Commercial Financial Services Brief: Should We Ever Make a Loan To a Borrower Who May Die?

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Not all borrowers are business entities with a perpetual existence. Some borrowers are sole proprietorships. And, even if a business is structured as a corporation or limited liability company, a prudent lender will often require the owners of the business to personally guarantee the obligations of the business. Unfortunately, we are all mortal.

Lenders may assume that upon the death of a borrower or guarantor, they will be paid from the decedent's estate or trust assets without resorting to their collateral. Minnesota law, however, has previously limited the ability of secured lenders to collect more than their collateral from a decedent's estate. In an August 1, 2012, decision, the Minnesota Supreme Court extended this principle to trusts used as will substitutes by ruling that a trustee was not required to pay a decedent's debts that were secured by the decedent's (but not the trust's) assets from the trust's assets despite an express direction in the trust agreement to pay from the trust estate all "my legal debts."

In the case, a trust settlor created a living trust which provided that, during her lifetime, she would continue to be the sole beneficiary. Upon her death, her children, as well as the children of her husband, would be the trust's beneficiaries. The trust's assets were to be divided equally between the children. Her husband was expressly omitted from the trust's distribution provisions. However, before any such distributions could be made, "my legal debts" were to be paid by the trustee.

The settlor died in 2002. At the time of her death, the trust's assets were approximately $9.1 million. Following her death, the settlor's husband demanded that the trustee pay from trust assets various unsecured debts of the decedent and approximately $4.3 million in debt which was secured by real estate and a brokerage account that were not trust assets. None of the secured debt was owed by the trust. Rather, only the decedent and/or her husband were obligated to repay the secured lenders.

The settlor's husband contended that the trust directions to pay his wife's "legal debts" were clear—all indebtedness for which the decedent was obligated was to be paid from the trust. The trustee refused to do so, asserting that the direction to pay the decedent's legal debts was mere "boilerplate" in the trust agreement and did not express an intent that the trustee satisfy the claims of the decedent's creditors that were secured by non-trust assets. The Supreme Court sided with the trustee and ruled that the direction to

pay the legal debts of the decedent did not require the trustee to pay the secured claims against the decedent that were not secured by trust assets.

As a result of the Court's decision, claims against the trust of a deceased borrower that are secured by non-trust assets will not be paid from the trust's assets unless the trust agreement expressly directs the trustee to pay such claims. How any deficiency remaining after the liquidation of the lender's collateral is to be treated is not addressed in the Court's opinion.

What can lenders do in response to this decision? While there may be little that can be done in many cases, there may be options available in some cases.

1. If a borrower or guarantor dies, a secured lender should be aware that it cannot seek to compel the use of trust assets of a trust created by the borrower or guarantor to satisfy its secured claim unless the trustee is specifically directed to do so. If the lender is relying upon assets held in the trust in extending credit to the settlor of the trust, the lender should always require that the trust agreement include a specific provision that requires the trustee to satisfy the secured debt with trust assets. The lender must also monitor any future amendments or revisions to the trust agreement which may alter or amend these provisions. Finally, secured lenders should consider requiring periodic certifications from the settlor of a living trust that no such amendments have been made. Should any such amendments be made without the consent of the secured lender, the loan documents should provide for the ability to declare a default on the credit facility on account of such action.
2. If there are other assets available to secure a credit facility which may be paid to the lender outside of the trust (e.g., life insurance proceeds, certificates of deposit), the lender may want to look to those assets as additional collateral and perfect a security interest in them in order to avoid the issues raised in this case.
3. Loan agreements with business entities should always contain provisions which include the death of a guarantor as an event of default so as to permit the lender to commence liquidation of its collateral. This is especially true if the guaranty is secured.
4. If a secured lender learns that its borrower or any guarantor has established a living trust and has transferred assets to the trust, it should obtain a copy of the trust agreement to determine if the trustee is directed to satisfy its secured claim against the borrower or guarantor. If not, the lender should either require such a provision be included in the trust agreement or, if permitted by the trust agreement, obtain a guaranty from the trust of the secured indebtedness.

This decision of the Supreme Court makes life more challenging for secured lenders when a borrower or guarantor dies. It will require lenders to carefully review trust agreements in their files which support existing loans secured by assets held outside of trusts. And it may require secured lenders to be more diligent in exercising their collection remedies following the death of an individual borrower or guarantor.

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