Guaranty Agreements in Bankruptcy

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I. Identifying Your Client

a. Counsel to Company or Guarantor?

1. Cannot be both
2. Separate counsel
3. Different "hats" talk with client who is both guarantor and owner

b. Required Disclosure

1. Bankruptcy Rule 2014(a)
2. Requires disclosure of "all" the connections with debtor
3. Address potential conflict now/avoid catastrophe later

c. Common Interest Doctrine

1. Consider applicability of common interest doctrine
2. Protects privileged communications between counsel for guarantor and company
3. Preserves privilege, does not create one
4. Loss of attorney/client privilege could be devastating
5. Legal Resources and Case Law

i. J. Michael Martinez de Andino & M. Thomas Andersen, *Common Interest Doctrine in Fourth Circuit*, VA. LAWYER, Feb. 2011, at 28-33.

ii. *McAirlaids, Inc. v. Kimberly-Clark Corp.*, No. 7:13-CV-193, 2014 U.S. Dist. LEXIS 201138, 2014 WL 12782814 (W.D. Va. Sept. 26, 2014) – "The common interest privilege is an extension of the attorney-client privilege that protects from forced disclosure communications between two or more parties and/or their respective

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counsel if they are 'part of an ongoing and joint effort to set up a common defense strategy' in connection with actual or prospective litigation." *Id.* (citing *In re Grand Jury Subpoena*, 274 F.3d 563 (1st Cir. 2001)).

"The common interest rule does not provide an independent basis for establishing the existence of an attorney-client relationship, but presupposes the existence of an otherwise valid privilege, and is an exception to the general rule that the privilege is waived when confidential information is communicated to a third party." *Id.* (internal citations omitted).

A party seeking to claim the common interest privilege bears the burden to demonstrate that "the parties had agreed to pursue a joint defense strategy." *Id.* (citing *Minebea Co. v. Papst*, 228 F.R.D. 13 (D.D.C. 2005)).

ii. *In re Zetia Antitrust Litig.*, No. 2:18md2836, 2019 U.S. Dist. LEXIS 206525, 2019 WL 6122011 (E.D. Va. Oct. 3, 2019) – "[T]he common interest privilege does not protect all communication between the cooperators, only those which relate to the giving or receiving of legal advice." *Id.* (citing *Hunton & Williams v. United States Dept. of Just.*, 590 F.3d 272 (4th Cir. 2010)).

iii. *United States v. Aramony*, 88 F.3d 1369 (4th Cir. 1996) – "To be entitled to the protection of [the common interest privilege] the parties must first share a common interest about a legal matter."

iv. *Am. Mgmt. Servs. v. Dept. of the Army*, 703 F.3d 724 (4th Cir. 2013) – "The common interest doctrine does not require a written agreement, nor does it require that both parties to the communications at issue be co-parties in litigation." *Id.* "However, there must be an agreement or a meeting of the minds. '[M]ere indicia of joint strategy as of a particular point in time are insufficient to demonstrate that a common interest agreement has been formed.'" *Id.* (citing *Hunton & Williams*, 590 F.3d at 285, 287).

d. Assess Possible Causes of Action against the Guarantor

1. 11 U.S.C. §§ 547, 548, 550

2. Need for committee to pursue cause of action?

3. Separate bankruptcy relief for individual guarantor?

4. Impact on strategy/willingness of guarantor to participate in company bankruptcy

e. Review Guaranty Agreement/Documentation

   1. Actually read them!

   2. Properly executed?

   3. Enforceable?

   4. Limited in scope?

II. Statutory Co-Debtor Stay

   a. Applies in Chapter 12 (section 1201) and Chapter 13 (section 1301)

   b. Only applies to individuals and only for consumers

   c. Lifting the Co-Debtor Stay (sections 1201(c) and 1301(c))

      1. 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 about the co-debtor

   d. Co-debtor stay can provide added protection to a debtor who otherwise would not be eligible

      1. Debtor who has had multiple cases dismissed in the year preceding the most recent filing, the automatic stay under section 362 will not be effective, but the co-debtor stay could potentially still protect property of that same debtor *In re King,* 362 B.R. 226 (Bankr. D. Md. 2007).

   e. Court may annual a co-debtor stay retroactively despite a creditor's violation of the stay based on a balancing of the equities

      1. Where, prior to causing foreclosure sale of house owned by chapter 13 debtor and her non-debtor husband, deed of trust holder failed to obtain relief from co-debtor stay, and sale's high bidder subsequently hold property to another entity, whose owner then purchased the property and granted a lien thereon to lender, bankruptcy court did not abuse its discretion in determining that equities favored retroactive annulment of co-debtor stay so as to validate foreclosure sale, even if, as debtor asserted, entity that purchased property from high bidder was aware of co-debtor stay violation prior to borrowing funds from lender; lender was an innocent third party that lacked notice of co-debtor stay violation, debtor failed to make plan payments, did not oppose lifting the automatic stay, and waited over four months before seeking to vacate the foreclosure, and bankruptcy court would have lifted the co-debtor stay had deed of trust holder so requested prior to the foreclosure sale. *In re Morris,* 385 B.R. 823 (E.D. Va. Mar. 28, 2008).

III. Extending Automatic Stay to Non-Debtor Guarantors in Chapter 11

a. Chapter 11 does not include a statutory co-debtor stay

b. Courts have extended the automatic stay to non-debtor guarantors in Chapter 11 cases under either sections 105 or 362

c. First arose in the 1980s in products liability litigation

1. *A.H. Robins Company Incorporated v. Piccinin*, 788 F.2d 944 (4th Cir. 1986) - A.H. Robins filed chapter 11 in 1985 after a decade of defending multiple lawsuits nationwide in the Dalkon Shield litigation. Many of the plaintiffs sought to sever their actions against the Debtor so they could proceed against the other defendants in the plaintiff's chosen forms. *Id.* at 966.

The Debtor filed an adversary proceeding seeking a determination that its product 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 the Debtor, all claims as to all defendants would be tried as part of the bankruptcy case. The Court did just this.

The Court found that there were "unusual circumstances" where section 362(a)(1) should be used to stay actions against non-bankruptcy co-defendants. *Id.* at 999. The unusual circumstances 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.*

The Court hypothesized that a co-debtor stay under section 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." *Id.*

d. Fourth Circuit declines to extend automatic stay to non-debtor guarantors in *Credit Alliance Corp. v. Williams*, 851 F.2d 119 (4th Cir. 1988)

The Debtor signed a note with a secured creditor for the purchase of a wheel loader. Two individuals executed a guaranty of the Debtor's contractual obligation. Debtor subsequently defaulted on the note. After the default, the secured creditor filed suit against both Debtor and the guarantors seeking judgment for the note balance. Debtor filed a petition under Ch. 11 and the secured creditor received a state court default judgment six weeks later.

After the bankruptcy court ruled the default judgment was void as a violation of the automatic stay, the district court reversed the decision as to the guarantors, finding the secured creditor's judgment was not void for their obligation under the note. On an appeal from one of the guarantors, the Fourth Circuit affirmed the district court.

Analyzing whether the automatic stay of Section 362 extended to a guarantor on an obligation held by a debtor in bankruptcy, the Fourth Circuit reasoned that "[t]he plain language of Section 362 . . . provides only for the automatic stay of judicial proceedings and enforcement of judgments 'against the debtor or the property of the estate.'" *Id.* (citing *Williford v. Armstrong World Indus.*, 715 F.2d 124, 126–27 (4th Cir. 1983)). Furthermore, the court concluded that had Congress intended to extend Section 362's protections to guarantors it could have included language to that effect. By way of example, the court noted that Chapter 13 of the Code included extensions of stay protections to some co-signers and found that Congress could have similarly written Section 362 to include guarantors.

Finally, the *Credit Alliance* court recognized an exception to the general rule that Section 362 does not extend stay protections to guarantors. Under *A.H. Robins v. Piccinin*, 788 F.2d 994 (4th Cir. 1986), in "unusual circumstances" a court may extend stay protections to non-debtor parties. "Such unusual circumstances might arise where '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' or where proceedings against non-debtor codefendants would reduce or diminish 'the property of the debtor [such as the debtor's insurance fund or pool] to the detriment of the debtor's creditors as a whole.'" *Credit Alliance Corp.*, 851 F.2d at 121 (citing *Piccinin*, 788 F.2d at 999, 1008). Here, no unusual circumstances existed to extend Section 362 to the guarantors as the judgment against them would not endanger Penn Hook or its estate and therefore the judgment against the guarantors was not void.

e. Recent 4th Circuit cases extending automatic stay to non-debtor guarantors

1. *In re Brier Creek Corp. Ctr. Assocs. Ltd. P'ship*, No. 12-01855, 2013 WL 144082 (Bankr. E.D.N.C. Jan. 14, 2013) – A group of the Debtors and affiliated entities filed a state court action against the Defendant relating to loans made by the Defendant to the Debtors. The Defendant responded by denying liability and bringing counterclaims against the plaintiffs in the state court action. The Debtors subsequently filed a Chapter 11 bankruptcy petition. After the state court action was removed to the bankruptcy court, the Defendant filed a demand for arbitration against several individuals and a limited liability company. Except for the limited liability company, each of the individuals in the demand for arbitration was either a current or former officer of an affiliate of the Debtors. That affiliate was the Debtors' property manager and oversaw the daily management and development of the Debtors' properties.

   First, the court noted that "while the 'unusual circumstances' exception may exist in a guaranty relationship, the mere fact that a non-debtor is a guarantor of the debtor is insufficient by itself to justify invoking the exception. . . . [T]here must be something unusual about the guaranty relationship that would

warrant applying the automatic stay . . . to a non-debtor guarantor." Here, two of the individuals named in the Defendant's demand for arbitration played an integral role in the Debtors' daily operations which would cause substantial impacts on the Debtors' ability to reorganize. Additionally, the Debtors' bankruptcy cases were at a 'critical juncture' and the individuals' attention and efforts were desperately needed for the Debtors to adequately prepare for confirmation. Finally, the Debtors' reorganization depended on continued financing from lenders who depended on a bank's underwriting assessment of the two individuals integral to the Debtors' business operations. The court, therefore, extended the automatic stay to the Defendant's demand for arbitration.

2. *Brantley v. Williams*, No. 5:08-cv-00935, 2008 U.S. Dist. LEXIS 63026, 2008 WL 3852153 (S.D. W. Va. Aug. 18, 2008) – Creditors of the Debtor filed an involuntary bankruptcy case. Prior to the involuntary bankruptcy case, the Plaintiffs and Defendant entered into an agreement for the purchase and sale of all outstanding shares of Debtor and BTU Sales, Inc. Under this agreement, the Plaintiffs were to pay sixty monthly installments to the Defendant for the companies' outstanding shares with the Defendant receiving a lien on the vast majority of shares as security for the agreement. Additionally, the Plaintiffs gave the Debtor a loan to purchase a reclamation bond on property owned by the Debtor and pay off the Debtor's creditors.

Just three months after executing the stock sale agreement, however, the Defendant sent the Plaintiffs a Notice of Right to Cure Default alleging the Plaintiffs failed to make its required monthly payment and failed to pay the Debtor's obligations as agreed. After the Defendant threatened to foreclose on the remaining stock if the alleged defaults were not cured, the Plaintiffs in the instant case filed suit seeking a declaratory judgment of the parties' rights and obligations under the sale agreement as well as injunctive relief preventing the Defendant from selling the stock.

In considering the applicability of the automatic stay from the Debtor's involuntary bankruptcy case to the instant suit, the court noted that as the stock was not property of the Debtor and the Debtor was not a defendant in the suit, the automatic stay would not affect the proceedings absent an exception to the general rule. Here, the court found the "unusual circumstances" exception applied the automatic stay to the instant suit. Although previous courts have found foreclosure sales of stock do not necessarily implicate unusual circumstances on their own, the court found this case involved "more than the mere transfer of stock between shareholders." Here, the sale agreement involved the ownership and oversight of the Debtor and required the Plaintiffs to negotiate with and pay off the Debtor's creditors. Furthermore, the Plaintiffs had established contractual relationships with other parties associated with the Debtor and those relationships, along with the Debtor's revenue stream, were threatened by the suit. Finally, the Plaintiffs were in the process of obtaining

third-party financing contingent on the Plaintiffs' continued ownership and management of the Debtor. The court, therefore, found the instant suit concerned the control of the Debtor, the property of the estate was necessarily implicated, and the automatic stay should extend to the instant suit.

3. *In re Shearin Family Invs., LLC*, No. 08-07082-8, 2009 Bankr. LEXIS 3105, 2009 WL 3106477 (Bankr. E.D.N.C. Sept. 23, 2009) – The Debtor in the instant bankruptcy case was a developer of a high-rise condominium project in North Carolina. After the Debtor filed its bankruptcy petition, three lawsuits were filed against the Debtor's principal regarding the Debtor's failure to deliver a completed condominium unit to each lawsuit's plaintiff in a timely manner. Arguing the three lawsuits should be stayed, the Debtor argued that its principal, as sole representative to the Debtor, was so intertwined in the reorganization that splitting his attention between the reorganization and the lawsuits should harm the bankruptcy estate. Furthermore, the Debtor alleged that it would be forced to indemnify the principal, risking liability and harm to the estate, unless the court stayed the lawsuits.

   Finding the lawsuits should be stayed as the case involved "unusual circumstances," the court noted the principal was the Debtor's only employee, he spent 95% of his time working for the Debtor, and his involvement was critical to the Debtor's successful reorganization. The court concluded, therefore, that "the chance of a successful reorganization will be maximized by the ability of [the principal] to devote his unfettered attention" to the Debtor's reorganization and extended the automatic stay to the three lawsuits naming the principal as the defendant.

IV. Are Guarantors Eligible to File Sub-Chapter V?

a. Guarantying debt may be a sufficient "business or commercial activity," for purposes of determining whether a debtor is "engaged in commercial or business activities" as required to be eligible to elect to proceed under subchapter V.

   1. *In re Blue*, 630 B.R. 179 (Bankr. M.D.N.C. 2021) – The Debtor, an individual, filed a petition under Subchapter V. Prior to filing her petition, the Debtor was the owner of a small business through which she provided IT consulting services. In a dispute over whether debt from a U.S. Small Business Administration loan was a personal obligation or an obligation to her small business alone, and therefore whether the debt entered into the calculation of the Debtor's eligibility under Subchapter V, the court made a note that "[g]uarantying debt can be a sufficient 'business or commercial activity.'" *Id.* at 191 n.11. The court found in this case, however, that the Debtor did not personally guaranty the debt under North Carolina law. As a result, the debt was excluded from the calculation of the Debtor's eligibility in Subchapter V.

In contrast, the court held a different debt was personally guaranteed by the Debtor and should be included in her eligibility calculation. The court found that the Debtor signed a business bankcard application on behalf of both herself and her business. This application indicated that the Debtor personally guaranteed the transactions on that account and the court, therefore, held the debt arose from the Debtor's business activities and included the obligation in the total debt calculation. *Id.* at 193 n.14.

2. *In re Ikalowych*, 629 B.R. 261 (Bankr. D. Colo. 2021) – The Debtor, an individual, filed a petition under Subchapter V. Before filing, the Debtor wholly owned a limited liability company, which itself owned a 30% minority interest in another limited liability company (the "Operating LLC"). The Debtor worked for and managed Operating LLC. Operating LLC failed shortly before the Debtor filed his petition and was the driving force behind the bankruptcy case as the Debtor had personally guaranteed most of Operating LLC's debts. Upon objection by the United States Trustee, the court considered whether the Debtor qualified as a "person engaged in commercial or business activities" under 11 U.S.C. § 1182(1)(A) and was therefore eligible to proceed under Subchapter V. The Debtor listed on his schedules over $7 million in debts of which $6.3 million were based on the Debtor's guarantees of Operating LLC's debt.

The court examined whether the Debtor was "engaged in commercial or business activities." This consisted of two separate analyses: temporal and substantive. In the temporal analysis, the court considered whether the Debtor was "engaged in" the commercial or business activities at the time he filed his petition. This was particularly relevant here as Operating LLC had financially failed and was in the process of winding down. The Debtor was actively engaged in the wind down process and worked on Operating LLC activities both before and after the petition date. Reasoning the phrase "engaged in" meant the person was presently doing something, the court concluded that "focusing only on the exact nano-second the Petition was filed is a bit too narrow." Rather, "in considering whether the Debtor was engaged in 'commercial or business activity' as of the Petition Date, the Court deem[ed] relevant the circumstances immediately preceding and subsequent to the Petition Date as well as the Debtor's conduct and intent" in finding the Debtor was indeed "engaged in" business or commercial activity. Next, in the substantive analysis of whether the Debtor was "engaged in commercial or business activities" the court used a "totality of the circumstances" test. Here, Operating LLC provided hail repair services for vehicles to the general public, the Debtor indirectly owned a minority interest in the business both on and after the petition date, the Debtor managed Operating LLC, and the Debtor was engaged in the wind down process. Although the court noted it was a "close" call due to Operating LLC ending operations a month prior to the petition date, the court ultimately found the Debtor was engaged in "commercial or business activity" as of the petition date.

Next, the court analyzed whether at least 50% of the Debtor's debts arose from "commercial or business activities." "For the debt to have 'ar[isen] from the commercial or business activities of the debtor,' the debt must be directly and substantially connected to the 'commercial and business activities' of the debtor." Considering whether the personal guarantee's of Operating LLC's debts satisfied this requirement, the court unquestionably found these debts qualified for the Debtor's eligibility analysis. In the court's own words, "[n]o one would put millions of dollars of personal guarantees on the line for a company unless it was to advance the guarantor's own commercial and business interests." Furthermore, "[m]aking financial guarantees for a company in which the Debtor has an indirect equity interest is itself a 'commercial or business activity.'" The Debtor, therefore, qualified under Subchapter V because over 80% of his debts arose from his commercial or business activities.

V. Discharge of Third-Party Guarantor in Chapter 11 Plans

a. Discharge granted to a Chapter 11 Debtor has no effect on the liability of a third-party co-debtor or guarantor of a discharged debt (Section 524(e))

b. *Behrmann v. Nat'l Heritage Found., Inc.*, 663 F.3d 704 (4th Cir. 2011) – In *Behrmann*, the court considered the circumstances in which a bankruptcy court may approve a non-debtor release as part of a final reorganization plan. The Debtor was a non-profit public charity that administered and maintained donor-advised funds. After a state court judgment was entered against the Debtor, it filed a Chapter 11 petition seeking to reorganize.

In its reorganization plan, confirmed by the bankruptcy court and affirmed by the district court, the Debtor included provisions releasing the Debtor, the committee of unsecured creditors, any representatives of the unsecured creditors committee, any officers, directors, or employees of the Debtor or the committee, and any successors or assigns.

After the bankruptcy court confirmed the Debtor's plan, several donors to the Debtor appealed the confirmed plan. The district court affirmed confirmation of the plan.

The Fourth Circuit rejected the donors argument that 11 U.S.C. § 524(e) prevented bankruptcy courts from approving releases for non-debtor parties. Citing *In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989) and *Stuart v. First Mount Vernon Indus. Loan Ass'n*, 3 F. App'x 38 (4th Cir. 2001), the court found the "assertion that equitable relief in the form of non-debtor releases is never permissible under the Bankruptcy Code is . . . without merit."

Next, the Fourth Circuit addressed whether the bankruptcy court erred in approving the non-debtor releases in the Debtor's reorganization plan. While the court noted non-debtor releases "should be granted cautiously and infrequently," it identified a series of factors courts should examine when determining whether to approve a non-debtor release in a reorganization plan. As laid out in *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002),

> the bankruptcy court may enjoin a non-consenting creditor's claims against a non-debtor [when]: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) The bankruptcy court made a record of specific factual findings that support its conclusions. *Behrmann*, 663 F.3d at 711–12 (citing *In re Dow Corning Corp.*, 280 F.3d 648).

Ultimately, the Fourth Circuit remanded the case, based on a lack of factual support in the record as to whether the non-debtor parties were entitled to the releases. The court, therefore, vacated the district court's judgment and remanded the case to the bankruptcy court to determine if factual findings in the record supported non-debtor releases.

Following remand, a different bankruptcy judge found the releases unenforceable and the district court affirmed the bankruptcy court. *Nat'l Heritage Found., Inc. v. Highbourne Found.,* 760 F.3d 344,347 (4th Cir. 2014). The Fourth Circuit affirmed, concluding that the Debtor had "failed to carry its burden of proving that the facts and circumstances of this case justify the [third-party releases]." *Id.* at 347.

VI. Cancellation of Debt ("COD") Income

a. Generally referred to as phantom income because the taxpayer is deemed to have received it even though there is no actual receipt of the income

b. General Rule is straightforward – If a creditor cancels a debt, then the debtor recognizes taxable income under section 61(a)(12) of the Internal Revenue Code ("IRC").

1. Must be some identifiable event indicating that the debt and/or interest on the debt will never be paid by the borrower in full

   i. Payment default under a loan does not cause borrower to recognize COD income

   ii. Property owned by taxpayer is foreclosed on and settlement agreement is reached between holder of the debt and taxpayer on discounted payoff of deficiency balance. COD income is recognized for portion of deficiency balance not repaid by taxpayer.

c. Guarantor does not realize COD income if the primary obligor has defaulted and the guarantor has become liable for the indebtedness *Landreth v. Commissioner*, 50 T.C. 803 (1968), *Whitmer v. Commissioner,* 71 T.C.M. (CCH) 2213 (1996).

   1. If the borrower is a pass-though entity, such as an LLC, then the COD income will flow through to the member(s), often the guarantor.

   2. In a Subchapter S corporation, COD income does not flow through to the shareholders but remains at the entity level. IRC § 108(d)(7).

d. Bankruptcy Exclusion – If a taxpayer's debts are discharged in bankruptcy, then the resulting COD income is fully excluded pursuant to IRC § 108(a)(1)(A). This rule applies whether the discharge occurs under Chapter 7, 11, 12 or 13 of the Bankruptcy Code.

   1. Taxpayer must be under the Bankruptcy Court jurisdiction at the time the COD occurs.

   2. Debt discharge must occur pursuant to a Bankruptcy Court order or a plan approved by the Bankruptcy Court.

   3. Not applicable for Business Chapter 7 Cases and Liquidating Chapter 11 Cases for Business

e. Insolvency Exclusion – If a taxpayer is balance sheet insolvent, and if the taxpayer would other realize COD income, then the taxpayer can exclude a portion of that COD income equal to the amount of the taxpayer's insolvency immediately before the debt forgiveness. IRC §108(a)(3).

   1. A taxpayer is insolvent to the extent that its liabilities exceed the "fair market value" of its asset immediately before the debt forgiveness. IRC § 108(d)(3).

   2. Exempt assets are included in the insolvency calculation. I.R.S. Tech. Adv. Memo. 199935002 (Sept. 3, 1999)