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Like Brangelina, a Promissory Note and Guaranty May Be Separated

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Recently, in the case of Emerald Portfolio, LLC v. Outer Banks/Kinnakeet Associates, LLC, the North Carolina Court of Appeals issued an opinion that reaffirms the independent nature of personal guaranty agreements. The court held that a guaranty agreement is not absolutely tethered to the promissory note it promises to pay if the borrower does not pay the note. Rather, a guaranty agreement is a separate obligation enforceable by a creditor even if the creditor cannot enforce the related promissory note. The decision is a welcome reminder for creditors − particularly where the creditor has problems with its promissory note.

The Backstory

Here are the important facts from Emerald Portfolio: Outer Banks/Kinnakeet Associates, LLC ("OBKA") executed a promissory note to First South Bank. As part of the loan transaction, Ray Hollowell and Donna Hollowell signed commercial guaranty agreements. Several years later, First South Bank sold the loan to Emerald Portfolio, LLC. Upon default, Emerald sued OBKA and the Hollowells under the note and guaranty agreements.

On its claim against OBKA − the borrower and maker of the note − Emerald ran into trouble because it did not have possession of the original note. Emerald alleged it was the lawful owner and payee of the note, that it could not locate the note, and that First South Bank had endorsed the note to it. OBKA contended that Emerald could not enforce the lost note. The trial court rejected this argument and entered summary judgment for Emerald on the note and Ray Hollowell's guaranty agreement. As to Donna Hollowell, the court found she was a guarantor and that she was jointly and severally liable to Emerald under the note unless she could prove an affirmative defense under the Equal Credit Opportunity Act.

The Case Heads to the N.C. Court of Appeals

On appeal, the North Carolina Court of Appeals reversed in part, holding that under N.C. Gen. Stat. § 25–3–309, Emerald could not enforce the note. The court held that where a party who would otherwise have a right to enforce a lost note under N.C. Gen. Stat. § 25–3–309 subsequently assigns that note, the assignee does not acquire the right to enforce the note unless the assignee is in actual possession of the note. Since the note remained missing, Emerald could not enforce it against OBKA.

The court then turned to Ray Hollowell's guaranty agreement. Hollowell argued he could not be held liable as

a guarantor if the note itself could not be enforced. The court rejected his argument, holding that North Carolina law recognizes that the obligation of the guarantor and that of the maker of a note, while often coextensive are, nonetheless, separate and distinct. A guarantor's liability depends on the terms of the contract − the guaranty agreement − construed by the general rules of contract construction. Summing up, the court held: “A guaranty is an obligation in contract, and irrespective of the status of the note, may be enforced in contract.”

The court reiterated that a guaranty of payment is an absolute and unconditional promise to pay a debt at maturity (or default) if not paid by the maker. Here, by his guaranty, Hollowell contractually promised to pay the outstanding debt represented by the missing note if OBKA failed to do so. The unenforceability of the obligation by Emerald against OBKA was no defense for Ray Hollowell as guarantor.

Conclusion

The takeaway for creditors is that even if there is a fatal defect in a promissory note, they should not concede defeat. If they have guarantors, creditors have a separate path to enforce their debt. Although they may have no recourse against the borrower, they may have an enforceable obligation against their guarantors.

Ward and Smith's Creditors' Rights Practice Group is available to provide you with additional information and answer any questions you have about Emerald Portfolio and how it may affect you.

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