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Suretyship

The generally poor economy of the past few years finally began to make itself felt at the appellate level last year as there were more cases directly involving security devices than there have been in the recent past. Not unexpectedly, few of the cases involve new or novel defenses or questions of law, with the defendants in many of them raising defenses with little merit, apparently grasping at straws to delay the day of reckoning. So called "lender liability" defenses, although quite popular were largely unavailing. More traditional attacks upon the contracts themselves continued to be made. In *Todd Oil Co., Inc. v. Wall*,[1] the defendants attempted to reform a continuing guaranty agreement by which they guaranteed all obligations of the principal debtor to the plaintiff, who had been selling the debtor gasoline for resale in a chain of convenience stores the debtor operated. The plaintiff thereafter made a loan to the debtor as part of a transaction by which the plaintiff purchased some of the debtor's stores. When the debtor failed to pay the loan, the plaintiff called upon defendants to pay under their guaranty. The defendants attempted to "reform" the contract and prove that they only intended to guarantee debts arising from the purchase of gasoline, not loans made for totally unrelated purposes. The court rejected their plea, properly pointing out that a contract of guaranty is simply a suretyship, and as such has to be in writing. It then noted that parol evidence normally is not admissible to prove a contemporaneous agreement on modification of a written contract or to vary its terms. Neither is such evidence admissible in the absence of ambiguity to explain or modify the clear words of the contract. Furthermore, to reform a contract on the grounds of mutual error, the proponent must show that there was an antecedent agreement between the parties to a written contract that the writing was intended to reflect, but that its terms were erroneously stated when it was reduced to writing.[2] The court rejected

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1. 581 So. 2d 333 (La. App. 3d Cir. 1991).

2. See First State Bank & Trust Co. v. Seven Gables, 501 So. 2d 280 (La. App. 1st Cir. 1986), writ denied, 502 So. 2d 103 (1987), which contains an excellent discussion of the matter and was relied upon by the court in the case under consideration.

the defense in the present case, because the defendants were unable to show the creditor had any understanding or agreement that his contract was to be limited in the matter claimed by the defendants.

In *Greene v. Gulf Coast Bank*,[3] the sureties were successful (for about the only time in Louisiana history) in setting aside their contract with the creditor on the grounds of false or fraudulent representations by the creditor. In that case the sureties proved that the creditor intentionally concealed the debtor's dismal past credit history from them, that this was done with an intent to deceive, and that the sureties relied upon the representations. The court also found that the bank had a duty to disclose the credit history to the sureties because of its involvement in the negotiations with them. Perhaps the most relevant fact, although not emphasized by the court, was that the sureties obligated themselves for loans that the bank had already made and which, it appeared, the bank thought were in jeopardy. The facts were extreme and, even then, the case at best looks marginal. Certainly, in most cases the debtor is better known to the surety than he is to the creditor; the creditor's very request for a surety may be indicative of a less than enthusiastic belief in the debtor's ability to pay the loan. To go further and prove that the creditor intends to defraud the surety by loaning money to a third person in most cases presents an almost insurmountable obstacle to the surety.[4] The contract of suretyship is between the surety and the creditor. Frequently, the surety is induced to contract with the creditor by representations and promises of the debtor as to the purpose, nature, and extent of the obligations contemplated by the arrangement. Attempts to thereafter modify the contract for mutual error or to set it aside for fraud by the debtor are generally unavailing since the creditor is seldom a party to representations or fraud and the contract is not with the offending party.

The recent revision of the Civil Code articles on obligations redefined the principles regulating error, and in the writer's opinion, considerably expanded the ordinary understanding in Louisiana that to vitiate a contract on the grounds of error the plaintiff had to show the error was a mutual one.[5] Revised Civil Code article 1950 now declares that

3. 580 So. 2d 712 (La. App. 3d Cir.), reh'g granted, 585 So. 2d 554 (1991).

4. Compare Commercial Nat'l Bank in Shreveport v. Audubon Meadow Partnership, 566 So. 2d 1136 (La. App. 2d Cir. 1990), in which claims somewhat similar to those made in the *Greene* case were rejected because the surety failed to prove any affirmative representations by the bank and any duty by the bank to investigate and analyze the feasibility of the project for which the loans were made. Similar claims also were rejected for much the same reasons in Bell v. Vickers, 568 So. 2d 160 (La. App. 2d Cir. 1990).

5. The Comments to Article 1950 indicate that it does not change the law. However, it articulates rules which, if they existed at all, were found in cases involving unusual factual situations that made it difficult to know whether and to what extent the courts

the error may concern any matter which "bears on the nature of the contract, or the thing that is the contractual object . . . or any other circumstance that the parties regarded, or should in good faith have regarded, as a cause of the obligation." Article 1952 then notes that a party who obtains recission on the grounds of *his own error* is liable for the loss thereby sustained by the other party *unless the latter knew or should have known of the error.*[6] It would thus seem in cases such as those under consideration, that the surety who proves he was induced to enter into the contract on the basis of false representations by the debtor, or who is mistaken as to the nature and extent of the obligations contemplated by the debtor and surety, may seek relief on the grounds of his own error. That would permit him to annul the contract. However, to escape responsibility to the creditor, he still would have the burden of proving that the creditor knew or should have known of his error. In the great majority of cases, the latter requirement will (and should) prohibit him from leaving unpaid the creditor who relied upon the guaranty. Nevertheless, in cases such as that under discussion, the surety could avoid the burden of proving that the debtor and creditor actually agreed that his liability should be in some manner restricted, and concentrate his efforts to proving that the creditor should have known the surety signed his agreement because of representations and promises of the debtor. The difference in the two, admittedly, is only one of degree—but not only may be significant in a particular case, but may permit the introduction of much evidence that would not be admissible under an action to reform for mutual error.

When a person sells or transfers his interest in a going concern, it is essential for the attorney handling the case, if there is one, to make a diligent inquiry as to the existence of guarantees and indemnity agreements that may have been signed by the transferor on behalf of the debtor. These frequently are of indefinite duration and are easily forgotten by the transferor. The consequences of failing to do so were again illustrated in *Robbins Tire & Rubber Co., Inc. v. Winnfield Retread, Inc.*.[7] The surety in the case had been the chief executive officer and primary shareholder of the defendant corporation. He gave the plaintiff, a supplier to his company, a continuing guaranty for all of the debts incurred by the company. The contract provided, as do most such contracts, that it would continue until revoked in writing by the surety. Three years later the surety sold his interest in the company to

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might extend them to more ordinary situations. A review of the comments to Article 1952 will, it is suggested, disclose a substantial difference in the old and new law and one that might well be utilized in cases such as those under discussion.

6. La. Civ. Code art. 1952 (emphasis added).

7. 577 So. 2d 1189 (La. App. 2d Cir. 1991), reh'g granted in part and denied in part, May 2, 1991.

a third person, sent a check to the plaintiff for the balance owed by the company, and told them that he was selling his interest. No mention was made of the guaranty. Thereafter, the company gave the plaintiff security over some of its assets, including a real estate mortgage. Later, to facilitate other financing, the creditor released the mortgage. Finally, four years after the sale, the plaintiff called upon the surety for payment. The surety defended on the grounds of equitable estoppel and that the release of the mortgage impaired the security of the principal obligation and released him.

The court noted that the suretyship was a contract and, although terminable at will, had to be terminated by written notice to the creditor. It rejected the plea that the creditor was estopped by noting that the plaintiff in no way misled the surety and took no action which would have lead him to believe he was no longer liable for the obligations of the corporation. Although it was not expressly mentioned by the court, it is clear the court did not believe that notice to a supplier that the surety has transferred his interest in the business does not necessarily mean that he no longer has a financial or personal interest in its affairs or create the presumption that he intends to cancel his suretyship.

As to the release of the mortgage, the court found the surety had virtually admitted he was not prejudiced by the action. The court noted that the 1988 revision of the code changed the burden of proof as to the effect of a release or impairment of security but not its substantive effect, at least as to commercial sureties. It then held that it did not have to pass upon the retroactivity of the act, as the evidence showed no prejudice actually occurred. Another factor not mentioned by the court that also should have disposed of the matter was the fact that the suretyship in question was virtually unlimited and unconditional, and was in full effect when the security was taken and released. The release or impairment of security releases the ordinary surety absolutely, and the commercial surety to the extent he is prejudiced. If, however, one guarantees without qualification or condition "all future obligations or indebtedness" of the debtor to the creditor, the release of the security should not affect his liability. A surety who agrees that he will guarantee all future indefinite obligations of the debtor can hardly complain if the parties transform a secured debt into an unsecured one. Could they not simply agree to extinguish the first obligation and substitute a new unsecured one? The purpose of the provisions in the code concerning the impairment of security is to insure that the contract of the surety is not changed to his detriment by forcing him to guarantee an obligation different from the one he agrees to undertake.[8] A person who guarantees

8. This is not to say that the surety is unaffected by the release of security taken after he gave his initial promise. The Code does not expressly address the matter, but the terms of Article 3062 do not limit its effect to the impairment of security contemplated by the parties, or held at the time the suretyship is given.

an obligation secured by a mortgage is entitled to be subrogated to the obligation and may enforce the mortgage if he is forced to pay. To release the mortgage and then require him to pay would materially change the nature of his contract. But if he agrees to guarantee any obligations, secured or unsecured, that may be then or thereafter owed by the debtor to the creditor, he is hard put to complain if the obligation he is ultimately forced to pay is not a secured one. The novation of the debt, the change of its terms, or the release of the security while his guaranty is in effect may cause the obligation he is called upon to pay to be quite different from that which was in existence when he guaranteed it, but the new and modified obligation is still one that he has agreed he will pay under his continuing guaranty.

MORTGAGE

Following the fourth circuit's decision in *First Financial Bank, F.S.B. v. Johnson*,[9] holding that a mortgage in the name of James J. Johnson did not give notice to third persons that it might affect the property of James Johnson, the legislature enacted Louisiana Revised Statutes 9:2728, which essentially provides that the inclusion or failure to include a middle name or initial, or the use of "any reasonable variation" of the mortgagor's name does not render the mortgage inferior to another security device.[10] In *Voelkel v. Harrison*,[11] the fourth circuit considered the applicability of the provision in a case where a mortgage was given in the name of Martin A. Harrison, III affecting property standing in the name of Martin Harrison, III. The mortgagee who sought to execute on its mortgage was met with the claim by a subsequent mortgagee that under the *First Financial* decision, the plaintiff's mortgage was not sufficient to constitute notice and was thus inferior to the later recorded mortgage. The plaintiff relied upon the provisions of the statute, claiming it was procedural and should be applied retroactively. The court rejected the claim, noting that to do so would have the effect of making the plaintiff's mortgage effective as to the later mortgagee after the latter's rights had vested—a conclusion that is undoubtedly correct. The court then made an extensive examination of the jurisprudence as to "when recorded instruments place a third party on inquiry as to the title and/

9. 477 So. 2d 1267 (La. App. 4th Cir. 1985).

10. One would assume the legislature intended to simply say that third persons are affected by mortgages and other instruments of record notwithstanding that the name of the person in the instrument does not include his middle initial, etc., since, in principle, the *First Financial* decision, if valid, would be applicable to any situation in which an instrument is filed in the mortgage or conveyance records. Limiting its effect between security devices seems unduly restrictive.

11. 572 So. 2d 724 (La. App. 4th Cir. 1990), writ denied, 575 So. 2d 391 (1991).

or description of the property involved."[12] It concluded that the determination must be made on a case by case basis, and that under the rules announced by the Louisiana Supreme Court "where a recorded instrument has language that fairly puts a third person on inquiry as to the title and he does not avail himself of the means and facilities at hand to obtain knowledge of the true facts, he is to be considered as having bought at his own peril."[13] The court then rightly noted that while the decisions enunciating the rules were not directly applicable to the names of persons in recorded instruments, they do "assist in determining when third persons must be placed on notice."[14] It then concluded that a mortgage in the name of "Martin A. Harrison, III" ought to provide sufficient notice to third persons that it might affect land owned by "Martin Harrison, III."[15] The court then reached the following rather interesting conclusion:

> The decision of *First Financial Bank*, substantially modifies the prior jurisprudence concerning the "sufficiency of notice" requirement under the public records doctrine. To apply the . . . decision to mortgages created and recorded prior to that decision would . . . [violate] . . . the mortgagee's vested right. . . . Thus it is appropriate that the *First Financial Bank* decision be applied prospectively to mortgages recorded after the date the decision was rendered.[16]

Since most of the "prior jurisprudence" which the court says was "substantially modified" by the *First Financial* case was that established by the Louisiana Supreme Court, one wonders how the court of appeal believed it could modify it, and why the court, after acknowledging that the *First Financial* decision was based upon an erroneous appreciation of that jurisprudence, did not simply indicate that it would no longer follow the case. It is unfortunate it did not do so, because even with Louisiana Revised Statutes 9:2728, the courts must decide the basic principles from which they must proceed to interpret its provisions. In the case under consideration, the court virtually admitted that the premises of *First Financial* are erroneous.[17] It must be hoped that *First Financial* will not only not be applied "retroactively," but that it will

12. Id. at 727.
13. Id.
14. Id.
15. Id.
16. Id. at 726.
17. Contrary to the inferences of the court in the *Voelkel* case, the *First Financial* decision did not "change" the prior jurisprudence, at least in the ordinary sense of considering and rejecting or modifying it. The authorities relied upon by the court in *Voelkel* as evidencing the law and principles applicable before *First Financial* were neither mentioned nor dealt with by the court's opinion in *First Financial*.

be consigned to the ash heap wherein are found all such temporary aberrations of the courts.

OIL, GAS AND WATER WELL LIEN ACT

In *Shamsie v. Pyramid Petroleum, Inc.*,[18] the third circuit, relying upon an earlier Louisiana Supreme Court decision, held that a claimant under the "Oil Well Lien Act"[19] is limited in the assertion of his lien to the amount of the debt stated in the notice of lien filed in the mortgage records to evidence and preserve his privilege.

PRIVATE WORKS ACT

The Private Works Act[20] establishes a dual system regulating the filing and effectiveness of notices of claim. If a notice of the contract is filed, the period for filing of notices of claims by persons granted a claim or privilege ends thirty days after the owner or contractor files a notice of termination.[21] If a notice of the contract is not filed, the period for filing by persons granted a claim or privilege ends sixty days after the filing of a notice of termination or after substantial completion of the work.[22]

The importance of the distinction is illustrated by *Bernard Lumber Co. v. Lake Forest Construction Co.*[23] The defendant was the general contractor of a lessee who had leased space in a shopping center. Although no bond was given by the defendant a notice of the contract was properly filed in the mortgage records. For some reason not revealed by the opinion, a notice of termination was not filed after the work was finished. The contractor was engaged in a dispute with the plaintiff, who was a subcontractor on the job, as to the amount due under its subcontract. When attempts to settle the matter were unavailing, the plaintiff filed a notice of its privilege, over 200 days after the work was completed. The owner (lessee) and general contractor argued that the time for filing expired sixty days after the work was substantially completed. The court properly rejected the claim, holding that the statute clearly distinguishes those cases where the owner files a notice of his contract and those where he does not, and that in the former case the period for filing does not end until thirty days after a notice of termination is filed. It is difficult to see any rational argument that could have been asserted to the contrary. If the owner or contractor is ignorant

18. 577 So. 2d 835 (La. App. 3d Cir. 1991).
19. La. R.S. 9:4861 et seq. (1991).
20. La. R.S. 9:4801-4855 (1991).
21. La. R.S. 9:4822(A) (1991).
22. La. R.S. 9:4822(C) (1991).
23. 572 So. 2d 178 (La App. 1st Cir. 1990).

of the requirements of the act, or for whatever reason does not want to file a notice of the contract, then the lien period commences when he finishes his job. Those persons dealing with the owner or a contractor or subcontractor must then investigate when the work is finished and file their claims within sixty days of that time. If, on the other hand, a notice of contract is filed, they may then rely upon filings in the mortgage records to determine when the filing period ends. The act is obviously drawn on the assumption that the owner who knows enough to file the contract will also know he is to file a notice of completion.

Once a notice of claim is properly filed, the Private Works Act provides that the claimant must file an action asserting his claim or privilege within one year or it is extinguished.[24] The act in substance also provides that if the claimant does not also file a notice of lis pendens of his action, the "effect of filing" the notice of claim shall "cease as to third persons."[25] It does not define who "third persons" are, leaving the matter to general principles of law.

In *First National Bank of Commerce v. de la Tour Contractors, Inc.*,[26] the defendant, a general contractor who had properly filed his claim and instituted an action against the owner, failed to file the notice of lis pendens. The plaintiff bank had obtained and recorded a mortgage against the property from the owner of the land after the work began, thus making it inferior to the defendant's privilege. The defendant claimed that the bank was not a "third person" and that in any event, when the bank's mortgage was recorded no litigation was pending, and that therefore, the filing of the notice of lis pendens would have been premature.[27] The court, relying primarily on Louisiana Revised Statutes 9:2722, concluded that the mortgagee bank was a third person. Louisiana Revised Statutes 9:2722 defines "third persons" entitled to rely upon the registry laws as "including any third person or third party dealing with any such immovable or immovable property, or acquiring a real or personal right therein as purchaser, mortgagee, grantee or vendee . . . and all other third persons or third parties acquiring any real or personal right, privilege or permit relating to or affecting immovable property." The court then held the failure to file the notice of lis pendens extinguished the effect of filing its notice of claim.

The dissent in the case argued that the effect stated should not apply because the filing of the notice of claim was effective when the mortgage was first filed:

24. La. R.S. 9:4823(A)(2) (1991).

25. La. R.S. 9:4833(F) (1991).

26. 570 So. 2d 239 (La. App. 4th Cir. 1990).

27. As a matter of fact, no suit had then been instituted, which means filing the notice would not only have been premature, but impossible.

> The clear intent . . . [of R.S. 9:2722] is to protect one who takes a mortgage on property from . . . unrecorded liens, mortgages, claims or alienations of interest in the property.
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> [The bank] is not in this class. It did not take its mortgage in reliance on the public records. It took its mortgage subject to de la Tour's lien and should remain in that position notwithstanding de la Tour's subsequent failure to avail itself of the protection of the public records law.

The decision is correct and the dissent is wrong for at least three reasons. First: Although in general the purpose of the public records doctrine is to establish a reliable method of determining ownership, actual reliance is irrelevant. As Judge Redmann so perceptively points out in his article on the public records doctrine, Louisiana's system is based on effectiveness, not notice.[28] An unrecorded act is ineffective as to third persons, even if they have notice of its provisions, and a recorded act is effective, even if such persons are unaware of its provisions. Therefore, when the act declares that the "effect of filing ceases," the instrument becomes as though it were unrecorded. Second: The provisions regulating the filing and preservation of privileges are both detailed and intricate. They also are deliberately constructed to provide certainty to those persons who deal with immovables and at the same time provide a method by which those who supply materials or services can have some assurance that they are paid. The activities that give rise to the privileges cannot be determined from the records. An examination of the history of the act, and the jurisprudence interpreting it will illustrate the difficulty in determining when and to what extent claims may exist. It is rare that a real estate transaction does not depend wholly or partly upon a lender who takes security in the land for the repayment of his loan. The inability of an attorney to express an unequivocal opinion as to the rank and status of the lender's security almost always will frustrate the transaction, or at best cause the parties to incur unnecessary and sometimes significant expenses. In constructing the act, the legislature established definite and particular rules as to what each party must do to preserve his rights. The act is clear that if a notice of claim is timely filed, the claimant must institute his action within a year, and if he wishes to preserve his claim as to third persons dealing with the property, he must file a notice of lis pendens. If he fails to do so the effect of registry ceases.[29] This is further borne out by the fact that the act is

28. Redmann, The Louisiana Law of Recordation: Some Principles and Some Problems, 39 Tul. L. Rev. 491 (1965).

29. It will be remembered that the provision under consideration is quite similar to Louisiana Civil Code article 3369 providing that unless a mortgage or privilege is reinscribed within a certain time, the effect of registry ceases. It has never been contended that the

silent as to when such effect would cease. Under the dissent's view, presumably it would be imprescriptible as to persons acquiring rights in or over the property before the effect of filing ceased, and would continue as long as the claimant maintained his rights against the owner or the contractor. Third: The "reliance," if such exists, of the mortgagee on the presence or absence of the claim does not terminate when it files its mortgage. Frequently mortgagees are prevailed upon to grant extensions of time, modify the terms of repayment, or otherwise amend their obligations. They may grant releases of security, accept the property partially or completely in settlement of the debt, or otherwise deal with the owner of the property. If more than a year has elapsed since the filing period ended and notice of lis pendens has not been filed, the mortgagee may assume the property is unencumbered by a prior claim and deal with it on that basis.

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effect of that provision is applicable only to persons who acquire interests after the period of inscription terminates.