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A Guaranty Is a Guaranty Is a Guaranty, Except When It's Not: Understanding the Illinois Sureties Act

Article By:

Corporate & Finance at Much

If I may be permitted to mix my literary references, a guaranty is a guaranty is a guaranty, except when it's a surety. And then it may not smell as sweet, especially if you are the party seeking to enforce it.

Everybody knows what a guaranty is, right? In a normal business situation, a company's owner might sign a guaranty regarding a line of credit or a bank loan. Generally, the bank (i.e., the creditor) will provide a form agreement in which the so-called "guarantor" promises to make good on the company's debt. As long as the party primarily responsible for the obligation (i.e., the principal obligor) makes payments in regular course, the guarantor generally is safe. But when there is a default (e.g., the company goes out of business and stops making its payments), then the creditor will look to the guarantor for payment. And since the principal obligor on the debt (e.g., the bankrupt company) often has no assets, the creditor does not want to waste time or money suing a bankrupt entity. Instead, the creditor sues the guarantor, which it has every right to do—unless that guarantor is actually what the law calls a surety.

Under the Illinois Sureties Act, if a party that promises to pay the debt of another falls into the category of surety (rather than guarantor), then the creditor seeking to enforce the agreement could be required to sue the principal obligor. For example, if a surety demands in writing that the creditor sue the principal obligor, then the creditor must do so—or forfeit its right of action against the surety.

While that may be all well and good, you are probably wondering, "What does it have to do with me?" Well, if you are a bank or other creditor seeking to enforce a guaranty, you might be surprised to find out that under the Illinois Sureties Act, your guarantor is really a surety. If so, you might be required to sue a bankrupt or out-of-business principal obligor in order to preserve your rights against the entity you thought was a guarantor. And if you are an entity that has promised to pay the debt of another (i.e., a guarantor of one type or another), you might have the right, if you are in fact a surety, to require the creditor to go after the principal obligor before it can sue you.

Surety vs. Guarantor

The distinction between a surety and a guarantor is subtle and does not depend on what the document calls the entity that has promised to pay the debt of another. Even if the document itself is called a guaranty, it might actually be a surety, depending on the exact terms of the agreement. The Illinois Supreme Court recently addressed this issue in ***JPMorgan Chase Bank N.A. v. Earth Foods Inc.*** In that important case, the appellate court had previously held that essentially all guarantors are treated as sureties under the Illinois Sureties Act. That decision could have had far-reaching consequences, but the Illinois Supreme Court granted an appeal—and took a step back, holding that not all guarantors are covered by the act.

Although guarantors and sureties are similar in that they promise to pay the debt of another, the *Earth Foods* court held that a surety and the principal obligor are both primarily and directly liable for the debt. A guarantor, on the other hand, becomes liable only after the principal obligor defaults. When that occurs, the guarantor (unlike a surety) does not have the right to require the creditor to proceed against the principal obligor or forfeit its right against the guarantor.

So, as in many things, language is important. The words used in the document will be crucial, though the Illinois Supreme Court also held that it is often appropriate to look beyond the mere language to determine what was intended. That is because the language may be ambiguous, especially since the words "guarantor" or "guaranty" will not alone be dispositive.

Still, careful drafting could resolve this ambiguity in most cases. If a creditor wants the right to proceed against the guarantor without also going after the principal obligor, then the language should unambiguously express that the guarantor's obligation only comes into play after the principal obligor has defaulted. If, however, the language indicates that the guarantor's liability is coextensive with the principal obligor (thus making the guarantor a surety), then the creditor very well may be required to spend time and money suing the principal obligor—even though that entity may be bankrupt and have no assets.

Although a rose may be a rose may be a rose, the same is not true for guaranties. If you are not careful, they just might become sureties.

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