Spousal Guaranties—Clarifying the Rules Governing Personal Guaranties from Spouses of Borrowers

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When lenders make a loan to a closely-held company, they frequently require one or more of the company's principals to personally guarantee repayment of the loan. Sometimes a lender will also request (or require) that the principal's spouse also personally guarantee the loan. In the past, the legality of a lender requiring a spouse's guaranty was usually decided based on a federal regulation known as "Regulation B" (sometimes shortened to just "Reg. B"). That may be changing, however, because the United States Supreme Court has decided to review a case where the primary issue is likely to be whether the existing Reg. B has exceeded the scope authorized by Congress.

The Rationale for Requiring Spousal Guaranties

For a lender, the rationale for requiring a spouse's guarantee is simple and understandable. In jurisdictions like North Carolina, married couples may, and usually do, own real estate together in what is known as a "tenancy by the entirety." A tenancy by the entirety is a form of property ownership that is specifically reserved for married couples and allows both spouses to own real property, together, as a single legal entity (the marriage). As a result, the property is immune from attack by the individual creditors of either spouse. In other words, a creditor must be seeking to collect on a joint debt for which both spouses are liable in order to have the property that is owned by the marriage seized and sold to satisfy a judgment for the debt.

Since a person's wealth is often tied up in real estate investments, it makes good business sense for a lender to obligate both spouses on any loan, so that any real estate they own as entirety property will be available to satisfy a judgment in the event of a loan default. Without guaranties from both spouses, the lender may obtain a judgment against a company's principal, only to find that all of the principal's wealth is tied up in real estate that is off limits to satisfy the judgment because it is co-owned with a non-guarantor spouse. For this reason, it was, and still is, common for lenders to seek personal guaranties from both the principal whose company is obtaining a loan and the principal's spouse, regardless of whether the spouse is also involved in the company.

The Equal Credit Opportunity Act and Reg. B

The problem for a lender requesting a personal guaranty from a principal's spouse is that the federal Equal Credit Opportunity Act ("ECOA") has often been interpreted by courts as making it illegal for the lender to
unilaterally require the guaranty without first meeting some strict criteria. Broadly, ECOA makes it illegal for a creditor to discriminate against an "applicant" in a credit transaction based on race, color, religion, national origin, sex or marital status, or age. In implementing ECOA, the United States Federal Reserve Board, which regulates banks and, at the time, had jurisdiction over ECOA matters, promulgated Reg. B that specifically defined the term "applicant." Under Reg. B, the term "applicant" means any person who is or may become liable for the debt, including a guarantor.

In attempting to address discrimination based on marital status, Reg. B expressly forbids lenders from requiring the signature of a borrower's spouse on "a credit instrument" unless certain conditions are met. Although courts are not necessarily bound by interpretations of federal law contained in the regulations of a government agency such as the Federal Reserve, many courts, including some in North Carolina, have deferred to the Federal Reserve's interpretations in Reg. B as defining the scope of what is prohibited under ECOA. As a result, these courts have frequently held that it is illegal for a lender to require a spousal guaranty if the sole reason the lender is requiring it is that the spouse happens to be married to the person seeking the loan. Lenders found to have illegally obtained a spousal guaranty may be liable for actual and punitive damages and, usually worse, left without any recourse under the guaranty agreement found to violate ECOA.

Divergent Application and Legal Uncertainty

This view of ECOA has not been shared by all courts, however, and some have refused to find lenders in violation of the law simply because they required a spousal guaranty for a loan to the other spouse or the other spouse's company. One such decision was handed down just last year by the United States Court of Appeals for the Eighth Circuit in the case of Hawkins v. Community Bank of Raymore.

The reasoning for the Eighth Circuit's ruling in Hawkins was simple and straightforward. First, contrary to Reg. B's definition of "applicant," a spouse is not really an applicant for credit under the common meaning of the word. It is the borrowing spouse or the borrowing spouse's company that is the "applicant."

Second, the Eighth Circuit determined that limiting a lender's ability to require a spousal guaranty does not further the purpose of ECOA. The purpose of ECOA was to prevent unfair discrimination in credit transactions which, historically, included the practice of refusing to lend to a woman (wife) unless her husband guaranteed the debt. ECOA was intended to prohibit lenders from unfairly excluding a qualified woman from obtaining a loan, based on stereotypical views of gender roles, unless her husband guaranteed or co-signed for the loan. But when a guarantor-spouse claims the guaranty was procured in violation of ECOA because it was required for the sole reason that the guarantor-spouse was married to the borrower, what the guarantor-spouse is really claiming is that he or she was improperly included in a credit transaction. Since ECOA is supposed to deal with unfair discrimination and exclusion from credit transactions, this allegedly wrongful inclusion is not conduct that ECOA was meant to regulate. Thus, the Eighth Circuit determined that a lender's requirement of a spousal guaranty does not violate ECOA because a guarantor-spouse is neither an applicant for credit nor the victim of discrimination.

Although the Eighth Circuit's ruling in the Hawkins case is in agreement with an earlier decision by the United States Court of Appeals for the Seventh Circuit, it is in opposition to decisions by the United States Courts of Appeal for the Third, Sixth, and Ninth Circuits. Those courts deferred to Reg. B's broad definition of "applicant" and held that lenders may not require spousal guaranties even where the spouse is not a co-applicant for credit unless certain other fairly strict conditions have been met.

The United States Court of Appeals for the Fourth Circuit, which hears cases from North Carolina, has never ruled on the issue. Consequently, there continues to be much uncertainty and litigation in North Carolina's
state and federal courts concerning when a lender's requirement of a spousal guaranty is appropriate and legal. The issue typically arises when a default occurs and the lender files a lawsuit seeking to enforce its loan documents. Since an ECOA violation may void an otherwise valid guaranty agreement, it has become common, if not standard, for guarantor-spouses to allege an ECOA violation in the form of a counterclaim or defense and seek to avoid liability on their guaranty.

Fortunately, the United States Supreme Court may soon decide this issue for all courts. In March, it agreed to review the Eighth Circuit's decision in the Hawkins case. With any luck, the Supreme Court will soon issue a ruling that will provide clarity as to whether Reg. B is impermissibly broad and what is acceptable practice under ECOA for lenders seeking spousal guaranties.

**Conclusion**

The United States Supreme Court may soon decide whether Reg. B's limitations on spousal guaranties are legal. If Reg. B is found to be overbroad, then it may be necessary for the Consumer Financial Protection Bureau, which now has the responsibility for implementing ECOA, to amend it. For the time being, however, state and federal courts in North Carolina are still likely to defer to Reg. B when considering the propriety of a spousal guaranty, and the safest course is for lenders to be careful when requiring or agreeing to accept a spousal guaranty of a loan or other credit transaction.

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