of the obligation"—i.e., the secured party may, but is not required, to seek or accept the collateral. The court also noted that its holding is consistent with New York court decisions holding that "it is not commercially unreasonable for a secured party to litigate damage claims on a debt while continuing to hold the secured property."

In sum, while the Guaranty might have been conditional in that it was triggered only upon the occurrence of a recourse event, McDevitt's obligation as a guarantor became unconditional once a Recourse Event occurred. As a result of Sensei's failure to pay the principal balance of the Note when due and the occurrence of other recourse events under the Note, McDevitt was required to pay the full amount that Sensei owed KLS, and KLS could pursue McDevitt

under the Guaranty without first proceeding against or exhausting its remedies with respect to Sensei or the collateral.²

Conclusion

Though McDevitt has appealed to the U.S. Court of Appeals for the Second Circuit, the District Court's *KLS* decision nonetheless serves as an important reminder to creditors that an unconditional guaranty of payment is a powerful collection tool. A creditor holding a guaranty of payment from a financially strong guarantor has an alternative avenue to collect from a source with potentially deeper pockets without having to exhaust its collection efforts against its financially distressed customer. And remember, as illustrated by the *KLS* case, it is the contents—not the title—of a guaranty that determines whether it is an unconditional guaranty of payment. Just as you cannot judge a book by its cover, don't judge a guaranty by its title!

- 1 Though the District Court's judgment for damages included interest at the contractual rate in the Note through the date of judgment and KLS's attorneys' fees, the District Court did not grant the request by KLS's attorney for "fees on fees"—the attorneys' fees for the work conducted in connection with collecting attorneys' fees. The District Court held that KLS's attorneys would only be entitled to such "fees on fees" if the Guaranty and KLS's counsel's engagement letter had provided such a right by their express terms, which they did not.
- 2 The District Court noted that any judgment against McDevitt under the Guaranty would have been reduced had KLS actually realized any value from the collateral.

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