

BANKRUPTCY AND GUARANTORS

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Katherine J. Clayton
Brooks, Pierce, McLendon, Humphrey & Leonard LLP
1600 Wachovia Capitol Center
150 Fayetteville Street
Raleigh, NC 27601
Phone: 919-573-6254
Email: kclayton@brookspierce.com

Martha R. Sacrinty
Tuggle Duggins & Meschan, P.A.
100 N. Greene Street
Suite 600
Greensboro, NC 27401
Phone: 336-271-5217
Email: msacrinty@tuggleduggins.com

I. Guarantees in General

A guarantee is a form of surety and its basic terms are governed by state law. A guarantee is subject to the statute of frauds and with a few exceptions must be in writing. N.C. Gen. Stat. § 22-1. The primary exception to the writing requirement is the “main purpose rule.” This exception applies where the guarantor or promisor “has such a direct, immediate, pecuniary interest in the subject matter of the principal debtor's contract so as to indicate that the guarantor has intended to adopt the original contract as his own.” Burlington Industries, Inc. v. Foil, 19 N.C. App. 172 (1973), aff'd, 284 N.C. 740.

A. Guarantee of Collection Versus Guarantee of Payment

There are generally two types of guarantees – a guarantee of collection and a guarantee of payment. A guarantee of payment is an absolute and unconditional promise to pay the debt at maturity if not paid by the principal debtor. Credit Corp. v. Wilson, 281 N.C., 140, 145 (1972); see also Jennings Communications Corp. v. PCG of Golden Strand, Inc., 126 N.C. App. 637, 640 (1997). The obligation of the guarantor is separate and independent from the obligation of the principal debtor. Investment Properties v. Norburn, 281 N.C. 191, 195 (1972). The creditor may pursue the guarantor immediately upon the failure of the principal debtor to pay the debt at maturity and the creditor need not first pursue the principal debtor without success before

seeking payment from the guarantor. Cameron-Brown v. Spencer, 31 N.C. App. 499, 502 (1976), disc. review denied, 291 N.C. 710 (1977). On the other hand, a guarantee of collection is a promise by a guarantor to pay a debt on condition that his or her creditor shall first diligently prosecute principal debtor without success. Credit Corp., 281 N.C. at 145. Such a guarantee will often have a condition precedent before the creditor can go against the principal debtor. Jennings Communications, 126 N.C. App. at 641.

It can be important to distinguish between the two types when the principal obligor is a debtor in bankruptcy – either under Chapter 7 or 11.¹ Because, the automatic stay of § 362 prevents a creditor from seeking payment from the debtor, if a creditor is the beneficiary of a collection guarantee where the conditions precedent for collection from the debtor have not been met, absent relief from the automatic stay, the creditor may be precluded from collecting from the guarantor. Whereas under a guarantee of payment, no such impediment would exist to prevent a creditor from proceeding against the guarantor or co-debtor, regardless of the bankruptcy of the principal obligor.

B. Specific Cases and Allocation of Payments

Unless specifically limited in the guarantee agreement, a guarantor is liable for all obligations of the principal obligor which are covered in the guarantee agreement. Indeed, § 524(e) of the Bankruptcy Code provides that “[e]xcept as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” 11 U.S.C. § 524(e). Thus it has been repeatedly held that a discharge granted a debtor has no effect on the liability of a non-debtor co-debtor or

¹ This discussion does not consider the co-debtor stay, discussed elsewhere in this paper, instituted under §§ 1201 and 1301 in a chapter 12 or 13 case, respectively, which prohibit a creditor from seeking recovery from a co-debtor of a chapter 12 or 13 debtor absent receiving relief from the automatic stay.

guarantor of a discharged debt. 4 Collier on Bankruptcy ¶ 524.05 (16th ed. 2010) (citations omitted).

However, other provisions of the Bankruptcy Code may limit what a creditor may receive. Section 502(b)(2) which limits post-petition interest that a creditor may receive can have an effect on the creditor's ability to collect a deficiency from the debtor's bankruptcy estate when the guarantor has only made a partial payment. In re National Energy & Gas Transmission, Inc. v. Liberty Electric Power, LLC, 492 F.3d 297 (4th Cir. 2007). In Natural Energy & Gas, the creditor was paid by the guarantor and allocated the payment it received first, to interest and then, to principal, leaving a deficiency that the creditor sought to recover from the debtor's bankruptcy estate. Id. at 302. The Fourth Circuit, in a split decision, held that because § 502(b)(2) barred the collection of postpetition interest, the creditor's internal allocation did not mean that it could then collect the remaining principal from the debtor. The Court stated "regardless of how the [creditor] classifies the [guarantor's] payment for its own purposes, we must sift the circumstances surrounding the claim to determine the reality of the transaction for purposes of the bankruptcy proceeding." Id. According to the Court, a contrary result would permit a creditor "to classify a payment on a debt from a non-debtor guarantor as non-principal, thus preserving the full value of the principal for collection in bankruptcy." Id. at 303. The Court looked behind the claim "to find that the claim really constitutes post-petition interest disguised as unpaid principal." Id.

II. Spousal Guaranties

Lenders frequently attempt to protect themselves by requiring spousal guaranties as a condition for lending. The process leading up to this requirement, however, is creating substantial litigation or, at a minimum, threats of litigation. The Equal Credit Opportunity Act

(“ECOA”), 15 U.S.C. § 1691, et. seq., and its accompanying interpretive regulation, Regulation B, have a strong effect on the litigation of spousal guaranties. Where the creditor cannot show that it considered the creditworthiness of its applicant prior to demanding the spousal guarantee, the creditor may be unable to collect on the guarantee due to ECOA or, even worse, may be liable for damages.

ECOA prohibits discrimination against any “applicant” on the basis of race, color, religion, national origin, sex, marital status, or age. 15 U.S.C. § 1691(a)(1). Pursuant to Regulation B, an “applicant” is

any person who requests or who has received an extension of credit from a creditor, and includes any person who is or may become contractually liable regarding an extension of credit. For purposes of § 202.7(d), the term includes guarantors, sureties, endorsers, and similar parties.

12 C.F.R. § 202.2(e). This regulation was amended in 1985 to include guarantors as “applicants.” Prior to this amendment, guarantors were excluded. See Douglas County Nat'l Bank v. Pfeiff, 809 P.2d 1100, 1102 (Colo.Ct. App.1991).

Under ECOA, a creditor may not refuse to grant an individual account to a creditworthy applicant on the basis of, among other things, marital status. 12 C.F.R. § 202.7(a). This means that only with certain exceptions, can a creditor require the signature of a joint applicant on a credit instrument. If the applicant qualifies under the lender’s standards of creditworthiness for the amount and terms of credit requested, the lender cannot require the signature of the applicant’s spouse. 12 C.F.R. §202.7(d)(1).

Generally, if the primary applicant is creditworthy, the creditor may not require a guarantor. An exception to this general rule applies when the lender requires the personal guarantee of the partners, directors, or officers of a company, or the shareholders of a closely held corporation, even if the business or corporation is creditworthy, so long as the requirement is applied without regard to marital status or any other prohibited basis. Regulation B Commentary § 202.7(d)(6)-1. In contrast, if the applicant is not creditworthy, the creditor may require a guarantor. 12 C.F.R. § 202.7(d)(5). The applicant's spouse may be the guarantor, but the lender may not require that the spouse be the guarantor. 12 C.F.R. § 202.7(d)(6); Regulation B Commentary § 202.7(d)(6)-2. The courts that have had the opportunity to evaluate ECOA claims generally conduct a factual inquiry into the creditworthiness of the principal borrower, the creditworthiness of the primary guarantor, the extent to which the spouse was required to sign a guarantee, and the extent to which the decision to require the spouse to sign was based on marital status rather than business-related considerations. See, e.g., Riggs Nat'l Bank v. Linch, 36 F.3d 370 (4th Cir. 1994); Suntrust Bank v. Hamway, 2010 WL 146858 (S.D.Fla. 2010); Boyd v. U.S. Bank Nat. Ass'n, 2007 WL 2822518 (D. Kan. 2007); Lewis Bros. Bakeries, Inc. v. Bittle, 2006 WL 3332705 (S.D.Ill. 2006); Still v. Cunningham, 94 P.3d 1104 (Alaska 2004).

These are the general rules and exceptions, of course, do exist. The problem with ECOA and Regulation B is that the exceptions are not clearly defined. First and foremost, it remains an open question as to whether an ECOA claim or defense on the basis of marital status can exist, as a matter of law, in a tenancy by the entireties state, such as North Carolina, where the spouses at issue actually do own real property. See 12 C.F.R. Pt. 202, Supp. I, Official Staff Interpretations, § 202.6(b)(8) ("A creditor may consider the marital status of an applicant or joint applicant for the purpose of ascertaining the creditor's rights and remedies applicable to the particular

extension of credit. For example, in a secured transaction involving real property, a creditor could take into account whether state law gives the applicant's spouse an interest in the property being offered as collateral. However, even if a required spousal guarantee is permissible because joint property is at issue, the spouse's signature can only be required for the instruments necessary, or reasonably believed by the lender to be necessary (following a "thorough review" of applicable law), to enable the lender to reach the property in the event of the death or default of the primary guarantor. 12 C.F.R. § 202.7(d)(2); Regulation B Commentary § 202.7(d)(2)-2. Whether that instrument is the guarantee itself, which obligates the spouse on the underlying debt, or something else such as a security agreement, is a matter of state law and may vary from state to state. Thus, the realm of case law which may be relied upon is somewhat limited and often distinguishable.

A. Applicability of ECOA and Regulation B to Guarantors

Even though the definition of "applicant" under Regulation B was amended to include a guarantor, there remains some dispute about the law's application to guarantors. The majority of courts to address the issue, including the bankruptcy court for the Middle District of North Carolina, have concluded that a guarantor is an applicant and is protected by ECOA. In re Westbrooks, 440 B.R. 677, 682 (Bankr. M.D.N.C. 2010). See also Silverman v. Eastrich Multiple Investor Fund, L.P., 51 F.3d 28 (3d Cir. 1995) (holding that guarantors are covered by the 1985 amendment to Regulation B); Bank of the West v. Kline, 782 N.W.2d 453 (Iowa 2010) (allowing two guarantors to use ECOA as an affirmative defense to an action by a creditor to collect on a guarantee); Boyd v. U.S. Bank Nat. Ass'n, 2007 WL 2822518 (D.Kan. 2007) (unpublished).

There is, however, an often-cited and evaluated minority view. In Moran Foods, Inc. v. Mid-Atlantic Market Development Co., LLC, 476 F.3d 436 (7th Cir. 2007), reh. den., cert. den. 552 U.S. 821 (2007), the Seventh Circuit called into question the validity of the 1985 amendment and portions of Regulation B. Moran Foods at 441 (“We doubt that the statute can be stretched far enough to allow this interpretation.”). The Court explained, “there is nothing ambiguous about ‘applicant’ and no way to confuse an applicant with a guarantor.” Id. Without any ambiguity in the statute itself, there would be no requirement for the Court to defer to the regulatory interpretation. Id. In addition to this narrow statutory reading, the Court found that the plaintiff had failed to prove unlawful discrimination based on marital status because the lender was relying on sound commercial practice in requiring the debt to be guaranteed by a party who owned assets and was listed on the credit application. Id. at 442. A handful of district courts have followed Moran Foods. See, e.g., Champion Bank v. Regional Development, LLC, 2009 WL 1351122 (E.D.Mo. 2009) (unpublished) (relying on Moran Foods in dismissing the spousal guarantor’s ECOA counterclaim and defense).

B. The Statute of Limitations

ECOA’s two-year statute of limitations begins to run “from the date of the occurrence of the violation.” 15 U.S.C. § 1691e(f). Courts are divided regarding whether and in what form ECOA violations may be alleged after the statute of limitations has expired.

With respect to claims for damages under ECOA, many courts have held that the statute of limitations is a bar after two years. However, agreement on this issue is not universal. Compare Chittenden Trust Co. v. Cabot, 2004 WL 2287763 at *1 (D.Me. 2004) (unpublished), with Sovereign Bank v. Catterton, 2004 WL 834721 at *2-3 (E.D.Pa. 2004) (unpublished), reconsideration den. 2004 WL 1166591.

Similarly, courts are split on the availability of ECOA as a defense subsequent to expiration of the statute of limitations. Courts generally fall into one of three categories when addressing this issue. Some courts conclude that an offensive action for damages brought within two years of the violation is the sole remedy. Other courts allow the assertion of ECOA by way of recoupment even after the two-year statute of limitations has expired. See In re Remington, 19 B.R. 718 (D. Colo. 1982) (holding that debtor's recoupment claim was not barred despite expiration of the statute of limitations because her claim was made in response to creditor's claims arising from debtor's alleged guarantee, with court noting that ECOA would not apply if the guarantee were of true leases rather than installment contracts). The final group of courts allows the assertion of an ECOA violation as an affirmative defense, even after the two-year statute of limitations has expired, based on the principle that a contract in violation of a statute is void and unenforceable. One of the best summaries of these cases and categories is found in Bank of the West v. Kline, 782 N.W.2d 453 (Iowa 2010).

In Westbrooks, the Middle District addressed the defensive use of ECOA after the statute of limitations has expired. Westbrooks, 440 B.R. at 682-683. The Court held that the statute of limitations does not bar the defensive use of ECOA "in response to an affirmative action to collect on the debt." Id. Even though the Westbrooks were the plaintiffs, the adversary proceeding was brought as an objection to the creditor's claim. This was sufficient to trigger the defensive use such that the statute of limitations was not a bar. Id. at 683.

C. The Burden of Proof

Because ECOA is a discrimination statute, unless there is direct evidence of discrimination, the burden shifting analysis that applies in employment discrimination cases is used. Crestar Bank v. Driggs, 995 F.2d 1062 (4th Cir. 1993)(unpublished). See also Craigin v.

First Federal S & L Ass'n, 498 F. Supp. 379, 384 (D. Nev. 1980) (citing 1976 US Code Cong. & Admin. News pp. 403-406 (suggesting that cases such as Griggs v. Duke Power Company, 401 U.S. 424 (1971), and Albemarle Paper Company v. Moody, 422 U.S. 405 (1975), should serve as guides for application of the ECOA)). In the burden shifting analysis, the plaintiff must present a prima facie case of discrimination. The burden then shifts to the defendant to articulate a legitimate, non-discriminatory reason for the challenged action. The burden finally shifts back to the plaintiff to prove that the defendant's stated reason was pretextual. McDonnell Douglas Corp. v. Green, 411 U.S. 792, 800-805 (1973). Despite these shifts, the ultimate burden of persuasion remains with the plaintiff at all times. Grant v. Vilsack, No. 5:10-CV-201-BO, 2011 WL 308418 (E.D.N.C. Jan. 27, 2011) (Boyle, J.) (addressing a claim under ECOA for discrimination on the basis of race).

D. Open Issues

With the growth of ECOA litigation, multiple other issues have arisen, including unsettled questions about the proper remedy for a violation. It appears that most courts agree that the successful assertion of an ECOA claim by a spousal guarantor relieves the spouse from the guarantee, but does not discharge the primary guarantor. See, e.g., Suntrust Bank v. Hamway, 2010 WL 146858 at *6; Still v. Cunningham, 94 P.3d 1104, 1115 (D. Alaska 2004). In a footnote, the Westbrooks Court identified these unsettled questions surrounding the proper remedy, but did not decide the issue because the only matter before the Court was the defendant's motion to dismiss. Westbrooks, 440 B.R. at 683, n. 5 ("it appears that the Court *may* cancel the guarantee if the Westbrooks are able to successfully prove a violation of the ECOA – either as a matter of law or, as a practical matter, by awarding them recoupment in the amount of the guarantee").

There also remain questions as to whether an individual can waive an ECOA claim. If so, the next question is whether the waiver can occur during the course of the application or only during negotiations subsequent to a default, such as in a forbearance agreement. At least one court has held that a release and waiver signed by spousal guarantors as part of a loan modification waived their ECOA claims and defenses to the guarantee. Pocopson Industries, Inc. v. Hudson United Bank, 2006 WL 2092578 at *7-11 (E.D.Pa. 2006) (unpublished).

Additional questions exist as to the effect of a lender's sale of a note to a third party. Regulation B expressly provides that a party is not a "creditor" "regarding any violation of the Act or this regulation committed by another creditor unless the person knew or had reasonable notice of the act, policy, or practice that constituted the violation before becoming involved in the credit transaction." 12 C.F.R. §202.2(l). But see Osborne v. Bank of America, N.A., 234 F.Supp. 2d 804 (M.D. Tenn. 2002). Based on this language, it should seem irrelevant whether ECOA is being analyzed as an affirmative claim for relief or a defense. However, at least one court has strongly implied that a note holder is a "creditor" under ECOA subject to defenses, but not affirmative claims for relief. Bolduc v. Beal Bank, SSB, 994 F. Supp. 83 (D. N.H. 1998), remanded by 167 F.3d 667 (1st Cir. 1999).

E. Regulation B and Bankruptcy

With splits among the courts and a significant number of unsettled issues, bankruptcy trustees are left to decide how to proceed when presented with an ECOA claim. Debtors' attorneys may need to consider inquiring of their clients about the existence of these claims and deciding whether to schedule the claims. Trustees must then determine whether the claim is an asset they must administer. This leads to unanswered questions about the application of setoff to the recovery.

Similarly, trustees must decide whether to use ECOA and Regulation B as the basis for an objection to a claim. See, e.g., Farris v. Jefferson Bank (In re Farris), 194 B.R. 931 (E.D. Pa. 1996) (sustaining in part and denying in part Chapter 13 debtors' objection to claim due to violation of ECOA); In re DiPietro, 135 B.R. 773 (E.D. Pa. 1992) (overruling Chapter 13 debtors' objection to lender's claim). With law being unsettled, the trustee of an asset case may face a difficult decision as to whether pursuing the objection to the claim will be less expensive to the estate than paying the claim.

III. The Co-Debtor Stay

A. The Statutory Co-Debtor Stay Under Chapters 12 and 13

Chapters 12 and 13 allow for the protection of the bankruptcy court to be extended to non-debtors through the co-debtor stay. 11 U.S.C. §§ 1201, 1301. The purpose of the co-debtor stay, which was originally only included in Chapter 13, was to protect principal debtors by preventing pressure on friends, relatives, and fellow employees of the debtor. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 121, 426 (1977). The statutory co-debtor stay is narrow in that it applies only to individuals and only for consumer debts. 11 U.S.C. §§ 1201(a), 1301(a). Therefore, where a business owner and guarantor files a Chapter 13 case, the creditor's collection efforts can proceed against the debtor's business without any action from the bankruptcy court.

The co-debtor stay will be lifted where the co-debtor received the consideration for the claim, the plan does not propose to pay the claim, or the creditor would be irreparably harmed if not allowed to proceed against the co-debtor. 11 U.S.C. §§ 1201(c), 1301(c). The co-debtor stay, though, can provide added protection to a debtor who otherwise would not be eligible. As an example, in the case of a debtor who has had multiple cases dismissed in the year preceding

bankruptcy, the automatic stay under § 362 will not be effective, but the co-debtor stay could potentially still protect property of that same debtor. See King v. Wells Fargo Bank, N.A. (In re King), 362 B.R. 226 (Bankr. D. Md. 2007).

B. The Co-Debtor Stay Under Chapter 11

There is no question that Chapter 11 does not include a statutory co-debtor stay like that available under Chapters 12 and 13. Presumably, this absence should be interpreted as legislative intent for no co-debtor stay to exist. See Wedgeworth v. Fibreboard Corporation, 706 F.2d 541 (5th Cir. 1983). Further, the statutory co-debtor stay is carefully worded to apply only to individuals and only to consumer debts. With these limitations, there would only be the rarest application of a similar co-debtor stay in Chapter 11 cases.

Despite all of these facts, courts have created a co-debtor stay in Chapter 11 cases upon affirmative application of a party. Generally, courts analyze requests for co-debtor stays in Chapter 11 cases under either § 362 or § 105. See Williford v. Armstrong World Industries, Inc., 715 F.2d 124 (1983) (refusing to grant a stay under Section 362); A.H. Robins Company Incorporated v. Piccinin, 788 F.2d. 994 (4th Cir. 1986) (discussing favorably a stay under §362); In re Johns-Manville Corp., 26 B.R. 420 (S.D.N.Y. 1983) (granting a stay under §105); In re Otero Mills, Inc., 25 B.R. 1018 (D.N.M. 1982) (granting a stay under §105). Regardless of which statute courts use as a basis, “unusual circumstances” must exist to justify imposition of the stay to protect a non-debtor.

Decisions imposing a co-debtor stay in a Chapter 11 case first widely arose in addressing requests from joint tortfeasors in products liability litigation in the early 1980s. However, these decisions have important implications in light of today’s economic conditions, particularly with the frequency of individual business owners guaranteeing corporate debt. A Chapter 11 debtor

may reasonably see the need to seek to stay collection efforts against the co-debtor principal of the company, on the grounds that the suit will inhibit the company's reorganization efforts. These decisions are closely linked with jurisdictional issues and determining whether "related to" jurisdiction exists. In order to understand the application (or creation) of the co-debtor stay in a Chapter 11 case, it is useful to review these products liability cases where the principles were first expansively developed.

The Fourth Circuit has two primary cases addressing whether to stay actions against non-debtors, with the first being Williford v. Armstrong World Industries, Inc., 715 F.2d 124 (4th Cir. 1983). In Williford, the Fourth Circuit upheld the District Court's holding that the Chapter 11 bankruptcy filing of four of the defendants in asbestosis litigation did not stay the action as to the remaining defendants. The non-debtor defendants made three arguments. First, they contended that the claims against all defendants were inextricably interwoven, such that the bankruptcy debtors were necessary parties under Federal Rule of Civil Procedure 19. Id. at 126. The Court rejected this argument, finding that joint tortfeasors are not indispensable parties. Id. Second, the defendants argued that the purpose of the automatic stay under § 362 would be violated if the suit against the non-debtors was allowed to proceed. Id. The Court also rejected this argument, concluding that the express language of § 362 applies only to "debtors." Id. The Court also looked to the fact that Chapter 13 includes an express statutory co-debtor stay, while Chapter 11 does not. Id. at 126-127. This absence in Chapter 11 indicates that there was no intention for a co-debtor stay under Chapter 11. Id. Finally, the non-debtor defendants argued that the Court should impose a discretionary stay. While the reasoning behind this argument is not entirely clear from the Fourth Circuit's decision, discretionary stays in this context are most often imposed under § 105 of the Bankruptcy Code, pursuant to a preliminary injunction theory and

analysis, or some combination of these two theories. In Willford, the Court rejected a discretionary stay, stating that the non-debtors had not presented sufficiently convincing circumstances to impose a stay. Id. at 127. Avoiding piecemeal litigation is an insufficient basis for imposing the discretionary stay. Id. at 128. In a footnote in the decision, the Court notes recent similar decisions from the Fifth and Sixth Circuits. Id. at 127, fn. 1 (citing Wedgeworth v. Fibreboard Corporation, 706 F.2d 541 (5th Cir. 1983); Lincoln Lynch v. Johns-Manville Sale Corp., 710 F.2d 1194 (6th Cir. 1983)).

The Fourth Circuit's second major decision on this issue came three years later in the Dalkon Shield litigation. A.H. Robins Company Incorporated v. Piccinin, 788 F.2d. 994 (4th Cir. 1986). After a decade of defending multiple lawsuits nationwide, A. H. Robins Company filed a Chapter 11 bankruptcy petition in 1985, staying the many still-pending suits against it. Many of the plaintiffs then sought to sever their actions against Robins so they could proceed against the other defendants in the plaintiffs' chosen forums. Id. at 996. In a carefully calculated and strategic response, Robins filed an adversary proceeding seeking a determination that its products liability insurance was an asset of the estate and for the plaintiffs' cases to be enjoined as to *all* defendants. If the court agreed with this argument, all claims as to all defendants would be tried as part of the bankruptcy case, moving the plaintiffs from their chosen forums and putting all of the claims in the court Robins felt would be the most favorable court in the country. The Court did just this.

The Robins Court acknowledged that there are "unusual circumstances" where § 362(a)(1) should be used to stay action against non-bankrupt co-defendants. Id. at 999 (citing Johns –Manville Sales Corp., 26 B.R. 405, 410 (S.D.N.Y. 1983)). These unusual circumstances can be found to arise "when there is such identity between the debtor and the third-party

defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor.” Id. at 999. In reaching this decision, the Court expansively reads § 362, in particular § 362(a)(3), explaining that it provides an action should be stayed “*whether against the debtor or third-parties*, to obtain possession or to exercise control over property of the debtor.” Id. at 1002 (emphasis original).

It should be noted that the Middle District of North Carolina recently rejected the Robins reasoning in a decision in the Westbrooks v. FNB United Corp. adversary proceeding. Subsequent to the Court’s denial of the defendant’s motion to dismiss, as discussed in the ECOA and Regulation B section above, the plaintiffs moved to have the state court action to collect the spousal guarantee enjoined. Westbrooks v. FNB United Corp., 10-02032 (M.D.N.C. March 10, 2011) (Waldrep, J.). While Westbrooks is a Chapter 13 case, because the debt is a business debt, the statutory co-debtor stay under § 1301 is inapplicable and the plaintiffs based their arguments on the Robins reasoning. The Court denied the motion, finding that the “balance of hardships” was in favor of the defendant.

C. Guarantors and the Co-Debtor Stay

The reasoning in these decisions can be applied outside of the products liability context and easily translate to cases involving guarantors. Presumably, where a company officer, director, or owner has guaranteed business debt, the “unusual circumstances” may seem even more likely than where otherwise unrelated joint tortfeasors are involved. This may also be true where the business has guaranteed the individual’s debt.

The Robins Court touched on this issue, hypothesizing that a co-debtor stay under § 362 could exist for “a suit against a third-party who is entitled to absolute indemnity by the debtor on account of any judgment that might result against them in the case.” Robins at 999. In the

Court's opinion, "[t]o refuse application of the statutory stay in that case would defeat the very purpose and intent of the statute." Id. The Robins Court discussed In re Metal Center, 31 B.R. 458 (D. Conn. 1983), at length in its decision. Robins at 999-1000. In Metal Center, a Chapter 11 debtor had agreed to indemnify a guarantor if the guarantee was ever enforced. The Metal Center Court declined to impose a stay under § 362(a)(1), but did impose a stay on equitable grounds. The Court explained that, where "a debtor and nondebtor are so bound by statute or contract that the liability of the nondebtor is imputed to the debtor by operation of law, then the Congressional intent to provide relief to debtors would be frustrated by permitting indirectly what is expressly prohibited in the Code." Metal Center at 462. Expressing its concern with the possible effects of preclusion on the debtor, the Court further stated, "[c]learly the debtor's protection must be extended to enjoin litigation against others if the result would be binding upon the debtor's estate." Id. The Fourth Circuit took this one step further in Robins, adding to this statement, "and this is so, whether the debtor is a party or not." Robins at 999.

The Robins Court would have imposed a co-debtor stay under §362 in this hypothetical situation because the indemnity would be null if the guarantor was forced to file a claim in the bankruptcy case that would not be paid in full. Id. at 1000. It appears, therefore, in the Fourth Circuit, that a contract to indemnify coupled with a guarantee will trigger both a stay under § 362 and the bankruptcy court's "related to" jurisdiction. Id. at 1001. See also In re Brentano's, 27 B.R. 90 (S.D.N.Y. 1983) (stating that a judgment against the non-debtor guarantor "could and would affect the estate in bankruptcy," because such a judgment would automatically trigger the debtor's contractual obligation to indemnify the guarantor); Seybolt v. Bio-Energy of Lincoln, Inc., 38 B.R. 123 (D. Mass. 1984) (imposing a co-debtor stay under §362(a)(1) out of concerns about res judicata and the effect of a judgment against the guarantors on the debtor's ability to

dispute the underlying debt); Johns – Manville, 26 B.R. at 418 (refusing to stay asbestos litigation as to co-defendants, but stating that a stay may be appropriate in other cases, such as where the co-defendants are key employees of the debtor). Cf. Pacor, Inc. v. Higgins, 743 F.2d 984, 995 (3d Cir. 1984) (finding that “related to” jurisdiction did not exist among co-defendants in asbestos litigation where there was no contractual guarantee or right to indemnity).

Given these decisions and the strong language from the Fourth Circuit in Robins, it seems that an officer, director, or key employee of a business debtor who has guaranteed a corporate debt may have a legitimate and, quite possibly, successful argument that action to enforce the guarantee outside of the bankruptcy be stayed. However, the recent Westbrooks decision may have some impact on this likelihood. At a minimum, the decision highlights the value of an indemnification agreement coupled with a guarantee.

IV. Abstention by Bankruptcy Court to Hear Actions against Guarantors of Debtor’s Obligations

Often when the debtor in bankruptcy is the primary obligor, the creditor will have filed suit in state court to collect from the principal obligor as well as from any guarantors. Such a prepetition lawsuit can be the precipitating event that causes a debtor to seek bankruptcy protection. Often the creditor wants to continue to pursue its action against the guarantors in state court, while the debtor will want the action heard in the bankruptcy court and may additionally seek to enjoin the guarantor action.

Upon the removal of such a state court action to the bankruptcy court, the Bankruptcy Court for the Middle District recently found that it must mandatorily abstain under 28 U.S.C. 1334(c)(2) from hearing the state court action against the guarantors. HHI, LLC v. Lo’r Decks at Calico Jacks, LLC, 2010 WL 1009235 (Bankr. M.D.N.C., Mar. 18, 2010).

In Lo'r Decks, the Bankruptcy Court found that an action against a non-debtor guarantor based on the default of the debtor as primary obligor is not a core proceeding. Rather it is a “related to” proceeding when it does not invoke a substantive right created by federal bankruptcy law and is based entirely on state law. Id. at *1.

Bankruptcy law recognizes two types of proceedings, core and non-core. There are three classifications of core proceedings over which a bankruptcy court has jurisdiction – proceedings “under” Title 11, “arising under” Title 11 and “arising in” Title 11. 28 U.S.C. § 157(a). The core bankruptcy case is “under” Title 11. Id. Proceedings “arise under” Title 11 if they invoke a “substantive right created by federal bankruptcy law.” Wood v. Wood (In re Wood), 825 F.2d 90, 97 (5th Cir. 1987). Proceedings “arising in” a case under Title 11 are those that “are not based on any right expressly created by Title 11, but nevertheless would have no existence outside of the bankruptcy.” Bergstrom v. Dalkon Shield (In re A.H. Robins Co.), 86 F.3d 364, 372 (4th Cir. 1996).

Because a typical action to collect on a guarantee does not invoke a substantive right created by federal bankruptcy law, it is not a core proceeding. L’or Decks, 2010 WL 1009235 at *1. Rather a guarantee action based on state law, although not core is a “related to” proceeding under 28 U.S.C. § 1334(c)(2). Id. at *2. The Fourth Circuit test to determine whether a matter is related to a bankruptcy case is known as the “Pacor test” first formulated by the Third Circuit in Pacor, Inc. v. Higgins, 743 F.2d 984 (3rd Cir. 1984). Id. Under the Pacor test a proceeding is related to a bankruptcy case when “the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy.” Owens-Ill., Inc. v. Rapid Am. Corp. (In re Celotex Corp.), 124 F.3d 619, 625 (4th Cir. 1997); A. H. Robbins Co. v. Piccinin, 788, F.2d 994 (4th Cir. 1986). The Court found that whether a guarantor is held liable is related to the

debtor's bankruptcy case because a recovery from the guarantor would reduce or eliminate the plaintiff's claim in the bankruptcy case and result in a substitution of the guarantors as the claimants against the debtor. Id. at *2.

Because an action against a guarantor of the debtor's obligation is non-core and "related to" the underlying bankruptcy case, the court must abstain if the six factors listed in 28 U.S.C. § 1334(c)(2) are met. These are: (1) a timely filed motion; (2) a proceeding based on state law; (3) a proceeding that is "related to" a case and is not a core proceeding; (4) a proceeding that could not have been commenced in US courts but for 28 U.S.C. § 1334; (5) an action commenced in state court; and (6) the appropriate state court must be able to timely adjudicate the matter.

The Lo'r Decks' Court held that the guarantor action met all six requirements and abstained from hearing the creditor's claims against the guarantors. Shortly thereafter, the Bankruptcy Court for the Eastern District, citing the Lo'r Decks' opinion, held that it was required to mandatorily abstain from hearing a suit against the guarantor of an obligation of the debtor. In re 3G Properties, LLC, 2010 WL 4027770 (Bankr. E.D.N.C. Oct. 14, 2010) (following the rationale of the Lo'r Decks' Court and likewise abstaining from hearing an action against guarantors of a corporate debtor).

B. Injunctions on Creditor Actions Against Guarantors

While a bankruptcy court may be required to abstain from hearing a creditor's claim against a guarantor, it may temporarily enjoin or stay any action against the guarantors for a period of time. Courts are particularly inclined to issue an injunction when the guarantors are also principals of a corporate debtor and the litigation would adversely affect a debtor's

reorganization. See the previous section for a discussion of when a court may temporarily enjoin a creditor from pursuing an action against guarantors.

V. Guarantee as Fraudulent Transfer

Under the fraudulent transfer section of the Bankruptcy Code of § 548 and North Carolina fraudulent transfer law invoked by § 544, a guarantee may be subject to avoidance as fraudulent transfer.² Section 548 permits a bankruptcy trustee to avoid a guarantee, as a transfer, given within two years of the bankruptcy filing if: (1) the guarantee obligation was incurred with an actual intent to hinder, delay or defraud creditor (actual fraud) or (2) the guarantor received less than reasonably equivalent value, and (a) was or became insolvent due to the guarantee; (b) was engaged in business with unreasonably small capital; or (c) intended to incur debt beyond the guarantor's ability to pay its creditors (constructive fraud). 11 U.S.C. § 548(a). Under constructive fraud, the guarantor's intent is irrelevant. If the guarantor is financially strong and will remain so, constructive fraud is not a concern. However, fraudulent transfer law can rear its head, particularly in the context of guarantees among related corporate entities, when one of the corporate guarantors becomes a debtor in bankruptcy.

A. Intercorporate Guarantees

In a world of multiple and related corporate affiliates, intercorporate guarantees are a routine business practice and are popular because they can benefit both the creditor and debtor. In re Image Worldwide, Ltd., 139 F.3d 574, 578 (7th Cir. 1998). Within a corporate group, some units will often have better credit ratings than others and those with poorer ratings may have limited or no access to loans. Id. Therefore, by combining the credit of all units, a corporate

² North Carolina has adopted the Uniform Fraudulent Transfer Act which is codified at N.C. Gen. Stat § 39-23.1 *et seq.*

group “exploits the units with good credit ratings by having them guarantee the debt of the weaker unit and the weaker unit will benefit from either obtaining the loan, or getting the loan at a better rate.” Id. The creditor also benefits from greater security of repayment and all win. However, should the guarantee push the guarantor into insolvency, the guarantee may be subject to avoidance by the trustee as a fraudulent transfer. Id.

These intercorporate guarantees are given the names “up-stream, down-stream or cross-stream” guarantees. Id. at 577. In an “up-stream” guarantee, a subsidiary guarantees the payment of a parent, while in a “down-stream” guarantee, a parent guarantees the payment of a subsidiary. Id. A cross-stream guarantee is when one entity guarantees the debt of an affiliated entity with whom it is not in a parent/subsidiary relationship. Id.

B. Reasonably Equivalent Value for Indirect Benefits

Where there are valid business and economic reasons for intercorporate guarantees, actual fraud will rarely be found. However, under constructive fraud many of the arguments will center on whether the guarantor received reasonably equivalent value for its guarantee. Because there is no actual money or property changing hands and no direct economic benefit to the guarantor as result of the guarantee, courts must look to indirect benefits received by the guarantor, but will not generally recognize such an indirect benefit unless it is fairly concrete. Id. at 578. The most straight-forward indirect benefit is when the guarantor receives some of the consideration paid to the debtor. Id.

Courts have also found reasonably equivalent value for a corporate guarantee in a number of other situations. Value has been found where the intangible benefits may include the opportunity to avoid default or to facilitate rehabilitation of an enterprise and to avoid bankruptcy. In re Touse, Inc., -- B.R.-- (2011 WL 522008 at *36) (S.D. Fla. 2011). Future value

may constitute reasonably equivalent value. In re R.M.L., Inc., 92 F.3d 139, 150 (3rd Cir. 1996). Reasonably equivalent value was given for a debtor corporation's guarantee of an affiliate's debt in a down-stream guarantee when the loan strengthened the corporate group as a whole and the guarantor benefited from "synergy" within the corporate group, which includes such intangibles as goodwill and an increased ability to borrow working capital. Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 646-48 (3rd Cir. 1991).

Some courts have adopted the "identity of interest" rule where even though reasonably equivalent value might not otherwise be found, there was substantial indirect benefit to the guarantor where the "debtor and third party are so related or situated that they share an 'identity of interest', because what benefits one, will in such case benefit the other to some degree." In re Miami General Hospital, Inc., 124 B.R. 383, 393-95 (Bankr. S.D. Fla.1991) (citing Telefest, Inc., v. VU-TV, Inc., 591 F.Supp 1368 (D.N.J. 1984)) (finding that such identity of interest meant that it was desirable and logical that a parent should be able to borrow based on the value of its subsidiaries' property when they were operated as an integrated economic unit).

Although as the recipient of a guarantee from a corporate debtor, the creditor may not have his guarantee avoided, it may behoove the creditor to structure his guarantees to reduce any likelihood of losing the guarantee. If one guarantor is not strong, the guarantee agreement could document in its recitals all the benefits that the guarantor is receiving in exchange for the guarantee. It has also been suggested that if a creditor limits its guarantee to the net worth of the guarantor, the guarantee may be less likely to be avoided.

VI. Discharge of Third-Party Guarantor in Chapter 11 Plan of Reorganization

Section 524(e) of the Bankruptcy Code provides that "[e]xcept as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other

entity on, or the property of any other entity for, such debt.” 11 U.S.C. 524(e).”³ Thus, it has been repeatedly held that a discharge granted a debtor has no effect on the liability of a third-party co-debtor or guarantor of a discharged debt. 4 Collier on Bankruptcy ¶ 524.05 (16th ed. 2010) (citations omitted). As discussed previously, a bankruptcy court using its equitable powers may grant a temporary injunction against a creditor prosecuting an action to collect from a non-debtor guarantor. But can a court permanently enjoin a creditor from pursuing a claim against a guarantor in a plan of reorganization in light of § 524(e)?

Many courts, such as those in the Ninth and Eleventh Circuits say no and have held § 524(e) prevents a plan of reorganization from discharging a co-debtor or guarantor from a debt owed as well by the debtor. See e.g., In re Sure-Snap, 983 F.2d 1015 (11th Cir. 1993); Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985). By using their equitable powers under § 105(a) other circuits, including the Fourth, permit the release of a guarantor from obligations on a debt dealt within the debtor’s Chapter 11 plan of reorganization.

These “discharges” or permanent injunctions against a creditor pursuing a guarantor or other third parties for collection of a debt dealt with in a plan of reorganization must be specific, and the analysis is very fact intensive. In another of the A.H. Robins bankruptcy cases forced by massive tort claims against Robins from the manufacture of the Dalkon Shield, the Fourth Circuit let stand confirmation of a plan that prevented certain claimants from suing all third parties other than insurers and medical providers for malpractice. A.H. Robins v. Mabey, 880 F.2d 694, 702 (4th Cir. 1989). The claimants argued that because of § 524(e) the bankruptcy

³ Note that §§ 524(g) and (h) are special exceptions and provide for a supplemental injunction in cases involving asbestos claims and specifically authorize the bankruptcy court to enter a “sweeping injunction” against any entity taking legal action to collect on a claim that is to be paid by a trust created under a confirmed plan of reorganization. 4 Collier on Bankruptcy, ¶ 524.07[1].

court had no power to permanently enjoin certain actions. Id. at 700. The Mabey Court responded that bankruptcy courts are courts of equity, and § 105(a) confers equitable powers on the court. Id. at 701. It did not construe § 524(e) to limit the equitable power of the bankruptcy court to enjoin the third-party actions where the plan provided for compensation of the claimants and the “entire reorganization of the debtor hinged on it being free from indirect claims such as suits against parties who would have indemnity or contribution claims against the debtor.” Id. at 702.

In reaching its conclusion, the Mabey Court found persuasive the reasoning of the Fifth Circuit in Republic Supply v. Shoaf that § 524(e) does not by its specific words preclude the discharge of a guarantee when it has been accepted and confirmed in a plan of reorganization. 815 F.2d 1046, 1050 (5th Cir. 1987) (finding that confirmation of a clear and “unambiguous plan” or reorganization that “expressly released” a third party guarantor has a res judicata effect on a subsequent action against the guarantor). See also FOM Puerto Roco S.E. v. Dr. Barnes Eyecenter Inc., 255 Fed.Appx. 909, 912 (5th Cir. 2007) (unpublished) (approving the release of a guarantor in a plan where the release of claims was an integral part of the bankruptcy order and the release was given in consideration for the subordination of certain claims benefitting the creditor).

But just because a bankruptcy court may release a guarantor from his obligations in a plan, does not mean it will do so in all circumstances; indeed the threshold may be quite high. A general release of third parties from certain types of claims is not adequate; the plan must contain a provision “specifically releasing” the individual guarantors. In re Applewood Chair, 203 F.3d 914, 919 (5th Cir. 2000) (denying a release of guarantors when the plan did not specifically mention the guarantors by name). The release must be fair to creditors and given in exchange for

reasonable consideration. In re Continental Airlines, 203 F.3d 203, 215 (3rd Cir. 2000) (denying provision in confirmed plan of reorganization releasing directors and officers from third-party claims where no consideration was given and the release was not a key element of the plan).

It is interesting to note that the first cases permitting the release of a third party were in the context of whether the language in the plan was res judicata. In Stoll v. Gottlieb, decided in 1938 under the 1898 Bankruptcy Act, the Supreme Court indicated that such a release was permissible in the context of whether a release given in a plan was res judicata on the issue of liability. 305 U.S. 165, 171-172 (1938). See also Republic Supply v. Shoaf, 815 F.2d at 1047 (citing Stoll v. Gottlieb). Therefore, it behooves a creditor to carefully review the plan to make sure that he is in accordance with any limitations placed upon him in the plan and if not, to timely object. Id. at 1049.

A. In re MAC Panel – The Middle District Analysis

The Bankruptcy Court for the Middle District in MAC Panel Co. v. Virginia Panel Corp. reviewed a release granted to a third party in a plan of reorganization in determining whether to grant a stay pending Virginia Panel's appeal to the confirmation of the debtor's plan based on the granting of the release in the plan to third parties. 2000 WL 33673784 (Bankr. M.D.N.C. 2000), aff'd, In re MAC Panel Co., 257 B.R. 773 (M.D.N.C. 2000), aff'd, MAC Panel Co. v. Virginia Panel Corp., 283 F.3d 622 (4th Cir. 2002). Virginia Panel had brought actions against both the debtor and its president and CEO alleging patent infringement and related claims. Id. at *1. The Bankruptcy Court enjoined the prosecution of the individual claims against the president. The debtor filed a plan of reorganization that proposed to pay all creditors in full and for the president to contribute significant funds to the debtor to permit it to have adequate cash to pay all claims due on the effective date of the plan. Id. at *8. The plan also had a provision that released the

president from all claims against him related to his services with the debtor provided Virginia Panel was paid in full on its claims. Id.

In finding the release of the president permissible, the Court delineated five circumstances where courts have found a third-party release is appropriate. These included: (1) whether the protected third party has made an important contribution to the reorganization; (2) whether the release is “essential to the confirmation of the plan;” (3) whether a majority of creditors have approved the plan; (4) whether there is a close connection between the claims against the third party and the debtor; and (5) whether the plan provides for substantially all the claims affected by the injunction or release. Id. at *8 (citations omitted). Determining that the debtors’ confirmed plan met all five circumstances, the Court found that the evidence supported its conclusion and that Virginia Panel was unlikely to successfully get a reversal of the confirmation order and denied Virginia Panel’ request for a stay pending appeal.

C. In re J. A. Jones – the Western District Analysis

In a more recent case, the Bankruptcy Court for the Western District of North Carolina, in In re J. A. Jones, Inc. found as valid and enforceable a plan that permanently enjoined third parties from filing claims against a group of related debtors’ insurance company where the debtors’ settlement with the insurance company “reflected an integral part of the transactions contemplated by the Plan, conferred a material benefit on the Debtors, their estates and creditors, and was important to the objectives of the Plan to resolve all claims involving the many parties in interest in the case.” 416 B.R. 202, 209 (Bankr. W.D.N.C. 2009).

Although there appears to be no Eastern District case on point, it appears that in North Carolina Chapter 11 plans of reorganization may include a release of or permanently enjoin

claims of third parties, including guarantors, but the threshold for such release is high.⁴ Furthermore, while the MAC Panel and J. A. Jones cases concern releases given to tort claimants, much like the first cases that issued a temporary injunction on the prosecution of third parties, a release through a plan of reorganization given to a third party guarantor should also be available in the proper situation.

⁴ The issue of guarantor releases also arises in what is known as “dirt for debt” cases where as part of a plan of reorganization the debtor proposes to give back to the secured lender the real property on which it has a lien in full satisfaction of the lenders claims and thereby obtain a release of the guarantors on the secured loan. See e.g. *In re Bannerman Holdings, LLC*, 10-01053 (E.D.N.C. October 10, 2010) (Humrickhouse, S.). Such a discussion is beyond the scope of this paper.