GUARANTIES IN BANKRUPTCY: A PRIMER II

Brian E. Greer, Joel S. Moss, and Nicole B. Herther-Spiro[*]

Introduction[1]

Guaranties are commonly used by creditors to limit their risk by shifting the risk of loss in a transaction to a third party (the guarantor) who will agree to pay the obligations owed by the person or entity primarily liable for the debt (the principal obligor) if the principal obligor defaults on its obligations. Generally, the creditor that is a beneficiary under a guaranty (the beneficiary) may rely on its contractual right to collect payment under the guaranty, and the guarantor may rely on its common law rights of subrogation, contribution and reimbursement to seek payment from the principal obligor for any amounts the guarantor pays under a guaranty. However, if the guarantor or principal obligor suffers financial distress and commences a bankruptcy case (or becomes the subject of an involuntary bankruptcy proceeding), the rights of the guarantor, principal obligor, and beneficiary may be significantly altered.

This article addresses certain of the key issues that guarantors, principal obligors, and beneficiaries may encounter if one or all of the obligors or guarantors files a case under the Bankruptcy Code.[2] Specifically, this article analyzes the following issues:

(I) The major differences between a guaranty of payment and a guaranty of collection and, in particular, the potential pitfalls of a guaranty of collection in bankruptcy;

---

[*]Brian E. Greer is a partner in the business restructuring and reorganization practice of Dechert LLP. Joel S. Moss is a partner in the restructuring, bankruptcy and insolvency practice of Mayer Brown LLP. Nicole B. Herther-Spiro is a senior associate in the business restructuring and reorganization practice of Dechert LLP. The authors would like to thank Monique J. Mulcare, a senior associate in the restructuring, bankruptcy and insolvency practice of Mayer Brown LLP, and Shana White, an associate in the business restructuring and reorganization practice of Dechert LLP, for their generous assistance in connection with the preparation of this article.

[1]This article updates the authors' previous article, Brian E. Greer & Joel S. Moss, Guaranties in Bankruptcy: A Primer, 16 J. Bankr. L. & Prac. 3, Art. 3 (2007).

[2]Title 11 of the United States Code (the "Bankruptcy Code").

(II) The applicability of the automatic stay to non-debtor guarantors;

(III) The applicability of res judicata in bankruptcy to guarantors;

(IV) The impact of sections 502(e) (disallowance of claims for reimbursement and contribution) and 509 (subrogation of certain claims of co-obligors) of the Bankruptcy Code on non-debtor guarantors;

(V) Whether both debtor and non-debtor guarantors can utilize sections 502(b)(6) (limitation on damages resulting from termination of real property leases) and 502(b)(7) (limitation on damages resulting from termination of employment contracts) of the Bankruptcy Code to limit their exposure under a guaranty;

(VI) The enforceability of multiple guaranties relating to the same primary obligation against multiple debtors;

(VII) The potential for avoidance of guaranties as preferential transfers and fraudulent transfers, particularly in the context of intercorporate guaranties;

(VIII) Issues relating to the enforcement of bad-boy or springing guaranties or non-recourse carve-outs in bankruptcy;

(IX) Whether non-debtor guarantors can be released from liability under their guaranties, notwithstanding the limitations on non-debtor discharge pursuant to section 524(e) of the Bankruptcy Code; and

(X) The impact of the section 1129(a)(10) requirement for confirming a Chapter 11 plan (impaired accepting class requirement) where a lender holds claims against multiple debtors.

As will be shown below, parties will want to keep these issues in mind when negotiating, drafting and enforcing guaranties.

I. Guaranties of Payment and Guaranties of Collection

A. Major Distinctions Between a Guaranty of Payment and a Guaranty of Collection

Guaranties come in two generic varieties—a guaranty of payment and a guaranty of collection.[3] A guaranty of payment, also known as an absolute guaranty, is enforced against the guaran-

[3] A guaranty is but one form of suretyship device. This article does not address the body of general suretyship law or any specific suretyship or commercial devices (*e.g.*, performance or surety bonds, letters of credit) other than guaranties.

tor after default by the principal obligor.[4] It does not require the satisfaction of any condition precedent (other than a simple showing that the principal obligor has defaulted on the underlying obligation) and obligates the guarantor to pay the debt owed if it is not paid by the principal obligor when due.[5] Thus the liability under a guaranty of payment is triggered upon a simple showing that the principal obligor has defaulted on the underlying obligation.[6]

In contrast, a guaranty of collection may only be enforced against the guarantor after the creditor demonstrates that either all attempts to obtain payment from the principal obligor have failed or that collection efforts would be futile.[7] Whether a creditor has acted diligently to collect on the underlying obligation is treated as a question of fact, dependent on the circumstances of each case.[8] As such, a guarantor under a guaranty of collection will often pay under the guaranty only on the condition that the creditor has diligently pursued the principal obligor, usually by suit,[9] and has still been unable to satisfy the debt.[10]

To determine whether a guaranty is a guaranty of collection or

---

[4]*U.S. v. Vahlco Corp.*, 800 F.2d 462, 466, 2 U.C.C. Rep. Serv. 2d 987 (5th Cir. 1986).

[5]*U.S. v. Vahlco Corp.*, 800 F.2d 462, 466, 2 U.C.C. Rep. Serv. 2d 987 (5th Cir. 1986); *Greenlight Reinsurance, Ltd. v. Appalachian Underwriters, Inc.*, 958 F. Supp. 2d 507, 519 (S.D. N.Y. 2013) ("[G]uarantees do not necessarily require that a plaintiff exhaust 'all efforts to collect from the principal obligor' before bringing a case against the guarantor." (citing *General Phoenix Corporation v. Cabot*, 300 N.Y. 87, 89 N.E.2d 238, 241 (1949))); *People's United Equipment Finance Corp. v. Halls*, 2011 WL 1831606, *6 (S.D. Tex. 2011) ("A guaranty of payment therefore requires no condition precedent to its enforcement other than a default by the principal debtor.") (citation omitted).

[6]*Greene v. Martin W. Hysong Co.*, 193 A.2d 893, 894 (D.C. 1963) ("A guarantor for payment assures the creditor that the debtor will pay, while a guarantor for collection gives assurance only that the debtor is able to pay. A guarantor for payment is subject to suit merely upon a showing that the debt remains unpaid; but to sustain an action against a guarantor for collection requires a showing that the creditor has been unable to gain satisfaction of his debt from the debtor by the use of due diligence."); *Forsyth County Hosp. Authority, Inc. v. Sales*, 82 N.C. App. 265, 346 S.E.2d 212, 214 (1986); 38 Am. Jur. 2d, Guaranty § 16 (2003).

[7]Gen. Phoenix, 89 N.E. 2d at 242.

[8]Greene, 193 A.2d at 894.

[9]*Marine Midland Bank, N.A. v. Elshazly*, 753 F. Supp. 20, 22–23 (D. Conn. 1991) ("This is a different situation from a guarantor of collection who contracts to pay the debt of the principal only after the creditor has secured a judgment against the principal (debtor) and has been unable to satisfy that judgment." (citing *In re Wilson*, 9 B.R. 723, 3 Collier Bankr. Cas. 2d (MB) 912, Bankr. L.

a guaranty of payment, courts look to the intent of the parties.[11] Thus, the creation of a guaranty of payment "does not depend on the use of technical words but upon a clear intent that one party as surety binds himself to the second party as creditor to pay a debt contracted by a third party . . . immediately upon default of the third party."[12] There is a presumption, absent clear evidence of a contrary intention, that a guaranty is intended to be a guaranty of payment, rather than a guaranty of collection.[13]

B. Impact of Bankruptcy on Guaranties of Payment and Guaranties of Collection

1. Where the Principal Obligor is a Debtor

As stated above, a beneficiary may seek payment from a guarantor under a guaranty of payment immediately upon a default on the underlying obligation. However, under a guaranty of collection, a beneficiary must first attempt to collect from the principal obligor as a precondition of enforcing the guaranty. If the principal obligor becomes insolvent or commences a bankruptcy case, the beneficiary's obligation to pursue the principal

---

Rep. (CCH) P 67893 (Bankr. E.D. N.Y. 1981))); 38 Am. Jur. 2d, Guaranty § 89 (2003).

[10]Forsyth Cnty., 346 S.E. 2d at 214.

[11]Gen. Phoenix, 89 N.E. 2d at 242; 38 Am. Jur. 2d, Guaranty § 53 (2003).

[12]Gen. Phoenix, 89 N.E. 2d at 242 ("If he binds himself to pay immediately upon default of the debtor, he becomes a guarantor of payment; if he binds himself to pay only after all attempts to obtain payment from the debtor have failed, he becomes a guarantor of collection.")

[13]*E.g.*, *Cusimano v. First Maryland Sav. and Loan, Inc.*, 639 A.2d 553, 557, 23 U.C.C. Rep. Serv. 2d 14 (D.C. 1994) ("In order for a guaranty to be one of collection, it must set forth with clear and unambiguous language the indication that the guarantor becomes liable only after the holder has reduced his or her claim against the primary guarantor to judgment, and after execution has been returned unsatisfied, or when it would be futile to pursue the primary guarantor." (citation omitted)); *Sprague Energy Corp. v. Levco Tech Inc.*, 2009 WL 1374593, *14 (D. Conn. 2009) ("A guaranty of the payment of an obligation without words of limitation on condition is construed as an absolute or unconditional guaranty." (citation omitted)); *see also* U.C.C. § 3-419(d) ("If the signature of a party to an instrument is accompanied by words indicating unambiguously that the party is guaranteeing collection rather than payment of the obligation of another party to the instrument, the signer is obliged to pay the amount due on the instrument to a person entitled to enforce the instrument only if (i) execution of judgment against the other party has been returned unsatisfied, (ii) the other party is insolvent or in an insolvency proceeding, (iii) the other party cannot be served with process, or (iv) it is otherwise apparent that payment cannot be obtained from the other party").

obligor under a guaranty of collection will, in most cases, be satisfied.[14]

While the Restatement (Third) of Suretyship and Guaranty provides that a creditor may enforce a guaranty of collection if the principal obligor is in bankruptcy, this rule may not apply in all cases. For example, a guaranty is a negotiated contract between the guarantor and the beneficiary, and the guarantor may therefore negotiate at the outset that the insolvency or bankruptcy of the principal obligor does not relieve the beneficiary from first seeking recovery from the principal obligor in the principal obligor's bankruptcy case before the beneficiary can seek recovery from the guarantor.[15] If the guaranty contains such a provision, the insolvency or bankruptcy of the principal obligor would be an insufficient basis, by itself, to excuse the beneficiary from first seeking recovery from the principal obligor prior to seeking recovery from the guarantor.

2. Where the Guarantor is a Debtor

When a guarantor commences a bankruptcy case, the Bankruptcy Code's automatic stay will, as a general matter, preclude substantially all action by a beneficiary under a guaranty of payment or a guaranty of collection to collect under the guaranty.[16] Instead, the beneficiary has a "claim" against the guarantor's

---

[14]Specifically, the Restatement (Third) of Suretyship and Guaranty provides that a guarantor under a guaranty of collection is required to perform its obligation under the guaranty if, among other things, the principal obligor is insolvent or a debtor in a bankruptcy proceeding. *See* Restatement (Third) of Suretyship and Guaranty § 15(b). The Restatement also provides that a guarantor under a guaranty of collection must honor the obligations of the principal obligor if (a) execution of a judgment against the principal obligor has been returned unsatisfied, (b) the principal obligor cannot be served with process, or (c) it is otherwise apparent that payment cannot be obtained from the principal obligor.

[15]*See* Restatement (Third) of Suretyship and Guaranty § 6 ("Each rule in this Restatement stating the effect of suretyship status may be varied by contract between the parties to it"); *Data Sales Co., Inc. v. Diamond Z Mfg.*, 205 Ariz. 594, 74 P.3d 268, 273–74 (Ct. App. Div. 1 2003) (affirming the "general policy that parties may contractually waive defenses," but noting that "[t]his does not mean, however, that all rights may be waived. According to the Restatement, a party's freedom to contract to be a guarantor is still limited by principles of contract law such as unconscionability, good faith and fair dealing, and the statute of frauds").

[16]*See* 11 U.S.C.A. § 362(a). There are a number of exceptions to the automatic stay, which apply to the exercise of rights under certain types of financial contracts such as "swap agreements," "securities contracts," "repurchase agreements" and "master netting agreements." The 2005 and 2006 amendments to the Bankruptcy Code expanded the protections afforded to

bankruptcy estate, which it can assert against the guarantor subject to any defenses the guarantor may have.[17] The beneficiary will have a claim against the guarantor in the guarantor's bankruptcy, regardless of whether a right to payment has matured under the guaranty or remains contingent, for example, because: (1) a default on the underlying obligation has not occurred (with respect to a guaranty of payment) or (2) the beneficiary must first seek performance of the underlying obligation from the principal obligor (with respect to a guaranty of collection).

As discussed below, the treatment of a beneficiary's claim in a guarantor's bankruptcy will vary depending on the nature of the underlying obligation, whether the beneficiary may recover on its claim from third-parties (i.e., the principal obligor or other guarantors), and whether the claim on the guaranty is contingent or matured.[18]

II. Applicability of the Section 362 Automatic Stay Provisions to a Guarantor

Section 362 of the Bankruptcy Code provides, among other things, that, upon the filing of a bankruptcy petition by a debtor, a creditor is automatically stayed from taking any action to recover from the debtor or its property on a prepetition debt.[19] Accordingly, upon the filing of a bankruptcy petition by a principal obligor or guarantor, the beneficiary will be stayed from taking

---

counterparties under such agreements. As a result, under certain circumstances, the exercise of rights under a guaranty issued in connection with such contracts would not be subject to the protections of the automatic stay. *See* 11 U.S.C.A. §§ 362(b)(6), (7), (17), (27), 555, 556, 559, 560 & 561.

[17] *See* 11 U.S.C.A. § 101(5), defining "claim" as:

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

[18] *See infra* Parts IV, V and VI.

[19] *See* 11 U.S.C.A. § 362(a). This section states that:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

any action to recover from the debtor principal obligor or debtor guarantor, as the case may be, without leave of the bankruptcy court. A party may only obtain relief from the automatic stay upon a showing of "cause" under section 362(d) of the Bankruptcy Code.[20] Although the automatic stay by its literal language only applies to the entity that has commenced the bankruptcy case, some courts have nonetheless extended the applicability of the automatic stay to enjoin litigation against nondebtor guarantors and other nondebtors where "unusual circumstances" are present.[21] Other courts have sometimes used section 105(a) of the Bankruptcy Code as a basis to enjoin litigation against a nondebtor guarantor.[22]

---

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning a corporate debtor's tax liability for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.

[20]Whether or not "cause" exists for obtaining relief from the automatic stay is a question that depends on the facts and circumstances of each case. Under section 362(d) of the Bankruptcy Code, "cause" includes, among other things, (i) a lack of adequate protection of a creditor's interest in property and (ii) the debtor having no equity in the property and such property is not necessary to an effective reorganization.

[21]*See infra* Part II.B.

[22]*See, e.g.*, *In re A.H. Robins Co., Inc.*, 972 F.2d 77, 82 (4th Cir. 1992); *Willis v. Celotex Corp.*, 978 F.2d 146, 149–50, 23 Bankr. Ct. Dec. (CRR) 1032, Bankr. L. Rep. (CCH) P 74938, 23 Fed. R. Serv. 3d 1067 (4th Cir. 1992); *Matter of Rustic Mfg., Inc.*, 55 B.R. 25, 31–32 (Bankr. W.D. Wis. 1985); *Matter of Johns-Manville Corp.*, 26 B.R. 405, 416, 9 Bankr. Ct. Dec. (CRR) 1403, 7 Collier Bankr. Cas. 2d (MB) 1025, Bankr. L. Rep. (CCH) P 69022 (Bankr. S.D. N.Y. 1983), order aff'd, 40 B.R. 219, 10 Collier Bankr. Cas. 2d (MB) 643, Bankr. L. Rep. (CCH) P 69600, 39 Fed. R. Serv. 2d 556 (S.D. N.Y. 1984); *In re Otero Mills, Inc.*, 21 B.R. 777, 779 (Bankr. D. N.M. 1982); *see also infra* Part II.C.

A. The Automatic Stay Generally Does Not Apply to Nondebtor Guarantors

As a general matter, courts have held that the automatic stay does not apply to a debtor's guarantors if such guarantors are not themselves debtors in bankruptcy.[23] For example, in *Credit Alliance Corp. v. Williams*,[24] the United States Court of Appeals for the Fourth Circuit held that the plain language of section 362, as well as the legislative history behind it, indicates that Congress did not intend for the automatic stay to extend beyond the debtor.[25] In addition, the court reasoned that, because Congress created a stay for co-debtors under Chapter 13 of the Bankruptcy Code, if Congress wanted to create the same protections under Chapter 11 it would have specifically included such protections in the statutory language.[26] However, as discussed below, in certain narrow circumstances, courts have been willing to stay actions against nondebtor guarantors.

B. The Automatic Stay May Apply to Nondebtor Guarantors or Other Nondebtors in "Unusual Circumstances"

Some courts have interpreted the automatic stay to apply to nondebtors, including guarantors, where they have found "unusual circumstances" to exist. In *A.H. Robins Co. v. Piccinin*,[27] the United States Court of Appeals for the Fourth Circuit held

---

[23]*See, e.g.*, *Credit Alliance Corp. v. Williams*, 851 F.2d 119, 121–22, 18 Bankr. Ct. Dec. (CRR) 227, Bankr. L. Rep. (CCH) P 72369 (4th Cir. 1988) ("Williams"); *Otoe County Nat. Bank v. W & P Trucking, Inc.*, 754 F.2d 881, 883, Bankr. L. Rep. (CCH) P 70256, 40 Fed. R. Serv. 2d 1482 (10th Cir. 1985); *In re Arrow Huss, Inc.*, 51 B.R. 853, 856, Bankr. L. Rep. (CCH) P 70682 (Bankr. D. Utah 1985) ("It is well settled that Section 362 of the Bankruptcy Code, which stays actions against the debtor and against property of the estate, does not forbid actions against its non-debtor principals, partners, officers, employees, co-obligors, guarantors, or sureties"); *In re Keyco, Inc.*, 49 B.R. 507, 509, 13 Bankr. Ct. Dec. (CRR) 25 (Bankr. E.D. N.Y. 1985); *Matter of Earth Lite, Inc.*, 9 B.R. 440, 444 (Bankr. M.D. Fla. 1981).

[24]Williams, 851 F.2d at 119.

[25]*See* Williams, 851 F.2d at 121.

[26]*See* Williams, 851 F.2d at 121; *see also Teachers Ins. and Annuity Ass'n of America v. Butler*, 803 F.2d 61, 65, 15 Collier Bankr. Cas. 2d (MB) 952, Bankr. L. Rep. (CCH) P 71512 (2d Cir. 1986) (holding that "Chapter 11, unlike Chapter 13, contains no provision to protect non-debtors who are jointly liable on a debt with the debtor").

[27]*A.H. Robins Co., Inc. v. Piccinin*, 788 F.2d 994, 1002, 14 Bankr. Ct. Dec. (CRR) 752, 15 Collier Bankr. Cas. 2d (MB) 235, Bankr. L. Rep. (CCH) P 71094 (4th Cir. 1986); *contra Algemene Bank Nederland, N.V. v. Hallwood Industries,*

that in "unusual circumstances" courts may utilize section 362(a) of the Bankruptcy Code to stay proceedings against nondebtor codefendants.[28] The court defined "unusual circumstances" to mean situations "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."[29] By way of illustration, the court identified a situation in which a third-party defendant would be entitled to absolute indemnity by the debtor on account of any judgment against such third-party defendant as an example of an "unusual circumstance" in which a court might stay proceedings against a nondebtor.[30] The court held that proceedings against a nondebtor insurer should be stayed because the insurer's interests were intertwined with those of the debtor and that a judgment against the insurer would adversely affect the debtor's estate.[31] The court reasoned that the debtor's products liability insurance policy was a limited fund that constituted property of the debtor's estate and should be available for the benefit of all creditors. With 5,000 litigations pending against the debtors and hundreds of millions of dollars already expended in defending or settling just 40 cases, the court indicated that the continuation of litigation against the debtor's insurance provider would contravene public interest and frustrate any effort at reorganization by the debtor. Applying that reasoning, the court affirmed the district court's stay of

---

Inc., 133 B.R. 176 (W.D. Pa. 1991) (rejecting the case on other grounds); *In re PTI Holding Corp.*, 346 B.R. 820 (Bankr. D. Nev. 2006) (rejecting the case).

[28]Piccinin, 788 F.2d at 999.

[29]Piccinin, 788 F.2d at 999; *see also Queenie, Ltd. v. Nygard Intern.*, 321 F.3d 282, 288, 65 U.S.P.Q.2d 1996, Bankr. L. Rep. (CCH) P 78803 (2d Cir. 2003) (extending the automatic stay to the wholly owned subsidiary of the debtor because adjudication of the claim against the subsidiary would have had an immediate adverse economic impact on the debtor); *In re Residential Capital, LLC*, 529 Fed. Appx. 69, 71 (2d Cir. 2013) (rejecting the district court's blanket holding that the automatic stay could not be extended to the debtor's parent and affiliates because they were not debtors, citing *Queenie*, and remanding the case to the district court to determine whether continuing the suit against the non-debtors would have immediate adverse economic consequences on the debtor).

[30]Piccinin, 788 F.2d at 999.

[31]Piccinin, 788 F.2d at 1008–1009.

proceedings against the debtor's insurer pursuant to section 362(a) of the Bankruptcy Code.[32]

A few decisions have relied on *A.H. Robins* as a basis for extending the automatic stay to a nondebtor guarantor where the court found "unusual circumstances" to be present. For example, in *First Nat'l Bank of Louisville v. Kanawha Trace Dev. Partners*,[33] the court stayed litigation against a guarantor on the basis that the guarantor had received a right of indemnification from the debtor for any amount paid under the guaranty.[34]

Courts have declined to interpret *A.H. Robins* so broadly as to shield nondebtor guarantors generally. Rather, cases subsequent to *A.H. Robins* stand for the proposition that nondebtor guarantors should not enjoy the benefit of the automatic stay where enjoining action against the guarantor is not necessary to preserve estate assets or to assist in the debtor's reorganization efforts. For example, in *Credit Alliance Corp. v. Williams*, the Fourth Circuit declined to stay a proceeding against a third-party guarantor because the automatic stay was not necessary to protect the debtor or to prevent dissipation of the debtor's assets.[35] The court reasoned that "the purpose of the guaranty would be frustrated by interpreting [the automatic stay] so as to stay [the beneficiary's] action against the nonbankrupt guarantor when the defaulting debtor petitioned for bankruptcy."[36]

C. Section 105(a) to Enjoin Litigation Against a Nondebtor Guarantor

Some courts have shielded nondebtor guarantors from suit

---

[32]Piccinin, 788 F.2d at 1008–1009; *see also In re Jefferson County, Ala.*, 491 B.R. 277, 296 (Bankr. N.D. Ala. 2013) (extending the automatic stay to insurer's state court action against the debtor county's underwriter, which was essentially identical to the insurer's prior action against the debtor that was stayed by the Chapter 9 filing, on the basis that the lawsuit was, in fact, an act to obtain possession of, or to exercise control over, the debtor's property).

[33]*In re Kanawha Trace Development Partners*, 87 B.R. 892, 18 Bankr. Ct. Dec. (CRR) 27 (Bankr. E.D. Va. 1988).

[34]Kanawha, 87 B.R. at 896.

[35]*See* Williams, 851 F.2d at 122; *see also In re Southside Lawn & Garden/Suffolk Yard Guard*, 115 B.R. 79, 81, 20 Bankr. Ct. Dec. (CRR) 971, 23 Collier Bankr. Cas. 2d (MB) 37 (Bankr. E.D. Va. 1990) (declining to stay litigation against the general partners of the debtor, even though the general partners were entitled to indemnification by the debtor, because the general partners were not an important continuing source of funds to the debtor's reorganization efforts).

[36]Williams, 851 F.2d at 122.

through the use of section 105(a) of the Bankruptcy Code[37] where such relief was deemed necessary to ensure the success of the debtor's reorganization or to protect the bankruptcy estate.[38] In *Otero Mills, Inc. v. Sec. Bank & Trust*,[39] the court used section 105(a) to enjoin a creditor's action against a nondebtor guarantor where the guarantor was president of the debtor corporation. In determining whether to issue an injunction, the court placed the burden on the debtor to meet the following three-part test: (a) irreparable harm to the bankruptcy estate if the injunction is not obtained, (b) a strong likelihood of success on the merits, and (c) no harm or minimal harm to other parties.[40] The court reasoned that under these circumstances the injunction "assures that a creditor may not do indirectly that which he is forbidden to do directly" because failure to enjoin action against a nondebtor would enable the creditor to "adversely or detrimentally influence and pressure the debtor" through a third party.[41] Similarly, in *In re F.T.L.*,[42] the court enjoined Crestar Bank's action to recover against an individual guarantor who was the president and principal owner of the debtor. The court articulated a four-part test for the use of section 105(a) to enjoin an action against a nondebtor[43] and stated that the case "presents the kind of 'unusual circumstances' set forth in *[A.H.] Robins* that warrant a temporary injunction against Crestar to cease collection

---

[37]11 U.S.C.A. § 105(a). The section states that:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

[38]*See, e.g.*, Celotex Corp., 978 F.2d at 149–50; *In re Steven P. Nelson, D.C., P.A.*, 140 B.R. 814, 816–17 (Bankr. M.D. Fla. 1992); *Noel Mfg. Co., Inc. v. Marathon Mfg. Co.*, 69 B.R. 120, 121–22 (N.D. Ala. 1985); Johns-Manville Corp., 26 B.R. at 416.

[39]*In re Otero Mills, Inc.*, 21 B.R. 777 (Bankr. D. N.M. 1982).

[40]Otero Mills, 21 B.R. at 779.

[41]Otero Mills, 21 B.R. at 778.

[42]*In re F.T.L., Inc.*, 152 B.R. 61, 24 Bankr. Ct. Dec. (CRR) 53, 28 Collier Bankr. Cas. 2d (MB) 1032, Bankr. L. Rep. (CCH) P 75194 (Bankr. E.D. Va. 1993).

[43]In *F.T.L.*, the court held that before a court can enjoin action against a non-debtor under section 105(a) the court must find that:

1. The plaintiff is likely to succeed on the merits;
2. The plaintiff has shown that irreparable injury will result without such relief;

activities."[44] The *F.T.L.* court issued a temporary injunction "to assist the debtor through a crucial point in the reorganization proceedings; [that would] expire in 90 days or upon confirmation of a plan." The court called this injunction for the benefit of a nondebtor a "type of extraordinary relief" that is only "appropriate in rare circumstances."[45]

Another one of those "rare circumstances" arose in *In re Lyondell Chemical Company*.[46] When Lyondell Chemical Company and other U.S. based affiliates filed their Chapter 11 petitions in the Southern District of New York in 2009, their non-U.S. parent, LyondellBasell Insdustries AF S.C.A. ("LBIAF"), and all of their other foreign affiliates (with the exception of one German affiliate—Basell Germany Holdings G.m.b.H, which also filed for bankruptcy) did not institute bankruptcy proceedings in their respective jurisdictions.[47]

In connection with various transactions, LBIAF and certain of its foreign affiliates had guaranteed various obligations of certain of the U.S. debtors.[48] In turn, certain of LBIAF's subsidiaries, including a number of the U.S. debtors, had guaranteed notes that had been issued by LBIAF ("Notes").[49] A default under the Notes had been triggered by the Chapter 11 filings of the U.S. debtors. As a result, either the indenture trustee for the Notes or noteholders holding at least 25% of the outstanding principal amount of the Notes could declare such notes due and payable.[50] If LBIAF was unable repay the Notes upon demand, the foreign affiliates could be forced into involuntary insolvency proceedings in various foreign jurisdictions that favored liquidation over restructuring.[51] Commencement of an involuntary insolvency proceeding against LBIAF would constitute a default under

---

3. Issuing the injunction would not substantially harm other interested parties; and

4. The public interest is best served by preserving the status quo until the merits of the controversy can be fully considered.

F.T.L., 152 B.R. at 63.

[44]F.T.L., 152 B.R. at 63.

[45]F.T.L., 152 B.R. at 63.

[46]*In re Lyondell Chemical Co.*, 402 B.R. 571, 61 Collier Bankr. Cas. 2d (MB) 567 (Bankr. S.D. N.Y. 2009).

[47]Lyondell, 402 B.R. at 576.

[48]Lyondell, 402 B.R. at 577–75.

[49]Lyondell, 402 B.R. at 577–78.

[50]Lyondell, 402 B.R. at 577–78.

[51]Lyondell, 402 B.R. at 578–81.

Lyondell's DIP agreement, which, in turn, could trigger the liquidation of the U.S. debtors in Chapter 11.[52]

The bankruptcy court examined the totality of these circumstances and, applying a four-factor test, issued an injunction pursuant to section 105 of the Bankruptcy Code barring actions against LBIAF.[53] Applying each of the factors in turn, the court found that (1) there had been sufficient progress in the bankruptcy to show that a reorganization was likely; (2) the combination of (a) the intertwined nature of the U.S. debtors, their foreign parent and their foreign nondebtor affiliates, (b) the cross-defaults set forth in the various agreements and (c) the potential spiral of insolvencies was sufficient to support a finding that the U.S. debtors would suffer irreparable harm without the court's intervention; (3) temporary stasis was the best way to balance potential harms faced by all involved; and (4) the public interest would best be served by the stay being limited to 60 days in duration.[54] The court believed that sixty days would be a sufficient window of time to permit LBIAF to voluntarily file for bankruptcy protection in the United States, in the country where its headquarters was located, the Netherlands, or in its country of organization, Luxembourg.[55] Two days before the stay expired, the parent company filed for Chapter 11 protection.

III. Applicability of Res Judicata in Bankruptcy to Guarantors

In bankruptcy, the rights of a guarantor can be significantly affected by application of the doctrine of res judicata.[56] The issue often arises in connection with the release of a nondebtor guaran-

---

[52]Lyondell, 402 B.R. at 583.

[53]Lyondell, 402 B.R. at 588–89.

[54]Lyondell, 402 B.R. at 587–94

[55]Lyondell, 402 B.R. at 594.

[56]The doctrine of res judicata bars a subsequent action where:

(1) the prior decision was a final judgment on the merits,
(2) the litigants were the same parties,
(3) the prior court was of competent jurisdiction, and
(4) the causes of action were the same.

E.g., *Corbett v. MacDonald Moving Services, Inc.*, 124 F.3d 82, 89, 31 Bankr. Ct. Dec. (CRR) 338 (2d Cir. 1997); *Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1051–52, 16 Collier Bankr. Cas. 2d (MB) 1305, Bankr. L. Rep. (CCH) P 71802 (5th Cir. 1987) ("Shoaf").

tor pursuant to the terms of a confirmed plan of reorganization.[57] In *Stoll v. Gottlieb*, the United States Supreme Court held that a beneficiary of a guaranty made by a nondebtor could not collaterally attack in state court a bankruptcy court's confirmation of a debtor's reorganization plan that provided for the cancellation of the guaranty, even assuming that the bankruptcy court incorrectly determined that it had jurisdiction to release the guaranty.[58] The Court reasoned that the bankruptcy court had the power to decide whether it had authority to cancel the guaranty by the nondebtor, even if such determination might ultimately be incorrect as a matter of law. Because no appeal of the bankruptcy court's decision was taken, the doctrine of res judicata precluded the beneficiary from collaterally attacking the release of the guaranty in state court.[59]

Although *Stoll* was decided in the context of a plan confirmed under the Bankruptcy Act of 1898, courts have confirmed the ap-

---

[57]The issue of whether non-debtor third-party releases, including releases of guarantors, are permissible in bankruptcy is a separate paper in and of itself. The courts of appeals are split on the availability of non-debtor third-party releases and permanent injunctions in bankruptcy, with three views prevailing. Some circuits hold that a Chapter 11 plan can include non-debtor third-party releases and permanent injunctions, without the affected creditors' consent, in certain circumstances. *E.g.*, *In re Airadigm Communications, Inc.*, 519 F.3d 640, 657, 49 Bankr. Ct. Dec. (CRR) 179, Bankr. L. Rep. (CCH) P 81123 (7th Cir. 2008); *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142–43, 44 Bankr. Ct. Dec. (CRR) 276, 54 Collier Bankr. Cas. 2d (MB) 1033, Bankr. L. Rep. (CCH) P 80397 (2d Cir. 2005); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 94, 17 Bankr. Ct. Dec. (CRR) 293, 18 Collier Bankr. Cas. 2d (MB) 316, Bankr. L. Rep. (CCH) P 72180 (2d Cir. 1988); *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293, 26 Collier Bankr. Cas. 2d (MB) 1413, 22 Fed. R. Serv. 3d 1091 (2d Cir. 1992); *In re A.H. Robins Co., Inc.*, 880 F.2d 694, 702, 19 Bankr. Ct. Dec. (CRR) 997, Bankr. L. Rep. (CCH) P 72955 (4th Cir. 1989); *In re Dow Corning Corp.*, 280 F.3d 648, 658, 39 Bankr. Ct. Dec. (CRR) 9, 47 Collier Bankr. Cas. 2d (MB) 1158, Bankr. L. Rep. (CCH) P 78582, 2002 FED App. 0043P (6th Cir. 2002). Other circuits permit non-debtor third-party releases and permanent injunctions but only with respect to those creditors consenting to the relief. *See, e.g.*, *In re AOV Industries, Inc.*, 792 F.2d 1140, 1154, 14 Bankr. Ct. Dec. (CRR) 816, Bankr. L. Rep. (CCH) P 71190 (D.C. Cir. 1986). Still other circuits prohibit non-debtor third-party releases and permanent injunctions altogether. *Matter of Zale Corp.*, 62 F.3d 746, 761, Bankr. L. Rep. (CCH) P 76617 (5th Cir. 1995); *In re American Hardwoods, Inc.*, 885 F.2d 621, 626, 19 Bankr. Ct. Dec. (CRR) 1354, Bankr. L. Rep. (CCH) P 73130 (9th Cir. 1989); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 601, 21 Bankr. Ct. Dec. (CRR) 320, 24 Collier Bankr. Cas. 2d (MB) 1012, Bankr. L. Rep. (CCH) P 73754 (10th Cir. 1990), opinion modified on other grounds, 932 F.2d 898 (10th Cir. 1991). For a further discussion of this topic, *see infra* Part IX.

[58]*Stoll v. Gottlieb*, 305 U.S. 165, 168–73, 59 S. Ct. 134, 83 L. Ed. 104 (1938).

[59]Stoll, 305 U.S. at 168–69.

plicability of *Stoll*'s holding in cases under the Bankruptcy Code.[60] For example, in *Republic Supply Co. v. Shoaf*, the United States Court of Appeals for the Fifth Circuit held that, notwithstanding the fact that section 524(e) of the Bankruptcy Code[61] precluded a bankruptcy court from releasing a nondebtor guarantor, a bankruptcy court's order confirming a Chapter 11 plan providing for the release of a nondebtor guarantor that was not appealed barred a beneficiary's action to recover on the guaranty under the principle of res judicata.[62]

In light of the potential applicability of res judicata to issues that arise in the bankruptcy context involving guarantors, guarantors (and other parties in interest) generally should take care to preserve their rights in the bankruptcy case itself and timely appeal any orders of the bankruptcy court that adversely affect their rights.

IV. Reimbursement and Subrogation Under Sections 502 and 509

Two mutually exclusive avenues of recovery exist for a guarantor's claim against a primary obligor.[63] Section 502 of the Bankruptcy Code permits allowance of a claim for reimbursement or contribution by a guarantor, unless the claim is "contingent as of the time of allowance or disallowance of such claim" or the underlying "claim against the estate is disallowed."[64] Section 509 of the Bankruptcy Code may be employed by a guarantor instead of seeking a claim for contribution or reimbursement under section 502 to allow the guarantor to subrogate the guarantor's claim to the claim of the underlying creditor against the principal obligor.

Each of these remedies has limitations. If a guarantor asserts

---

[60] *See, e.g.*, *Sanders Confectionery Products, Inc. v. Heller Financial, Inc.*, 973 F.2d 474, 481–82, Bankr. L. Rep. (CCH) P 74917, Fed. Sec. L. Rep. (CCH) P 96966, R.I.C.O. Bus. Disp. Guide (CCH) P 8063 (6th Cir. 1992); Shoaf, 815 F.2d at 1051–52.

[61] *See infra* Part IX.

[62] Shoaf, 815 F.2d at 1054.

[63] *See generally* 4 Collier on Bankruptcy ¶ 502.06 (16th ed. 2010); Norton Bankruptcy Law and Practice § 48:40 (3d ed.). Section 509(b) provides that a creditor is not subrogated to the extent its claim for reimbursement or contribution is allowed under section 502, *see* 11 U.S.C.A. § 509(b)(1)(A), and section 502(e) provides, among other things, that contribution or reimbursement claims must be disallowed where the creditor has asserted a right of subrogation under section 509, *see* 11 U.S.C.A. § 502(e)(1)(C).

[64] 11 U.S.C.A. § 502(e)(1)(B), (A).

a claim for reimbursement or contribution, the claim will be disallowed under section 502(e)(1)(B) if the claim is contingent (for example, in cases where the obligation under the guaranty has not been triggered).[65] Under section 509(c), the claim of a guarantor by way of subrogation or for reimbursement or contribution is subordinated to the claim of the underlying creditor until such creditor's claim is paid in full.[66] Whether a claim proceeds under section 502 or section 509 is determined in part by the contractual relationship between the beneficiary, debtor, and guarantor and the amount the guarantor has paid to the creditor. In some circumstances, the guarantor may be able to choose whether its claim will proceed under section 502 or section 509.[67] |P|There are a variety of factors that a guarantor must consider in choosing whether to assert a reimbursement claim against the principal obligor or choosing to become subrogated to the claim of

---

[65]*See In re Drexel Burnham Lambert Group Inc.*, 148 B.R. 982, 986, 23 Bankr. Ct. Dec. (CRR) 1315 (Bankr. S.D. N.Y. 1992) ("The determination of whether the claim is contingent is made at the time of the allowance or disallowance of the claim, which courts have established is the date of the ruling.").

[66]*See In re Condor Systems, Inc.*, 296 B.R. 5, 15, 41 Bankr. Ct. Dec. (CRR) 190 (B.A.P. 9th Cir. 2003) (stating that "the co-obligor's claim by way of subrogation or for reimbursement or contribution is statutorily subordinated to the creditor's claim until such creditor's claim is paid in full, either through payments under [the Bankruptcy Code] or otherwise") (citations omitted); *In re Northeastern Contracting Co.*, 187 B.R. 420, 423, 27 Bankr. Ct. Dec. (CRR) 1176 (Bankr. D. Conn. 1995) ("Section 509(c) provides that a co-debtor or guarantor's claim of subrogation, reimbursement or contribution is subordinated to the creditor's claim until the creditor's claim is paid in full.") (citation omitted); *In re Lambert Oil Co., Inc.*, 347 B.R. 508, 518, 46 Bankr. Ct. Dec. (CRR) 268 (W.D. Va. 2006) (same). The underlying policy behind section 509 has been described by the Supreme Court as follows:

> The bond was intended to protect materialmen and laborers who worked on the job so that they would not have to bear the risk of Stratton's insolvency. But for his insolvency and bankruptcy these laborers and materialmen would have been able to recover from him the money due them, no matter what their rights against the surety might have been. Consequently the surety should not by claiming under subrogation or indemnity for money paid to some of the creditors for whose benefit the bond was intended, be allowed to reduce the share of the bankrupt's assets due to other creditors whom the bond also was intended to protect from insolvency. For this would tend to defeat the very purpose for which the bond was given and therefore cannot be permitted under the equitable principles governing distribution of a bankrupt's assets.

American Sur. Co. of N.Y. v. Sampsell, 327 U.S. 269, 273–74, 66 S. Ct. 571, 90 L. Ed. 663 (1946).

[67]*See In re Dow Corning Corp.*, 250 B.R. 298, 365, 55 Fed. R. Evid. Serv. 118 (Bankr. E.D. Mich. 2000) (holding that a co-liable party could choose to recover under either a reimbursement or contribution claim under section 502 or a subrogated claim under section 509); 4 Collier on Bankruptcy ¶ 509.02[3] (16th ed. 2010); Norton Bankruptcy Law and Practice § 48:40 (3d ed.).

the beneficiary. A guarantor whose reimbursement claim is unsecured would, in all likelihood, choose to become subrogated under section 509 if the underlying claim of the beneficiary against the principal obligor is a secured claim. This is because a party who becomes subrogated to a secured claim is entitled to assert that secured claim.[68] Additionally, subrogation may be the preferred avenue for a guarantor where the payment under the guaranty is triggered by a postpetition breach by the primary obligor that gives rise to an administrative expense priority claim by the beneficiary against the primary obligor. In such an instance, the guarantor would be entitled to an administrative expense priority claim by virtue of its payment on the guaranty.[69] On the other hand, a reimbursement claim under section 502 may be the preferred route for a guarantor where the guarantor's reimbursement or contribution claim is secured, but the claim of the beneficiary under the guaranty against the primary obligor is unsecured.[70]

Taken together, section 502(e)(1)(B)'s disallowance of contingent claims for contribution or reimbursement and section 509(c)'s subordination of reimbursement, contribution, and subrogation claims until the underlying claim is paid in full require that a guarantor pay the debt in full to the beneficiary in order to receive a distribution from the primary obligor's estate.[71] The disallowance of contingent reimbursement or contribution

---

[68] *In re The Medicine Shoppe*, 210 B.R. 310, 313, 38 Collier Bankr. Cas. 2d (MB) 698 (Bankr. N.D. Ill. 1997) ("Subrogation under [section] 509(a) allows a guarantor, who pays a debt for which a debtor is primarily liable, to assume the creditor's rights. These rights include any rights to . . . secured status to which the subrogor's claim was entitled").

[69] *In re Wingspread Corp.*, 116 B.R. 915, 932, 24 Collier Bankr. Cas. 2d (MB) 244 (Bankr. S.D. N.Y. 1990) (guarantor under rejected lease that gave rise to administrative expense priority claim by landlord was entitled to assert administrative expense priority claim on account of its right of subrogation to landlord's claim). Please note that while subrogation by a guarantor to an allowed administrative expense priority claim under section 507(a)(2) is permitted, subrogation by a guarantor to other types of priority claims under section 507(a) is expressly precluded under section 507(d) of the Bankruptcy Code.

[70] *See In re Microwave Products of America, Inc.*, 118 B.R. 566, 573–74, 23 Collier Bankr. Cas. 2d (MB) 1065 (Bankr. W.D. Tenn. 1990) ("To the extent his claim for contribution would be advantageous to him, e.g., when the contribution or reimbursement claim is secured by assets of the debtor, the surety may opt for reimbursement or contribution by way of a claim allowable under section 502(e) for, as is plain, such claims are allowable save to the extent that sections 502(e)(1)(A), (B), (C) make them disallowable").

[71] *In re White Trailer Corp.*, 266 B.R. 390, 394, 2001-1 U.S. Tax Cas. (CCH) P 70160, 86 A.F.T.R.2d 2000-7370 (Bankr. N.D. Ind. 2000), aff'd, 264 B.R. 916,

claims and the subordination of a guarantor's claims for reimbursement, contribution, or subrogation until the underlying claim is paid in full prevent competition between the guarantor and the beneficiary for the debtor's assets.[72]

An interesting issue arises if a guarantor has its claim disallowed under section 502(e)(1)(B) because the guaranty obligation is contingent but later makes payment on the guaranty to the beneficiary. If a guarantor makes payment to the beneficiary and thus the guarantor's reimbursement or contribution claim is no longer contingent, section 502(j) of the Bankruptcy Code permits the guarantor to move for reconsideration of the disallowance of its claim on the basis that its claim is no longer contingent.[73] Although a guarantor may seek to have the disallowance of its claim reconsidered under section 502(j) even after the primary obligor's bankruptcy case is closed,[74] this remedy may prove a hollow one for the guarantor if insufficient estate assets remain to satisfy its claim. To guard against this risk, when its claim is initially disallowed, the guarantor could move the court for an order requiring the debtor to place property in reserve to satisfy the guarantor's claim if it is ultimately allowed. While a bankruptcy court might conduct an estimation hearing to determine the appropriate amount to place in reserve on account of the guarantor's claim, a bankruptcy court could also determine that a guarantor's contingent claim for reimbursement or contribution (that is being disallowed under section 502(e)(1)(B)) is too contingent to warrant the establishment of a reserve.

2001-2 U.S. Tax Cas. (CCH) P 70170, 88 A.F.T.R.2d 2001-5355 (N.D. Ind. 2001) (noting that notwithstanding partial allowance of co-debtor's claim for contribution or reimbursement under section 502, "any distribution on the co-debtor's claim must be subordinated until the primary creditor's claim is paid in full."); 11 U.S.C.A. § 509(c).

[72]4 Collier on Bankruptcy ¶ 502.LH[8] (16th ed. 2010); Norton Bankruptcy Law and Practice § 48:30 (3d ed.); 11 U.S.C.A. § 502.

[73]Section 502(j) of the Bankruptcy Code permits reconsideration of a claim that has been disallowed for "cause." Courts have noted that if a surety that has its claim disallowed later makes a payment to the principal obligor, the surety could move under section 502(j) for reconsideration of the disallowance of its claim. *See e.g.*, *In re Pinnacle Brands, Inc.*, 259 B.R. 46, 55, 37 Bankr. Ct. Dec. (CRR) 127, 45 Collier Bankr. Cas. 2d (MB) 1037 (Bankr. D. Del. 2001); *Aetna Cas. and Surety Co. v. Georgia Tubing Co.*, 1995 WL 429018, *5 (S.D. N.Y. 1995), aff'd, 93 F.3d 56, 29 Bankr. Ct. Dec. (CRR) 723 (2d Cir. 1996).

[74]*See In re International Yacht and Tennis, Inc.*, 922 F.2d 659, 662 n.9, 24 Collier Bankr. Cas. 2d (MB) 725, Bankr. L. Rep. (CCH) P 73817 (11th Cir. 1991).

V. Limitation of Liability Under Sections 502(b)(6) and 502(b)(7) of the Bankruptcy Code

A. The Section 502(b)(6) Cap on Damages for Termination of Real Property Lease

A debtor may assume or reject its executory contracts and unexpired leases pursuant to section 365 of the Bankruptcy Code. If a debtor rejects an executory contract or unexpired lease, the rejection is deemed a breach of that executory contract or unexpired lease as of the date immediately prior to the date the bankruptcy petition was filed.[75] When the debtor rejects an executory contract or unexpired lease, the nondebtor contract party, landlord, or tenant holds certain rights under the Bankruptcy Code. As a general matter, the nondebtor party is entitled to money damages resulting from the rejection (determined under the nonbankruptcy law applicable to the particular rejected contract or lease), which will be allowed as a prepetition claim against the debtor's estate.

Section 502(b)(6) of the Bankruptcy Code limits a lessor's damages arising from the rejection of a real property lease. Section 502(b)(6) limits a lessor's damages to the rent reserved under the lease for the greater of (1) one year or (2) 15% of the remaining lease term, not to exceed three years after the earlier of the date of the filing of the petition and the date of the surrender or repossession.[76] Even where the lease provides for liquidated damages, courts will impose the section 502(b)(6) cap.[77]

---

[75] *N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 530, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) P 69580, 100 Lab. Cas. (CCH) P 10771 (1984); 11 U.S.C.A. § 365(g)(1).

[76] 11 U.S.C.A. § 502(b)(6). The operation of the section 502(b)(6) cap is illustrated by the following example: Assume that a tenant that files for bankruptcy has a five-year lease, with four years remaining on the lease at a rent of $1,000 per month. Further assume that upon the tenant's rejection of the lease, the landlord is unable to mitigate its damages such that it would be entitled under non-bankruptcy law to a claim of $48,000 (i.e., 48 months of lease payments at $1,000 per month). Under the section 502(b)(6) cap, the landlord's claim would be capped at $12,000 (i.e., one year's rent under the lease), because that amount is greater than 15% of the remaining three years of the lease term (i.e., $4,800, which is the rent for 15% of the three years of the remaining lease term).

[77] *In re Premier Entertainment Biloxi, LLC*, 413 B.R. 370, 51 Bankr. Ct. Dec. (CRR) 219 (Bankr. S.D. Miss. 2009); *see also In re Flanigan*, 374 B.R. 568, 576, 48 Bankr. Ct. Dec. (CRR) 203 (Bankr. W.D. Pa. 2007) (rejecting a lease

1. Nondebtor Guarantor's Liability for Rejection of a Lease

Nondebtor guarantors have argued that the 502(b)(6) cap applicable to lease rejection damages against a debtor principal obligor should also cap the beneficiaries' claims against the nondebtor guarantors under the guaranty. The rationale behind this argument is that the guarantor should not be required to pay any amounts that the principal obligor is not legally required to pay.[78] When faced with these arguments, courts have overwhelmingly concluded that a nondebtor guarantor should not be protected by the section 502(b)(6) cap.[79] In so concluding, courts have primarily cited three reasons to exclude guarantors from the benefits of the section 502(b)(6) cap.

The first reason for maintaining full guarantor liability was set forth by the United States District Court for the District of Maryland in *Bel-Ken Assocs. Ltd. P'ship v. Clark*: "[W]hat good is a guaranteed lease if the guarantor escapes liability when the debtor does?"[80] The answer flowed from common sense and, according to the in *Bel-Ken* court, required that the nondebtor guarantor remain fully liable under the guaranty.[81]

The second reason for maintaining full guarantor liability is founded on section 524(e)[82] of the Bankruptcy Code, which provides that those debts discharged in bankruptcy shall not af-

---

guarantor's argument that the court should find an equitable exception to section 502(b)(6) where the statute clearly applied).

[78]*See In re Modern Textile, Inc.*, 900 F.2d 1184, 1191, Bankr. L. Rep. (CCH) P 73330, 16 Fed. R. Serv. 3d 212 (8th Cir. 1990) ("Defendants argue that, based upon the principle that extinction of the underlying obligation discharges the guarantor's guaranty of that obligation, the Trustee's rejection of the Clarksville sublease . . . terminated the debtor's obligations on the lease and thereby discharged their guaranty at least to the extent of any amount in excess of the amount chargeable against Buyer's bankruptcy estate").

[79]Lichtenstein, Does the Guarantor of a Real Property Lease Enjoy the Protection of Section 502(b)(6) of the Bankruptcy Code?, 33 Real Est. L.J. 46, 51–53 (2004); 4 Collier on Bankruptcy ¶ 502.03[7](f) (16th ed. 2010); Norton Bankruptcy Law and Practice § 48:36 (3d ed.).

[80]*Bel-Ken Associates Ltd. Partnership v. Clark*, 83 B.R. 357, 359 (D. Md. 1988).

[81]Bel-Ken, 83 B.R. at 359.

[82]"[D]ischarge 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.A. § 524(e). Section 16 of the Bankruptcy Act of 1898 preceded section 524(e) and more explicitly countenanced the liability of a guarantor: "[T]he liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt."

fect any obligations by other parties on such debts.[83] As decided by the United States Court of Appeals for the Eighth Circuit, this provision, on its face, excludes guarantors from the protective shelter of section 502(b)(6)'s cap.[84] The Court of Appeals reasoned that the plain language of section 524(e) excludes nondebtors from protection, and courts "must interpret a bankruptcy statute according to its plain meaning, except in the rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters."[85]

The third reason for maintaining full guarantor liability is based on the policy rationales behind section 502(b)(6) of the Bankruptcy Code.[86] The Bankruptcy Code's limitation on damages arising out of the rejection of a real property lease was intended to preserve the estate for creditors other than real property lessors, and such policy justification evaporates in the case of a nondebtor guarantor because the recovery comes from the assets of the guarantor rather than the estate of the debtor.[87]

2. Debtor Guarantor's Liability for Rejection of a Lease

Because a debtor guarantor enjoys the protections of the Bankruptcy Code, debtor guarantors stand in different shoes than those guarantors not in bankruptcy. Most courts note that a plain reading of section 502(b)(6) "underscores that it is the claim of

---

[83]Modern Textile, 900 F.2d at 1191. "[The predecessor to section 524(e)] has been cited in a number of cases which hold that a guarantor's liability remains even after the bankrupt principal is released from liability." Bel-Ken, 83 B.R. at 358 (citing *Union Carbide Corp. v. Newboles*, 686 F.2d 593, 595, 7 Collier Bankr. Cas. 2d (MB) 1, Bankr. L. Rep. (CCH) P 68790 (7th Cir. 1982); *R.I.D.C. Indus. Development Fund v. Snyder*, 539 F.2d 487, 490 n.3, 20 U.C.C. Rep. Serv. 188 (5th Cir. 1976); (*U. S. on Behalf of Small Business Administration v. Kurtz*, 525 F. Supp. 734, 32 U.C.C. Rep. Serv. 1688 (E.D. Pa. 1981), aff'd, 688 F.2d 827 (3d Cir. 1982) and (disavowed by, C.I.T. Corp. v. Anwright Corp., 191 Cal. App. 3d 1420, 237 Cal. Rptr. 108, 3 U.C.C. Rep. Serv. 2d 1638 (2d Dist. 1987)); *In re Harvey Cole Co., Inc.*, 2 B.R. 517, 22 C.B.C. 673 (Bankr. W.D. Wash. 1980)).

[84]Modern Textile, 900 F.2d at 1191.

[85]*In re Arden*, 176 F.3d 1226, 1229, 34 Bankr. Ct. Dec. (CRR) 551, 42 Collier Bankr. Cas. 2d (MB) 1, Bankr. L. Rep. (CCH) P 77937 (9th Cir. 1999) (internal quotation marks omitted) (quoting *U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 18 Bankr. Ct. Dec. (CRR) 1150, Bankr. L. Rep. (CCH) P 72575, 89-1 U.S. Tax Cas. (CCH) P 9179, 63 A.F.T.R.2d 89-652 (1989)).

[86]Arden, 176 F.3d at 1229.

[87]Exceptions to this argument exist, as where the debtor merged with the guarantor prior to bankruptcy. *See Fisher v. Lee Bros. Value World, Inc.*, 486 F.2d 1037, 1038 (9th Cir. 1973); Arden, 176 F.3d at 1229.

the lessor, not the status of the lessee—or its agent or guarantor—that triggers application of the [section 502(b)(6)] [c]ap."[88] The identity of the debtor thus becomes secondary, as the statutory language relates to the claimant. Because the language of section 502(b)(6) relates to the claim of a lessor, as opposed to the status of a lessee, most courts considering whether a claim against a debtor guarantor should be subject to the section 502(b)(6) cap have held that the cap applies to reduce a claim of a lessor against a debtor guarantor for damages resulting from the termination of a real property lease.[89] Observing that the claim before it was a "claim of a lessor" for "damages resulting from the termination of a lease of real property," the United States Court of Appeals for the Ninth Circuit wrote in *In re Arden* that "[b]ecause the [section 502(b)(6) cap] snugly fits, the [lower] court should have donned it."[90]

In only a couple cases has the section 502(b)(6) cap not been applied to a lessee's claim against a debtor guarantor.[91] In *In re Danrik*, the United States Bankruptcy Court for the Northern District of Georgia relied on the following equitable considerations to deny a debtor guarantor protection of section 502(b)(6)'s cap:

(1) the lessee was not a debtor in bankruptcy,
(2) the debtor guarantor was solvent,
(3) the debtor guarantor was already reorganized,
(4) the lease was short-term, and
(5) the debtor guarantor paid all other unsecured creditors in full.[92]

The court in *In re Dronebarger* similarly refused to apply the cap where all unsecured claims against the debtor would be paid in

---

[88] Arden, 176 F.3d at 1229.

[89] "Although the language of § 502(b)(6) neither includes nor excludes claims of a lessor against a guarantor of a lease, case law strongly indicates that the cap applies to guarantors of leases in bankruptcy, as well as lessees." *In re Southern Cinemas, Inc.*, 256 B.R. 520, 534, 37 Bankr. Ct. Dec. (CRR) 12, 45 Collier Bankr. Cas. 2d (MB) 567 (Bankr. M.D. Fla. 2000); Lichtenstein, *supra* note 79, 47–51.

[90] *In re Southern Cinemas, Inc.*, 256 B.R. 520, 37 Bankr. Ct. Dec. (CRR) 12, 45 Collier Bankr. Cas. 2d (MB) 567 (Bankr. M.D. Fla. 2000).

[91] *In re Danrik, Ltd.*, 92 B.R. 964, 18 Bankr. Ct. Dec. (CRR) 642, 20 Collier Bankr. Cas. 2d (MB) 43, Bankr. L. Rep. (CCH) P 72484 (Bankr. N.D. Ga. 1988). The Danrik case has been roundly criticized by subsequent decisions, especially due to subsequent Supreme Court assertions relating to statutory interpretation. *See* Arden, 176 F.3d at 1229.

[92] *See In re Danrik, Ltd.*, 92 B.R. at 970–72 (Bankr. N.D. Ga. 1988).

full.[93]

B. Section 502(b)(7) Cap on Damages Relating to Termination of Employment Contract

Similar to its counterpart relating to the termination of a real property lease, section 502(b)(7) establishes a cap on the maximum allowable claim for damages for an employee arising from the termination of an employment contract. Section 502(b)(7) limits an employee's allowable claim to (a) compensation for one year following the earlier of the bankruptcy petition or the termination of the contract, plus (b) any unpaid compensation due as of the earlier of those dates. As with the section 502(b)(6) lease rejection cap, the section 502(b)(7) cap establishes a limit on the maximum claim to be allowed against and paid from the bankruptcy estate and is neither a substantive damages remedy nor a limit on substantive damages.[94]

1. Applicability of Section 502(b)(7) Cap to Nondebtor Guarantors

The few cases addressing the issue of whether or not a nondebtor guarantor may avail itself of the section 502(b)(7) cap (where the principal obligor has commenced a bankruptcy case) to limit exposure under a guaranty of an employment contract are in accord with the vast majority of the cases under section 502(b)(6).[95] As in the section 502(b)(6) context, nondebtor guarantors remain liable to creditors for the full amount of the guaranty and are unable to use the bankruptcy of the primary obligor as a basis to invoke the protections of the section 502(b)(7) cap.[96]

2. Applicability of the Section 502(b)(7) Cap to Debtor Guarantors

Unlike the section 502(b)(6) cap, courts have not given debtor guarantors the benefits of the section 502(b)(7) cap.[97] In holding that section 502(b)(7) (then numbered as section 502(b)(8)) did

---

[93] *In re Dronebarger*, 2011 WL 350479, *20 (Bankr. W.D. Tex. 2011).

[94] *See* Condor Systems, 296 B.R. at 12.

[95] *See supra* Part V.A.

[96] *See In re Modern Textile, Inc.*, 28 B.R. 181, 188 (Bankr. E.D. Mo. 1983) (holding that section 502(b)(7), then called section 502(b)(8), does not limit claim of employee against non-debtor guarantors of an employment contract).

[97] *In re Goforth*, 179 F.3d 390, 394, 34 Bankr. Ct. Dec. (CRR) 800, 42 Collier Bankr. Cas. 2d (MB) 366, Bankr. L. Rep. (CCH) P 77957 (5th Cir. 1999) ("§ 502(b)(7) does not limit the claim of an employee against the guarantor of an employment contract."); *In re Johnson*, 117 B.R. 461, 20 Bankr. Ct. Dec. (CRR)

not protect debtor guarantors, the United States Bankruptcy Court for the District of Minnesota in *In re Johnson* reasoned that "[t]he whole tenor of [section 502(b)(7)] is such as to limit it to claims against debtors which were the employers in contractual privity with the employee-claimant under the contract in question."[98] In *Hall v. Goforth*, the United States Court of Appeals for the Fifth Circuit recognized that there are several cases holding that the section 502(b)(6) lease rejection damages cap protects debtor guarantors but declined to extend the protection of the section 502(b)(7) employee damages cap to debtor guarantors, arguing that it had a "duty to avoid reading broadly provisions such as § 502(b)(7)."[99] Instead, the *Goforth* court approvingly cited *Johnson*'s conclusion that the section 502(b)(7) cap only applies where the terminated employment relationship runs directly between the debtor and the claimant.[100]

It is not clear whether other cases will follow cases such as *Goforth* and *Johnson* that hold that the section 502(b)(7) cap is inapplicable to debtor guarantors or will instead choose to follow those cases decided in the section 502(b)(6) context that hold that debtor guarantors enjoy the protection of the section 502(b)(6) cap. Given the similar language of sections 502(b)(6) and 502(b)(7), it is possible that courts could choose to follow the reasoning of the line of section 502(b)(6) cases holding that debtor guarantors benefit from the section 502(b)(6) cap and conclude that debtor guarantors should likewise benefit from the section 502(b)(7) cap on claims for damages resulting from the termination of an employment contract. Alternatively, it is possible that courts will look to the cases decided in the section 502(b)(7) context when addressing the applicability of the section 502(b)(6) cap to claims against a debtor guarantor.

C. Reimbursement, Contribution and Subrogation Claims Capped by Section 502(b)(6) and Section 502(b)(7)

If a guarantor pays amounts owed under a guaranty of a real property lease or employment contract and such lease or employment contract is rejected in the principal obligor's bankruptcy case, the guarantor may not seek recovery from the debtor on a claim greater than the capped amounts as set forth in section

---

1324 (Bankr. D. Minn. 1990) (holding that section 502(b)(8), later renumbered as section 502(b)(7), did not limit claim against a debtor guarantor for damages under a guaranty of an employment contract).

[98] Johnson, 117 B.R. at 469.

[99] Goforth, 179 F.3d at 394.

[100] Goforth, 179 F.3d at 394 (citing Johnson, 117 B.R. at 469).

502(b)(6) and section 502(b)(7). Section 502(e)(1)(A) specifically provides that the claim of the guarantor for reimbursement or contribution depends on the vitality of the underlying claim against the debtor. Because the claim by a lessor or employee for an amount in excess of the section 502(b)(6) and section 502(b)(7) caps would be disallowed, the dependent reimbursement or contribution claim of a guarantor for an amount in excess of the applicable statutory cap will likely be disallowed as well.[101] The same will likely be true under section 509 for subrogated claims,

[101]"A co-obligor may file a claim on its own behalf for reimbursement or contribution, which will be allowed to the extent the creditor's claim is allowed." Condor Systems, 296 B.R. at 16. In *Condor*, the court noted that the underlying premise of the caps imposed by section 502(b)(6) and (b)(7) of the Bankruptcy Code is that property of the estate should only be liable up to the statutory cap for damages arising from the termination of a lease or the termination of an employee. The cap on allowable claims applies regardless of whether the claimant is the landlord or employer or a co-obligor asserting reimbursement, contribution, or subrogation rights. The court in *Condor* held that the cap on allowable claims should not be reduced to reflect payments to a terminated employee made under a letter of credit because to reduce the amount of allowed claims would frustrate the letter of credit issuer's rights to contribution, reimbursement, or subrogation. Condor, 296 B.R. at 15–16. The court distinguished the result under the section 502(b)(7) cap from the result under the cases addressing the section 502(b)(6) cap, which provide that the amount of a security deposit, including a security deposit delivered by the issuance of a letter of credit, would reduce the allowable amount of a claim for lease termination. The reason for the divergent result with respect to security deposits is the presumption under landlord-tenant law that a security deposit on a lease is refundable to the lessee and is not entirely the landlord's property. Thus, if the amount of a security deposit was not counted against the cap on allowable damages under 502(b)(6), a landlord's total allowed claims against a tenant's bankruptcy estate could exceed the maximum amount allowable under the cap and thereby defeat the purpose of section 502(b)(6). *See In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 202–10, 41 Bankr. Ct. Dec. (CRR) 16, 49 Collier Bankr. Cas. 2d (MB) 1749, Bankr. L. Rep. (CCH) P 78824 (3d Cir. 2003) (holding that a landlord's claim, which was capped by section 502(b)(6), must be reduced by the amount drawn on a letter of credit, which was provided to the landlord in lieu of a security deposit, and concluding that the landlord's claim was not rendered impaired solely by operation of the section 502(b)(6) cap for purposes of treatment under a Chapter 11 plan); *In re Mayan Networks Corp.*, 306 B.R. 295, 300–01, 42 Bankr. Ct. Dec. (CRR) 196, 52 Collier Bankr. Cas. 2d (MB) 815, 53 U.C.C. Rep. Serv. 2d 105 (B.A.P. 9th Cir. 2004) (holding that landlord's draw on letter of credit secured by debtor's property had to be deducted from landlord's claim for lease termination damages, after statutory cap on landlord's claim for such damages had been applied, to reduce landlord's allowed unsecured claim against that estate because the letter of credit was in the nature of a security deposit that impacted on property of the estate); *but see In re Stonebridge Technologies, Inc.*, 430 F.3d 260, 268–74, 45 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 80389 (5th Cir. 2005) (concluding that the section 502(b)(6) cap was not triggered and did not limit the lessor's claim where the claim was substantially

since the guarantor assumes the underlying claim of the beneficiary.[102] Although section 502(e)(1)(A) does not apply to subrogation claims, the subrogation claim by a guarantor in excess of the statutory cap should be disallowed because a guarantor would only become subrogated to a claim to the extent that the beneficiary has a valid, allowable claim against the guarantor.

VI. Enforceability of Guaranties Against Multiple Debtors

A. General Principles

Generally, when a claimant holds a claim with respect to which multiple parties are liable, the claimant may assert the entire claim, as it existed on the petition date, against the estate of each bankrupt obligor and recover distributions from each obligors' estate on the basis of the full amount of the petition date claim.[103] Until the claim has been paid in full, the claim need not be reduced to reflect any partial payments made by other obligors post-petition.[104] Also, a creditor is generally not required to first pursue any third-party collateral or guaranties prior to seeking satisfaction from the debtor's estate.[105] The creditor can seek to recover its full claim from the debtor's estate without regard to the existence of third-party collateral or guaranties or proceeds received therefrom after the petition date.[106]

The principle that a creditor may assert its full claim against

---

secured by cash and a letter of credit, which the court concluded were not property of the debtor's estate, and the lessor did not file a proof of claim).

[102]*See* In re Wingspread Corp., 116 B.R. 915 at 931, 24 Collier Bankr. Cas. 2d (MB) 244 (Bankr. S.D. N.Y. 1990) (noting that "one who is entitled to invoke the doctrine of subrogation is entitled to the benefit of the rights that flow with the claim").

[103]*See, e.g.*, *In re Realty Associates Securities Corp.*, 66 F. Supp. 416, 424 (E.D. N.Y. 1946), judgment aff'd, 162 F.2d 350 (C.C.A. 2d Cir. 1947) and aff'd in part, modified in part on other grounds, 163 F.2d 387 (C.C.A. 2d Cir. 1947).

[104]Realty Associates, 66 F. Supp. at 424.

[105]*In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413, 417, 27 Bankr. Ct. Dec. (CRR) 284 (Bankr. E.D. Pa. 1995). Note that in some narrow circumstances, the doctrine of marshaling of assets might come into play and alter this general rule. *See generally* Henry Karwowski, Marshaling Against Guarantors: Not a Fool's Errand?, 23 Am. Bankr. Inst. J. 6 (Dec./Jan. 2005).

[106]*See R.F.C. v. Denver & R.G.W.R. Co.*, 328 U.S. 495, 66 S. Ct. 1282, 90 L. Ed. 1400 (1946) (citing *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245, 55 S. Ct. 685, 79 L. Ed. 1419 (1935)). For more cases that follow the same general principle, *see In re Gessin*, 668 F.2d 1105, 1107 (9th Cir.

multiple obligors until paid in full permits the enforcement of multiple guaranties of the same obligation where the guarantors are also in bankruptcy. This allows the creditor to maximize its recovery against each debtor guarantor. For example, suppose that Company Alpha is the parent of Company Beta and Company Gamma, each of which execute guaranties of notes issued by Company Alpha to a third party, Creditor Delta. If Company Alpha, Company Beta, and Company Gamma each files for bankruptcy, Creditor Delta will be able to file proofs of claim for the full amount owed under the notes against each debtor company. If, post-petition, Company Beta pays part of Creditor Delta's claim, Creditor Delta will not be required to reduce its proof of claim against Company Alpha or Company Gamma by that amount. Instead, Creditor Delta will be allowed to assert the entire amount of its claim against Company Alpha and Company Gamma and seek a recovery on the entire pre-petition claim until it obtains full satisfaction of its claim.[107]

Of course, Company Delta may not receive more than full recovery. Returning to the above example, suppose that Company Alpha is the principal obligor of an unsecured $100 million note and Company Beta and Company Gamma each executed unsecured guaranties for $100 million of the same note. Creditor Delta holds the $100 million note issued by Company Alpha and is the beneficiary of each of the guaranties. If Company Alpha's plan of reorganization provides a 75% distribution to unsecured creditors, Company Beta's plan of reorganization provides a 50% distribution to unsecured creditors, and Company Gamma's plan of reorganization provides no distribution to unsecured creditors,

---

1982) ("It has long been established that a creditor is entitled to pursue his claims against others liable on the same debt to the full extent of the amount owed on that debt"); *In re Washington Bancorporation*, 1996 WL 148533, *18 (D.D.C. 1996) (applying the principle that "a bankruptcy claim is not reduced or impaired by subsequent payments received from third party obligors until such claim has been satisfied in full"); *In re F.W.D.C., Inc.*, 158 B.R. 523, 528 (Bankr. S.D. Fla. 1993) (finding that a creditor is allowed to "prove the total amount of an indebtedness against a guarantor-debtor without deducting the amount of collateral received from a third party"); *In re Northeast Dairy Co-op. Federation, Inc.*, 88 B.R. 21 (Bankr. N.D. N.Y. 1988) (permitting creditor to assert the full amount of its claim against each debtor that is jointly and severally liable on the claim and finding that the joint and several nature of the debtors' obligation does not affect the total amount due on the claim); *In re Coastland Chrysler Plymouth, Inc.*, 76 B.R. 212, 213, 16 Bankr. Ct. Dec. (CRR) 282 (Bankr. S.D. Fla. 1987) (finding that a creditor's claim should not be reduced unless and until it has been paid in full).

[107] *See* Mark P. Kronfeld, The Anatomy of a Double-Dip, 31 ABI Journal 24 (Mar. 2012).

then Creditor Delta would stand to recover a total of $125 million from Company Alpha and Company Beta. This result would obviously be inequitable, and the law precludes such recovery by Creditor Delta. The "single satisfaction" rule prevents a creditor from ultimately collecting more than the full value of the claims less the amounts previously received from a third party obligor.[108] However, unless and until the creditor's claims are satisfied in full, the creditor is entitled to assert the full amount of its claims in the debtor's bankruptcy proceedings.[109] If, however, the payments made by the guarantors, together with the payments made by the principal obligor, exceed the total amount of indebtedness owed to the creditor, the creditor would hold such excess in trust for the guarantors.[110]

If there are multiple guaranties on the same principal obligation, the beneficiary may choose which guarantor to assert a claim against. To avoid paying more than its fair share of liability, the guarantor that makes payment to the beneficiary may be able to obtain contribution from the other guarantors of their fair share of liability on the principal obligation, either pursuant to a contribution agreement among the guarantors or under a theory of equitable contribution.[111]

The general rule that a claimant that with a claim against multiple debtors may assert the entire claim, as it existed on the petition date, against the estate of each bankrupt obligor has its

---

[108]*See In re Washington Bancorporation*, 1996 WL 148533, *17 (D.D.C. 1996).

[109]*See In re Washington Bancorporation*, 1996 WL 148533, *17 (D.D.C. 1996); *see also* F.W.D.C., 158 B.R. at 528 ("if a creditor received collateral of a third party worth $8 million securing the third party's indebtedness of $10 million and the guarantor of this $10 million indebtedness were in bankruptcy, such creditor would be allowed to prove a claim of $10 million but would not be allowed to realize more than $2 million").

[110]In re Realty Associates, 66 F. Supp. at 423.

[111]In the absence of a contribution agreement among guarantors, a guarantor who pays more than its fair share of liability may be able to recover from other guarantors of the same principal obligation under a theory of equitable contribution. *See, e.g.*, *Clark v. Trumble*, 44 Mass. App. Ct. 438, 692 N.E.2d 74, 80, 35 U.C.C. Rep. Serv. 2d 184 (1998); *Rodehorst v. Gartner*, 266 Neb. 842, 669 N.W.2d 679, 685–86, 51 U.C.C. Rep. Serv. 2d 604 (2003); *Barone v. O'Connell*, 785 A.2d 534, 536 (R.I. 2001); *Jans v. Nelson*, 83 Cal. App. 4th 848, 100 Cal. Rptr. 2d 106, 115 (5th Dist. 2000); *McCarthy v. Schwalje*, 234 N.J. Super. 396, 560 A.2d 1283, 1284 (Ch. Div. 1988) (noting that a guarantor "has a right to exoneration, and in cases of hardship an equity court may order the other guarantors to pay their fair share before a default where otherwise an action at law or in equity would be required to reimburse the plaintiff through equitable contribution").

origins in a 1935 Supreme Court case, *Ivanhoe Building & Loan Association of Newark, N.J. v. Orr*.[112] In *Ivanhoe*, the Supreme Court ruled that a creditor who had recovered a portion of the debt owed through foreclosure against a nondebtor's property could still assert the full amount of the claim against the bankrupt entity, provided that the creditor could not recover more than the full amount of its claim.[113] This ruling has been affirmed over the years by the lower courts.[114]

However, in *In re National Energy and Gas Transmission, Inc.*, the Fourth Circuit arguably placed the *Ivanhoe* principle into question, at least where applicable nonbankruptcy law provides that a co-obligor could reduce the amount of its liability where the creditor partially recovers on the debt from one or more other co-obligors. The court reasoned that *Ivanhoe* provides that, as a matter of bankruptcy law, a creditor need not deduct from its bankruptcy claim amounts received from nondebtor third parties in partial satisfaction of its claim.[115] However, the *National Energy* court went further, stating that this "merely leads to the question of what the value of [the creditor's] debt is, and New York law (i.e., applicable nonbankruptcy law) provides the answer to this question."[116] The court concluded that since the guarantor was a surety, and not a co-obligor under New York law, state law did not require that the claim against the principal obligor be reduced.[117] It is not yet clear whether other courts will follow the *National Energy* analysis and require a determination of whether

---

[112]*Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[113]Ivanhoe Building & Loan, 295 U.S. at 244–47.

[114]*E.g.*, *Feder v. John Engelhorn & Sons*, 202 F.2d 411, 412–13 (2d Cir. 1953) (citing *Ivanhoe* and ruling that a secured creditor that had received some recovery from security provided by a third party could still assert the full amount of its claim against the bankrupt, so long as it did not recover more than the full amount owed); In re Realty Associates, 66 F. Supp. at 424 ("[I]t has been conclusively settled that an obligee of a bond or the holder of a claim upon which several parties are liable may prove its entire claim against the estate of any who become bankrupt . . .."); *see infra* note 106.

[115]*In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[116]*In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[117]*In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

a creditor's claim is reduced as a matter of applicable nonbankruptcy law by recoveries from other obligors or sureties, in order to determine whether to follow the general principle set forth in *Ivanhoe*.[118]

B. Substantive Consolidation

The general principle that a creditor may assert its full claim against joint obligors will apply even when one co-obligor is wholly owned by another co-obligor.[119] If the co-obligors are substantively consolidated, however, the claims against multiple guarantors (or against a primary obligor and a guarantor) will merge into a single claim against the substantively consolidated entities.[120] After substantive consolidation,[121] the assets and liabilities of the consolidated entities are pooled and claims are satisfied from the combined assets of the consolidated entity.[122] As a result, intercompany claims are eliminated and recovery is redistributed among the creditors of the consolidated companies, as each consolidated company is likely to have a different asset-

---

[118]*See* Joel H. Levitin & Michael R. Carney, Satisfaction Not Guaranteed—Claims Against Guarantors in Bankruptcy, BNA Bankr. L. Rep. (June 13, 2013). The only court to address this reasoning in *National Energy* has rejected this portion of the ruling as "at most an alternative holding" and followed *Ivanhoe* as a general bankruptcy law principle. *In re Del Biaggio*, 496 B.R. 600, 605 (Bankr. N.D. Cal. 2012).

[119]In re Northeast Dairy Co-op. Federation, Inc., 88 B.R. 21 at 24 (Bankr. N.D. N.Y. 1988).

[120]*See In re Owens Corning*, 419 F.3d 195, 212, 45 Bankr. Ct. Dec. (CRR) 36, Bankr. L. Rep. (CCH) P 80343 (3d Cir. 2005), as amended, (Oct. 12, 2005) (noting that effect of "deemed" substantive consolidation would be to eliminate guaranties by subsidiaries of parent company's indebtedness under credit facility to banks); *See also In re Parkway Calabasas Ltd.*, 89 B.R. 832, 837, 18 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 72428 (Bankr. C.D. Cal. 1988), subsequently aff'd, 949 F.2d 1058 (9th Cir. 1991) (explaining that "[a]ssets and liabilities of each entity are pooled and inter-entity accounts and claims are eliminated. Creditors of the separate entities become creditors of the consolidated entity. Duplicative claims by creditors, uncertain as to which debtor owes their debts, are eliminated").

[121]Substantive consolidation is a complex topic, which this article only briefly addresses in relation to the enforceability of guaranties against multiple debtors. For a thorough discussion of substantive consolidation, *see* Mary Elisabeth Kors, Altered Egos: Deciphering Substantive Consolidation, 59 U. Pitt. L. Rev. 381 (1998); J. Stephen Gilbert, Note, Substantive Consolidation in Bankruptcy: A Primer, 43 Vand. L. Rev. 207 (1990); Kit Weitnauer, Substantive Consolidation of Non-Debtors: Another Perspective, 23 Am. Bankr. Inst. J. 1 (2004).

[122]In re Owens Corning, 419 F.3d at 211; *In re World Access, Inc.*, 301 B.R. 217, 272 (Bankr. N.D. Ill. 2003).

to-liability ratio.[123] The holder of a bankruptcy claim against multiple substantively consolidated companies will only be able to prove and recover on a single claim against the consolidated pool of assets. When considering substantive consolidation in the context of guaranties, it is important to bear in mind that in a few cases courts have ordered the substantive consolidation of a debtor with a nondebtor,[124] although most courts urge particularly strong caution in doing so.[125] Consequently, it might be possible under certain circumstances for a bankruptcy court to order the substantive consolidation of a nondebtor guarantor with a debtor guarantor or a debtor principal obligor.

In the guaranty context, substantive consolidation and the resulting limitation of a creditor to a single consolidated claim on account of multiple guaranties and/or the principal obligation may have a profound adverse economic impact on the holder of such claim. Returning to the above example, assume that the bankruptcy court ordered the substantive consolidation of Company Alpha, Company Beta, and Company Gamma. The companies would then be treated as a single company with a single pool of assets and liabilities. Creditor Delta would have the ability to assert its claim only against the joint pool. Further assume that, absent substantive consolidation, Company Alpha could have paid Creditor Delta 25% of the $100 million owed, Company Beta could have paid 50% of the $100 million, and Company Gamma could have paid 25% of the $100 million, resulting in a full $100 million recovery for Creditor Delta from the nonconsolidated estates of Company Alpha, Company Beta, and Company Gamma. However, if the consolidated plan of reorgani-

---

[123]Owens Corning, 419 F.3d at 211.

[124]*See, e.g.*, *In re United Stairs Corp.*, 176 B.R. 359, 369, 32 Collier Bankr. Cas. 2d (MB) 1908 (Bankr. D. N.J. 1995); *see also In re S & G Financial Services of South Florida, Inc.*, 451 B.R. 573, 584–85 (Bankr. S.D. Fla. 2011) (denying a motion to dismiss Chapter 7 trustee's motion to substantively consolidate a debtor with two of its non-debtor affiliates).

[125]*See e.g.*, *In re Fas Mart Convenience Stores, Inc.*, 320 B.R. 587, 594 (Bankr. E.D. Va. 2004) (substantive consolidation between debtors and non-debtors "requires an even more cautious application of the usual test"); *In re Alico Mining, Inc.*, 278 B.R. 586, 589 (Bankr. M.D. Fla. 2002) (such consolidation would be appropriate only after a "searching inquiry" and after a "substantial" showing); *In re Lease-A-Fleet, Inc.*, 141 B.R. 869, 872–73 (Bankr. E.D. Pa. 1992); *but see In re Pearlman*, 462 B.R. 849, 856, 55 Bankr. Ct. Dec. (CRR) 275, 66 Collier Bankr. Cas. 2d (MB) 1522, Bankr. L. Rep. (CCH) P 82157 (Bankr. M.D. Fla. 2012) (ruling that substantive consolidation of a debtor with non-debtors was impermissible, since substantive consolidation is a remedy distinct to bankruptcy).

zation for Company Alpha, Company Beta, and Company Gamma calls for a payment of less than a 100% dividend to creditors in Creditor Delta's class, Creditor Delta will recover less than it would absent substantive consolidation. Because of the dangers in forcing creditors of one debtor to share equally with creditors of a less solvent debtor, substantive consolidation is regarded as a measure vitally affecting substantive rights.[126] Accordingly, courts generally regard substantive consolidation as a remedy that should be used sparingly.[127]

The intersection of intercorporate guaranties and substantive consolidation in complex corporate enterprises was addressed by the United States Court of Appeals for the Third Circuit in *In re Owens Corning*.[128] In *Owens Corning*, the debtors sought to obtain a "deemed substantive consolidation" of a parent corporation and its subsidiary guarantors.[129] The result of substantive consolidation of the parent company and subsidiary guarantors would have been to eliminate the subsidiary guarantees that various

---

[126]*In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518, 18 Bankr. Ct. Dec. (CRR) 852, Bankr. L. Rep. (CCH) P 72482 (2d Cir. 1988) (quotations omitted); Owens Corning, 419 F.3d at 211.

[127]Augie/Restivo, 860 F.2d at 518 ("[B]ecause substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this 'rough justice' remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies."); Augie/Restivo, 860 F.2d at 518 (substantive consolidation is a remedy that should be used "sparingly").

[128]Owens Corning, 419 F.3d at 195.

[129]In *Owens Corning*, the Third Circuit declared five principles for determining whether or not substantive consolidation is appropriate in a given case. Those principles are:

> (1) limiting liability by respecting entity separateness is a "fundamental ground rule." "As a result, the general expectation of state law and of the Bankruptcy Code, and thus of commercial markets, is that courts respect entity separateness absent compelling circumstances calling equity (and even then only possibly substantive consolidation) into play";
>
> (2) "[t]he harms substantive consolidation addresses are nearly always those caused by debtors (and entities they control) who disregard separateness," rather than by creditors;
>
> (3) "mere benefit to the administration of the case (for example, allowing a court to simplify a case by avoiding other issues or to make post-petition accounting more convenient) is hardly a harm calling substantive consolidation into play";
>
> (4) "because substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this "rough justice" remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies (for example, the possibility of more precise remedies conferred by the Bankruptcy Code)"; and
>
> (5) "[w]hile substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used of-

banks had obtained. In reversing the district court's grant of the deemed substantive consolidation, the Third Circuit recognized the importance of intercompany guaranties in enabling large corporate enterprises to obtain credit and indicated that undoing the bargain struck in such an arrangement by substantively consolidating the primary obligor and its subsidiary guarantors would prove a "demanding task."[130] The Third Circuit rejected the argument that the banks that obtained the subsidiary guaranties had relied on the credit of the consolidated enterprise, notwithstanding the fact that the banks did not obtain separate financial statements for each of the subsidiary guarantors. Specifically, the court relied on the fact that the banks had obtained structural seniority for their claims by relying on the existence of subsidiary guarantors as entities separate from the parent.[131] Additionally, the Third Circuit rejected the argument that the benefit to the parent corporation's other creditors, at the expense of the banks that obtained subsidiary guaranties, could qualify as a benefit to creditors that could justify substantive consolidation, particularly where the proponents of substantive consolidation could not demonstrate that the assets and liabilities of the parent and subsidiary guarantors were "hopelessly commingled."[132]

---

fensively (for example, having a primary purpose to disadvantage tactically a group of creditors in the plan process or to alter creditor rights)."

Thus, in the Third Circuit, the proponent of substantive consolidation must demonstrate "(absent consent) concerning the entities for whom substantive consolidation is sought that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) post-petition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors." Owens Corning, 419 F.3d at 211–12.

[130]Owens Corning, 419 F.3d at 212 ("To begin, the Banks did the 'deal world' equivalent of 'Lending 101.' They loaned $2 billion to OCD and enhanced the credit of that unsecured loan indirectly by subsidiary guarantees covering less than half the initial debt. What the Banks got in lending lingo was 'structural seniority'—a direct claim against the guarantors (and thus against their assets levied on once a judgment is obtained) that other creditors of OCD did not have. This kind of lending occurs every business day. To undo this bargain is a demanding task").

[131]Owens Corning, 419 F.3d at 213–14.

[132]Owens Corning, 419 F.3d at 214 ("As we have explained, commingling justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities will reduce the recovery of every creditor—that is, when every creditor will benefit from the consolidation. Moreover, the benefit to creditors should be from cost savings that make assets available rather than from the shifting of assets to benefit one group of creditors at the expense of another").

The case law on substantive consolidation establishes that courts do have some flexibility in ordering substantive consolidation. Courts may, where appropriate, restrict substantive consolidation to treat the parties equitably and to avoid prejudice to an innocent party.[133] "The bankruptcy court has the power, in appropriate circumstances, to order less than complete substantive consolidation, or to place conditions on the substantive consolidation."[134] For example, in *In re F.W.D.C. Inc.*, the court allowed the debtor co-obligors to substantively consolidate, subject to the condition that the creditor's claim against the newly consolidated debtors be preserved and otherwise remain unaffected.[135] This approach allows bankruptcy courts to grant substantive consolidation and realize its benefits, while at the same time protecting creditors of multiple obligors from realizing less on their claims than they would have absent consolidation.

VII. Preferences, Fraudulent Transfers, and Intercorporate Guaranties

Often, businesses organized through multiple entity corporate structures obtain financing through the use of "intercompany guaranties." While such financing practices may be valuable tools and readily enforceable in most business contexts,[136] they may become particularly vulnerable to attack in the bankruptcy context.[137] Two potential avenues of attack would be to recover the payment under a guaranty as a preferential transfer or to avoid the guaranty itself as a fraudulent transfer.

---

[133] *In re Jeter*, 171 B.R. 1015, 1020 (Bankr. W.D. Mo. 1994), decision aff'd, 178 B.R. 787 (W.D. Mo. 1995), opinion aff'd, 73 F.3d 205, 28 Bankr. Ct. Dec. (CRR) 513, Bankr. L. Rep. (CCH) P 76751 (8th Cir. 1996).

[134] *In re Parkway Calabasas Ltd.*, 89 B.R. 832, 837, 18 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 72428 (Bankr. C.D. Cal. 1988), subsequently aff'd, 949 F.2d 1058 (9th Cir. 1991); *see also In re Giller*, 962 F.2d 796, 799, 22 Bankr. Ct. Dec. (CRR) 1505, Bankr. L. Rep. (CCH) P 74547 (8th Cir. 1992) (stating that "the bankruptcy court retains the power to order a less than complete consolidation"); *In re Jennifer Convertibles, Inc.*, 447 B.R. 713, 724, 65 Collier Bankr. Cas. 2d (MB) 259 (Bankr. S.D. N.Y. 2011).

[135] F.W.D.C., 158 B.R. at 526–28.

[136] Jack F. Williams, The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System, 15 Cardozo L. Rev. 1403, 1409–1410 (1994).

[137] "It is well-established that a bankruptcy trustee may avoid transfers made by the bankrupt to pay valid debts of a corporate affiliate." *In re C-T of Virginia, Inc.*, 124 B.R. 700, 702 (W.D. Va. 1990) (citing *In re Rodriguez*, 895 F.2d 725, 22 Collier Bankr. Cas. 2d (MB) 633, Bankr. L. Rep. (CCH) P 73282 (11th Cir. 1990); *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991, 8 Bankr. Ct. Dec. (CRR) 297 (2d Cir. 1981)).

A. Preferential Transfers

Payments made by a guarantor on a guaranty within the 90-day preference period (or the one-year period in the case of a payment made to insiders) are vulnerable to attack as preferential transfers. However, unlike fraudulent transfer law, which permits a trustee (or debtor in possession) to avoid all "obligations incurred by the debtor" satisfying the test for a fraudulent transfer, the Bankruptcy Code's preference provision—section 547(b)—only applies to a "transfer of an interest of the debtor in property." Since section 547(b) only applies to a "transfer of an interest of the debtor in property," as opposed to "obligations incurred by the debtor," only the payment under a guaranty, as opposed to the guaranty itself, should be able to be avoided as a preference. Under fraudulent transfer law, the guaranty itself may be avoided as a fraudulent transfer.[138]

Section 547(b) of the Bankruptcy Code[139] grants a trustee (or a debtor in possession in a case under Chapter 11 (or creditors given standing to pursue claims on behalf of the debtor's estate)) the power to recover certain payments or to unwind other types of transfers made to creditors within 90 days before the bankruptcy filing (or one year for transfers involving "insiders" of the debtor). The preference action aims to ensure that creditors are treated equitably with respect to any distributions they are entitled to receive. To establish the elements of a preference

---

[138] A security interest granted in connection with a guaranty can also potentially be avoided as a preference if created or perfected within the applicable preference window.

[139] Section 547(b) states:

> (b) Except as provided in subsection (c) of this section, the trustee [or debtor in possession] may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> (A) the case were a case under Chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C.A. § 547(b).

claim, the trustee need only show that a payment was made to or for the benefit of a creditor during the 90-day pre-bankruptcy period (or the one-year period with respect to "insiders" of the debtor) in respect of an antecedent debt and that the creditor received more than it would have received in a liquidation.[140] If the elements for a preferential transfer are satisfied, the recipient of such transfer is liable for the amount preferentially transferred, unless one of the statutory affirmative defenses in section 547(c) of the Bankruptcy Code applies or there is an exemption from avoidance under one of the Bankruptcy Code's financial contract safe harbors.[141]

Once a transfer is identified as an avoidable preference under section 547(b), section 550(a) of the Bankruptcy Code identifies those from whom that preferential transfer may be recovered, including "the initial transferee of such transfer or the entity for whose benefit such transfer was made."[142] The avoidable transfer may, therefore, according to section 550(a), be recovered from the

---

[140]A statutory presumption of insolvency exists for the one-year period prior to a debtor's bankruptcy filing, and the practical presumption exists that the creditor will have received more through its "preferential" payment than it would have received under Chapter 7 of the Bankruptcy Code had the debtor filed a petition under Chapter 7 before paying the creditor.

[141]Section 547(c) of the Bankruptcy Code sets forth certain affirmative defenses to a preferential transfer that can be asserted by a defendant in order to avoid preference liability (e.g., that the alleged payment was made in the ordinary course of a debtor's business or that the transfer was a contemporaneous exchange for new value advanced by the creditor). The availability of such defenses depends on the facts of a particular case. Under the amendments to the Bankruptcy Code enacted as part of the Bankruptcy Abuse and Consumer Protection Act of 2005 ("BAPCPA"), the so-called "ordinary course" defense was amended to make it easier for a defendant to avoid preference liability. Under prior law, a defendant needed to demonstrate both that (1) the payment was made in the ordinary course of business or financial affairs of the debtor and the transferee (which looks to whether the payment is consistent with the business relationship between the debtor and the defendant) and (2) the payment was made according to ordinary business terms (which looks to whether the payment is consistent with the practices in the relevant industry). Now, a defendant only needs to satisfy one of the two foregoing tests in order to avail itself of the ordinary course defense. 11 U.S.C.A. § 547(c)(2).

Section 546 of the Bankruptcy Code provides certain exemptions from avoidance as preferences for certain "margin payments", "settlement payments" and other transfers made in connection with certain safe harbored contracts such as "swap agreements," "securities contracts," "repurchase agreements" and "master netting agreements." 11 U.S.C.A. § 546(e), (f), (g) and (j).

[142]11 U.S.C.A. § 550(a)(1).

party to whom it was made, with no qualification that this be the same party to whom the transfer was a preference.[143]

B. Fraudulent Transfers

1. Overview of the Sources and Purpose of Fraudulent Transfer Law

During bankruptcy, the trustee (or debtor in possession (or creditors given standing to pursue claims on behalf of the debtor's estate)) is given broad powers to restore and redistribute the estate among creditors in accordance with the Bankruptcy Code. Among these broad powers, section 548 of the Bankruptcy Code allows the trustee to avoid any actual or constructively fraudulent transfers.[144] Most states' laws contains provisions that substantially parallel the Bankruptcy Code's fraudulent transfer

---

[143]One historical preference issue arose in the context of the payment of a debt owed to a noninsider, which was guarantied by an insider. Under *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186, 19 Bankr. Ct. Dec. (CRR) 574, 22 Collier Bankr. Cas. 2d (MB) 36, 11 Employee Benefits Cas. (BNA) 1323, Bankr. L. Rep. (CCH) P 72910 (7th Cir. 1989) and its progeny, payments made to a noninsider lender within the period between 90 days and one year of the debtor's bankruptcy filing that resulted in the release of an insider-guarantor's obligation under its guaranty were recoverable as preferences from the noninsider lender (assuming that all of the other elements for a preferential transfer were satisfied).

In 1994, Congress amended section 550 of the Bankruptcy Code by adding section 550(c), effectively keeping more transfers out of the reach of trustees. Despite this expanded protection for transfers, section 550(c) commanded heightened protection for noninsider creditors only as to the recovery, rather than the avoidance, of preferential transfers. As a result, nonpossessory preferential transfers, such as liens and security interests, to which section 550's recovery provisions are inapplicable, were free from the protection of section 550(c).

To address the incomplete reach of section 550(c), Congress, as part of BAPCPA, added section 547(i) to the Bankruptcy Code. Section 547(i) provides that transfers made by a debtor to a noninsider creditor for the benefit of an insider creditor (i.e., an insider guarantor) between 90 days and one year before the debtor's bankruptcy filing that are avoided as preferences are considered to be avoided only with respect to the insider creditor.

[144]11 U.S.C.A. § 548. This section states in relevant part that:

> (a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

provisions, namely the Uniform Voidable Transactions Act ("UVTA")[145] and, to a lesser extent, the Uniform Fraudulent Conveyance Act ("UFCA").[146] These sources, united in purpose and generally in substance, work in concert to assist the trustee in its mission of preserving the estate and maximizing distributions to the debtor's creditors.[147]

The Bankruptcy Code allows for avoidance of all fraudulent transfers made within the two years prior to filing of a bankruptcy case; however, some states have longer statutes of limitation for fraudulent transfer. To avoid a fraudulent transfer, the trustee must show that the transfer was made with the intent to hinder, delay, or defraud creditors or was constructively fraudulent. For cases under the Bankruptcy Code and UVTA, the elements of a constructively fraudulent transfer require a showing that the debtor made a transfer without receiving "reasonably equivalent value" in exchange, paired with the debtor's contemporaneous or subsequent insolvency.[148] Cases under the UFCA require proving similar elements, except that a plaintiff

---

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

[145]The UVTA was formerly known as the Uniform Fraudulent Transfer Act ("UFTA").

[146]The UFCA still applies to transfers governed under the laws of five states, including New York.

[147]"[T]he UFTA should be viewed as an effort generally, but not universally, to harmonize the state statutes with the [Bankruptcy] Code. Only in isolated cases does the UFTA materially differ from the code." Phillip I. Blumberg, Intragroup (Upstream, Cross-Stream, and Downstream) Guaranties Under the Uniform Fraudulent Transfer Act, 9 Cardozo L. Rev. 685, 696 (1987).

[148]11 U.S.C.A. § 548(a)(1)(B); UVTA § 5(a). In addition, section 548(a)(1)(B) was amended by BAPCPA to add a new category of constructively fraudulent transfers for which proof of insolvency is not required, namely transfers made to or for the benefit of an insider and not in the ordinary course of business under an employment contract. 11 U.S.C.A. § 548(a)(1)(B)(iv). Additionally, under the UVTA, certain transfers made to "insiders" on account of an antecedent debt are voidable if the debtor is insolvent at the time of the transfer and

must demonstrate that the transfer in question was made without "fair consideration," as opposed to focusing on whether the transferee received "reasonably equivalent value."[149]

While intercorporate guaranties are frequently legitimate financing arrangements designed to help the corporate group rather than to hinder, delay, or defraud creditors, and thus are not intentionally fraudulent, the structure of a transaction may render the guaranty constructively fraudulent. If a corporation guaranties the debts of an affiliate and subsequently files for bankruptcy, the trustee may attempt to avoid guaranties where reasonably equivalent value was not directly received by the guarantor corporation.

2. Types of Intercorporate Guaranties

In bankruptcy, the trustee may seek to avoid any contingent obligations that diminish the debtor's estate as fraudulent transfers. As a result, the debtor corporation's guaranties will be examined in bankruptcy to determine whether they can be avoided as fraudulent transfers.

The guaranties that are most likely to fail the "reasonably equivalent value" or "fair consideration" test are those that a corporation undertakes on behalf of a related third party. A guaranty entered into gratuitously (i.e., for no consideration) by a debtor for the benefit of a third party would be avoidable as a fraudulent transfer (e.g., a friend guaranties the obligations of another friend). The reason that such a guaranty would be avoided is that such guaranty would not be in exchange for "reasonably equivalent value."

Transactions that commonly present potential fraudulent transfer issues are those guaranties that a corporation undertakes on behalf of an affiliate. Intercorporate guaranties generally fall into one of three structures: downstream, upstream, and cross-stream guaranties.[150] "Downstream" refers to guaranties provided by a parent corporation for the benefit of a directly or indirectly owned subsidiary. Since the guarantor parent is typically the sole owner of the beneficiary subsidiary, the guarantor parent typi-

---

the insider had reasonable cause to believe that the debtor was insolvent, even in circumstances where the debtor received "reasonably equivalent value." UVTA § 5(b).

[149]The concept of "fair consideration" is similar to the concept of "reasonably equivalent value," except that the "fair consideration" standard also requires that the conveyance be made in "good faith." *See* Cook, et al., Fraudulent Transfers, 887 PLI/Comm 183, 201 (2006).

[150]*See* Blumberg, *supra* note 138, at 696.

cally receives some economic benefit from the obligation; namely, the improved financial condition of the subsidiary is translated directly into benefits for the sole shareholder/guarantor.[151] The downstream guaranty is thus the type of intercorporate guaranty least vulnerable to avoidance as a fraudulent transfer based on an inadequate receipt of value by the guarantor.[152] However, a downstream guaranty by a parent corporation for the benefit of a grossly insolvent subsidiary may be vulnerable to attack as a fraudulent transfer, because the guaranty would not have the effect of increasing the parent's equity value in the subsidiary.[153]

In an upstream guaranty, a subsidiary serves as guarantor for the parent. Lenders frequently require upstream guaranties in instances where the subsidiary is the sole asset of the parent corporation, effectively circumventing the corporate veil by contract.[154] The "reasonably equivalent value" received by the subsidiary for its obligation is not as easily defended via shareholder benefits as in a downstream guaranty. In an upstream guaranty, creditors may seek to defend the transfer by pointing to the lower interest rate consequently available to the entire enterprise. The upstream guaranty is most frequently

---

[151] *See Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1174 (Del. 1988) ("[I]n a parent and wholly-owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders").

[152] "Downstream guaranties do not pose special transfer problems since the guarantor owns the stock of the principal debtor." *In re Lawrence Paperboard Corp.*, 76 B.R. 866, 871 (Bankr. D. Mass. 1987) (quoting Kenneth J. Carl, Fraudulent Transfer Attacks on Guaranties in Bankruptcy, 60 Am. Bankr. L.J. 109, 115 (1986)); *In re Royal Crown Bottlers of North Alabama, Inc.*, 23 B.R. 28, 29 (Bankr. N.D. Ala. 1982) ("[T]he passing to a subsidiary of the consideration for a transfer by a debtor-parent may be presumed to be substantial, because the subsidiary corporation is an asset of the parent corporation, and what benefits the asset will ordinarily accrue to the benefit of its owner").

[153] "If the subsidiary were insolvent, no benefits could flow to the debtor by virtue of the corporate relationship between the debtor and its subsidiary—any increase in the subsidiary's value would accrue only to the benefit of its creditors." Robert K. Rasmussen, Guarantees and Section 548(A)(2) of the Bankruptcy Code, 52 U. Chi. L. Rev. 194, 214 (1985); *see also In re Rodriguez*, 895 F.2d 725, 729, 22 Collier Bankr. Cas. 2d (MB) 633, Bankr. L. Rep. (CCH) P 73282 (11th Cir. 1990) (concluding that the payment by parent corporation of subsidiary's debt on an aircraft loan that was not guarantied by parent failed to provide "reasonably equivalent" value to parent corporation, where the subsidiary was insolvent, such that such payments by parent did not enhance the value of the parent's equity in the subsidiary; rather, the effect of the payments was to reduce the amount of the deficiency judgment against the subsidiary and delay foreclosure on the aircraft).

[154] Williams, *supra* note 128, at 1420.

challenged as a fraudulent transfer in the form commonly used for acquisitions, the leveraged buyout, which is discussed below.

The last type of intercorporate guaranty is known as a cross-stream guaranty; as the name implies, one entity in a corporate family acts as guarantor for a related entity where they are related neither as parent nor subsidiary (e.g., two corporations with a common parent). In a cross-stream guaranty, the guarantor may not have any ownership interest in the principal obligor as the guarantor may reside in a separate corporate chain from the principal obligor. This makes the value received by the guarantor a far more nebulous concept. As a result, cross-stream guaranties are the most difficult type of intercorporate guaranty to defend against a constructive fraudulent transfer claim.

3. Constructive Fraud Requires Insolvency and Lack of Reasonably Equivalent Value

The questions of whether a guarantor was insolvent at the time of the guaranty (or rendered insolvent as a result of the guaranty) and whether reasonably equivalent value/fair consideration has been received by the guarantor in exchange for the guaranty are fact-based and often vigorously litigated. The Bankruptcy Code, UFCA, and UFTA contain slightly different definitions of insolvency.[155] Courts have differed in their approaches to valuing guaranties for purposes of determining whether an entity is insolvent (or rendered insolvent) as a result of entering into a guaranty. The most common approach recognizes that guaranties are contingent obligations and requires a court to discount the

---

[155]Under the Bankruptcy Code, an entity is "insolvent" where "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 U.S.C.A. § 101(32). Under the UVTA, a debtor is insolvent "if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation." Further, a debtor who is "generally not paying his debts as they become due is presumed to be insolvent." UVTA § 2. Under the UFCA, a debtor is insolvent when "the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."

In addition, the Bankruptcy Code, UVTA, and UFCA also incorporate various financial tests into a determination of whether or not a debtor has made a fraudulent transfer. *See e.g.*, 11 U.S.C.A. § 548(a)(1)(B)(II), (III) (a transfer is voidable as constructively fraudulent if made within two years of the debtor's bankruptcy filing for less than "reasonably equivalent value" and the debtor was "(II) engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; [or] (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured . . ..").

face amount of a guaranty by the probability that the contingency (payment on the guaranty) will occur.[156]

As alluded to above, it is fairly easy for the court to find a reasonable exchange of value with respect to a downstream guaranty. However, upstream and cross-stream guaranties often present situations where the benefits received by the guarantor, if any, are indirect and difficult to appraise.

4. Reasonably Equivalent Value May be Satisfied by Indirect Benefits

Although most courts have agreed that the "value" received need not replenish the actual financial diminution from the estate on account of the transfers, the amount of play in the phrase "reasonably equivalent value" is far from clear. Further, whether an indirect benefit is a value received by the debtor is generally a question of fact.[157] A higher court may thus intimate that the lower court's interpretation of "value," though too narrow, must stand affirmed because narrow readings of "value," though discouraged, may not rise to the standard necessary for an appellate court to reverse the lower court's decision.[158]

The pivotal case setting forth a flexible standard of reasonably equivalent value is *Rubin v. Mfrs. Hanover Trust Co.*, which stands for the principal that "the transaction's benefit to the debtor need not be direct; it may come indirectly through benefit to a third person."[159] *Rubin* further clarifies that, while the indirect value gained by the guarantor must be economic, it will constitute reasonably equivalent value if it "approximates the value of the property or obligation he has given up."[160] *Rubin*'s reasoning relies in large part upon an identity of economic inter-

---

[156]*See e.g.*, *Matter of Xonics Photochemical, Inc.*, 841 F.2d 198, 200, 17 Bankr. Ct. Dec. (CRR) 606, 18 Collier Bankr. Cas. 2d (MB) 711, Bankr. L. Rep. (CCH) P 72211 (7th Cir. 1988); *see also In re Chase & Sanborn Corp.*, 904 F.2d 588, 594, 20 Bankr. Ct. Dec. (CRR) 1146, 23 Collier Bankr. Cas. 2d (MB) 5, Bankr. L. Rep. (CCH) P 73503 (11th Cir. 1990); *In re R.M.L., Inc.*, 92 F.3d 139, 156, 29 Bankr. Ct. Dec. (CRR) 591, 36 Collier Bankr. Cas. 2d (MB) 498 (3d Cir. 1996).

[157]*In re Grabill Corp.*, 121 B.R. 983, 994 (Bankr. N.D. Ill. 1990) ("Whether a transfer is made for reasonably equivalent value is a question of fact to be determined in light of the facts presented in each particular case).

[158]*See, e.g.*, *In re Image Worldwide, Ltd.*, 139 F.3d 574, 581, 32 Bankr. Ct. Dec. (CRR) 394 (7th Cir. 1998).

[159]*Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991, 8 Bankr. Ct. Dec. (CRR) 297 (2d Cir. 1981) (internal citations omitted).

[160]Rubin, 661 F.2d at 991.

est uniting the guarantor and the third-party beneficiary. Where such a shared identity exists, the purpose of fraudulent transfer law, preservation of the debtor's estate, is not implicated.

Over time, most courts have adopted *Rubin*'s approach to finding reasonably equivalent value from indirect sources,[161] departing from the earlier and stricter tendency to find no value per se where an obligation is incurred to secure a loan to a third party.[162] For example, in *In re Tryit Enterprises*,[163] the United States Bankruptcy Court for the Southern District of Texas, relying in part on *Rubin*, refused to hold the debtors' lender liable for a fraudulent conveyance under Texas law in connection with the debtors' cross guaranties of the indebtedness of certain of their affiliates. In reasoning that the debtors had received "fair consideration" for the cross guaranties of their affiliates' obligations, the court relied on the fact that the debtor-plaintiffs were able to "qualify for [an] optimal financing arrangement" from the defendant-lender by providing such guaranties, which they would not have been able to obtain had each affiliate attempted to receive separate financing.[164]

Courts have found that various forms of indirect benefits may constitute value for purposes of a fraudulent transfer analysis. Some courts have indicated a willingness to recognize value in gains from synergy, which increases the guarantor's goodwill and borrowing ability.[165] Among the benefits suggested by courts as synergistic gains are safeguarding the guarantor's supply source or important customer, improvements in the general relationship among the corporate group,[166] use of the distribution system of a

---

[161] *In re Northern Merchandise, Inc.*, 371 F.3d 1056, 1058, 43 Bankr. Ct. Dec. (CRR) 49, Bankr. L. Rep. (CCH) P 80112 (9th Cir. 2004); *Image Worldwide*, 139 F.3d at 578 (citing Xonics, 841 F.2d at 201; Rubin, 661 F.2d at 991–92; *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1377–81 (D.N.J. 1984)).

[162] *See* Williams, *supra* note 128, at 1425.

[163] *In re Tryit Enterprises*, 121 B.R. 217, 223–24 (Bankr. S.D. Tex. 1990).

[164] *In re Tryit Enterprises*, 121 B.R. 217 (Bankr. S.D. Tex. 1990).

[165] *Mellon Bank, N.A. v. Metro Communications, Inc.*, 945 F.2d 635, 646–48, 22 Bankr. Ct. Dec. (CRR) 251, 25 Collier Bankr. Cas. 2d (MB) 1064, Bankr. L. Rep. (CCH) P 74288, 15 U.C.C. Rep. Serv. 2d 1119 (3d Cir. 1991), as amended, (Oct. 28, 1991) (accepting the premise that increased borrowing ability of a subsidiary acquired in connection with leveraged buyout could constitute value in connection with subsidiary's guaranty of a loan made to the parent by defendant).

[166] Telefest, 591 F.Supp. at 1379–81.

larger affiliate,[167] increase in a credit line, or the increased monetary "float" resulting from guarantying the loans of another.[168]

5. Upstream and Cross-Stream Guaranties

In modern business transactions, "intercorporate guaranties are routine business practice, and their potential voidability creates a risk for unwary lenders."[169] Thus, while generally upstream and cross-stream guaranties are not intentionally fraudulent, they are vulnerable to avoidance as constructively fraudulent transfers if the guarantor is insolvent, unless the court accepts that the insolvent guarantor received "reasonably equivalent value" in return for its obligation.

While certain courts have upheld cross-stream and upstream guaranties (see further discussion below) on the theory that the entity providing such guaranty has received sufficient indirect benefits, a notable recent example where a court refused to rely on the existence of indirect benefits to prevent fraudulent transfer liability was in *In re TOUSA, Inc*.[170] In *TOUSA*, the Eleventh Circuit Court of Appeals upheld the bankruptcy court's ruling that the liens granted by certain subsidiaries in connection with the refinancing of their parent's indebtedness were avoidable fraudulent transfers pursuant to sections 548 and 550(a) of the Bankruptcy Code.

In *TOUSA*, to settle an action with the repayment of $421 million to an existing lender syndicate ("Transeastern Lenders"), which had funded a failed joint venture, the parent ("Parent") and certain of its other wholly owned subsidiaries ("Conveying Subsidiaries") borrowed $500 million in two new loans ("New Loans") from a new lending syndicate ("New Lenders" and, together with the Transeastern Lenders, the "Lenders") just six

---

[167]Xonics, 841 F.2d at 202.

[168]*Matter of Fairchild Aircraft Corp.*, 6 F.3d 1119, 1127, 24 Bankr. Ct. Dec. (CRR) 1569, 30 Collier Bankr. Cas. 2d (MB) 211, Bankr. L. Rep. (CCH) P 75603 (5th Cir. 1993) (citing Metro Communication, 945 F.2d at 647–48); Rubin, 661 F.2d at 992–94.

[169]Image Worldwide, 139 F.3d at 578 (citing Blumberg, *supra* note 138, at 696; Williams, *supra* note 128, at 1425; Barry L. Zaretsky, Fraudulent Transfer Law as the Arbiter of Unreasonable Risk, 46 S.C. L. Rev. 1165 (1995); Scott F. Norberg, Fraudulent Transfer Law as the Avoidability of Intercorporate Guaranties Under Sections 548(b) and 544(b) of the Bankruptcy Code, 64 N.C. L. Rev. 1099 (1986)).

[170]*In re TOUSA, Inc.*, 680 F.3d 1298, 56 Bankr. Ct. Dec. (CRR) 135, 67 Collier Bankr. Cas. 2d (MB) 1035, Bankr. L. Rep. (CCH) P 82276 (11th Cir. 2012).

months before their eventual bankruptcy filings. In connection with the New Loans, the Conveying Subsidiaries had granted liens to the New Lenders covering substantially all of their assets.[171]

Six months later, as a crisis enveloped the housing market, the over-levered Parent and the Conveying Subsidiaries filed for protection under Chapter 11. The official committee of unsecured creditors appointed in the Chapter 11 cases of the Parent and the Conveying Subsidiaries ("Committee") commenced an adversary proceeding in which it alleged that the entire transaction was a fraudulent transfer, and the Committee sought to have (i) the proceeds received by the Transeastern Lenders disgorged and (ii) the liens provided to the New Lenders voided. The Committee argued that "the Conveying Subsidiaries were insolvent when the transfer occurred, were made insolvent by the transfer, had unreasonably small capital, or were unable to pay their debts when due; and the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for their grant of liens."[172] The Lenders contended that the Conveying Subsidiaries did receive equivalent value in exchange for liens they provided; they had (i) received the economic benefit of staving off the imminent default of more than $1 billion of debt that the Conveying Subsidiaries had guaranteed, (ii) avoided the bankruptcy that would have resulted if they had defaulted and (iii) the opportunity of possibly becoming profitable again.[173] To counter the argument that they were entities "for whose benefit" the transfers were made, the Transeastern Lenders argued that they were one transfer removed from the New Lenders and, therefore, were only subsequent transferees and not the entities that immediately benefitted from the transfer as required by section 550(a)(1) of the Bankruptcy Code.[174]

After a trial, the U.S. Bankruptcy Court for the Southern District of Florida ruled in favor of the Committee, finding that (i) the Conveying Subsidiaries were insolvent at the time they granted liens to the New Lenders; and had not received value reasonably equivalent to the obligations that they had incurred under the liens they granted in connection therewith; and (ii) the Transeastern Lenders were entities for whose benefit the Convey-

---

[171]TOUSA, Inc., 680 F.3d at 1302.

[172]TOUSA, Inc., 680 F.3d at 1302.

[173]TOUSA, Inc., 680 F.3d at 1303.

[174]TOUSA, Inc., 680 F.3d at 1303.

ing Subsidiaries had granted liens to the New Lenders.[175] The bankruptcy court rejected the notion that staving off the bankruptcy of the Parent and the Conveying Subsidiaries could constitute "value," let alone "reasonably equivalent value" sufficient to defeat a fraudulent transfer claim, concluding that "value" requires evidence of receipt of something tangible, such as property.[176] The bankruptcy court alternatively concluded that even under the Lenders' more expansive concept of "value," the Conveying Subsidiaries still had not received reasonably equivalent value. The bankruptcy court concluded the benefits received by the Conveying Subsidiaries were insubstantial.[177] In fact, for the Conveying Subsidiaries, " 'even assuming that all of the TOUSA entities would have spiraled immediately into bankruptcy without [the New Loans], the Transaction was *still* the more harmful option.' "[178] As a consequence of its findings, the bankruptcy court ordered the disgorgement of the proceeds of the New Loans from the Transeastern Lenders and voided the Conveying Subsidiaries' liens.

On appeal of the bankruptcy court's decision, the U.S. District Court for the Southern District of Florida quashed the bankruptcy court's opinion. The district court disagreed with the bankruptcy court's view of what constitutes value for fraudulent transfer purposes. For the district court, "value" encompassed both direct and indirect benefits and the indirect benefits could "take many forms both tangible and intangible."[179] The district court found sufficient evidence to determine that the Conveying Subsidiaries had received reasonably equivalent value.[180]

On appeal of the district court's decision, the Eleventh Circuit reversed the district court and affirmed the bankruptcy court.[181] It found that the bankruptcy court's rulings were not clearly erroneous. The Eleventh Circuit agreed with the bankruptcy court that the Conveying Subsidiaries had not received reason-

---

[175]TOUSA, Inc., 680 F.3d at 1308.

[176]TOUSA, Inc., 680 F.3d at 1303–04.

[177]TOUSA, Inc., 680 F.3d at 1304.

[178]TOUSA, Inc., 680 F.3d at 1305.

[179]*In re TOUSA, Inc.*, 444 B.R. 613, 657 (S.D. Fla. 2011).

[180]TOUSA, Inc., 444 B.R. at 666–67.

[181]TOUSA, Inc., 680 F.3d. at 1310–11.

ably equivalent value in exchange for their liens.[182] As such, the Eleventh Circuit reached the same conclusion as the bankruptcy court that the debtor's and Conveying Subsidiaries bankruptcies were inevitable and, while the New Loans exacerbated and deepened the insolvency of the Conveying Subsidiaries, the Conveying Subsidiaries had received no value in exchange for their liens. Accordingly, the liens provided by the Conveying Subsidiaries were avoidable under as fraudulent transfers. In addition, the Eleventh Circuit, relying on its prior decision in *In re Air Conditioning Inc. of Stuart*,[183] a case where the court found that the beneficiary of a letter of credit could be liable for a preference as a result of the debtor providing collateral to the issuing bank to secure the debtor's reimbursement obligation on the letter of credit, agreed with the bankruptcy court's ruling that the Transeastern Lenders were the initial transferees of the New Loans for the purposes of section 550(a)(1) of the Bankruptcy Code. The Eleventh Circuit remanded the case for a determination of the exact amounts to be disgorged.[184]

TOUSA is notable because it brings sharply into focus the fraudulent conveyance risk associated with making loans to complex corporate families, particularly where a loan is used to refinance an existing obligation and additional entities not liable on the existing obligation become liable on, or provide credit support in the form of guaranties and liens in connection with, the new loan.[185]

The decision underscores that a careful assessment of both the financial condition of the borrower(s) and affiliated guarantor(s)

---

[182]TOUSA, Inc., 680 F.3d. at 1310–11. There was no dispute among the parties that the Conveying Subsidiaries were "insolvent, had unreasonably small capital, or were unable to pay their debts when the liens were conveyed."

[183]*In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293, 17 Bankr. Ct. Dec. (CRR) 1385, 18 Collier Bankr. Cas. 2d (MB) 973, Bankr. L. Rep. (CCH) P 72302 (11th Cir. 1988).

[184]TOUSA, Inc., 680 F.3d at 1316.

[185]The Bankruptcy Court also voided the "savings clause" in documentation for the New Loans. *In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009). Savings clauses are common provisions in loan agreements and guaranties that are designed to prevent liability for fraudulent transfer. In this instance, the savings clause stated:

> Each Borrower agrees if such Borrower's joint and several liability hereunder, or if any Liens securing such joint and several liability, would, but for the application of this sentence, be unenforceable under applicable law, such joint and several liability and each such Lien shall be valid and enforceable to the maximum extent that would not cause such joint and several liability or such Lien to be unenforceable under applicable law, and such joint and several liability and such Lien shall be deemed to have been automatically amended accordingly at all relevant times.

and the benefits those entities are receiving in connection with a financing may be advisable, particularly where the debtor and/or its affiliates are highly leveraged or will become highly leveraged as a result of the new financing.

6. Intercorporate Guaranties and Leveraged Buyouts

Perhaps the most infamous type of upstream guaranty, the leveraged buyout (LBO), presents a particularly problematic example of a meaningful and legitimate business tool that may carry heightened risks in instances where the courts do not recognize the value of the transaction. The term LBO refers to the acquisition of a "target" corporation in which all or a substantial portion of the purchase price paid for the stock of the target corporation is borrowed from a third party and where the loan financing the transaction is secured by the assets of the target corporation. Usually the buying entity infuses little or none of its own funds as equity, and therefore the transaction results in equity being exchanged for debt.

The end result of an LBO may be a highly leveraged company, leaving the target's original debt holders in a vulnerable position should the newly leveraged corporation succumb to the burden attendant upon its new financial position. Where the target corporation guaranties the purchaser's debt to the lender, this guaranty, combined with the target's other debts, may render the target corporation insolvent. As one court has stated, in providing the credit support to obtain the funds needed to finance the purchase of the target's stock, "the target corporation . . . receives no direct benefit to offset the greater risk of now operating as a highly leveraged corporation."[186] Rather, "[t]he effect of an LBO is that a corporation's shareholders are replaced by secured creditors. Put simply, stockholders' equity is supplanted by debt. The level of risk facing the newly structured corporation rises significantly due to the increased debt to equity ratio. This

---

TOUSA, Inc., 422 B.R. at 863, n.49. The bankruptcy court in *TOUSA* declined to enforce the savings clause, because the savings clause hinged on the borrowers' insolvency and, therefore was an ipso facto provision. As a consequence, it was unenforceable since it violated the public policy behind bankruptcy. Specifically, the bankruptcy court found the savings clause to be a "frontal assault on the protections that Section 548 provides to other creditors" and it was "entirely too cute to be enforced." TOUSA, Inc., 422 B.R. at 864.

[186] Metro Communication, 945 F.2d at 646.

added risk is borne primarily by the unsecured creditors, those who will most likely not be paid in the event of bankruptcy."[187]

Most courts have thus recognized that an LBO may be vulnerable to attack as a fraudulent transfer where the lender knew that the borrowing entity would not receive the loan proceeds but would still assume responsibility for repaying the debt and the eventual insolvency and bankruptcy of the borrower were foreseeable results of the LBO.[188] While courts have recognized that LBOs are often legitimate transactions, courts nonetheless carefully scrutinize failed LBOs in order to guard against abuse. As stated by the Third Circuit in its analysis of a failed LBO in *Metro Communications*:[189]

> At first glance, it seems difficult to reconcile the original purpose of the fraudulent conveyance laws with what has become a common, arms-length transaction— . . .. Where there exists no intentional fraud, setting aside the security interests of a lender who has indisputably *given* reasonably equivalent value, cash for a promise to repay a loan, appears to be a patent anomaly . . . Nonetheless . . . there is a potential for abuse of the debtor's creditors, particularly those who are unsecured, when a company is purchased through an LBO.

Although courts carefully scrutinize upstream guaranties provided in connection with an LBO, such guaranties may ultimately be found by a court to provide a benefit to the guarantor that may be sufficient to defeat a fraudulent transfer claim. Possible benefits of an LBO upstream guaranty include monthly income from the borrower's operations, lower lease rates and customer lists given to a guarantor subsidiary by a new parent, and a reciprocal (more valuable) guaranty granted by the parent

---

[187] Metro Communication, 945 F.2d at 645.

[188] *See, e.g.*, *In re Chas. P. Young Co.*, 145 B.R. 131, 137 (Bankr. S.D. N.Y. 1992) ("[r]egardless of the number of steps taken to complete a transfer of debtor's property, such as in a leveraged buyout transaction, if they reasonably collapse into a single integrated plan and either defraud creditors or leave the debtor with less than equivalent value post-exchange, the transaction will not be exempt from the Code's avoidance sections"); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 493, 18 Bankr. Ct. Dec. (CRR) 1134, 20 Collier Bankr. Cas. 2d (MB) 776, Bankr. L. Rep. (CCH) P 72574A, Fed. Sec. L. Rep. (CCH) P 94872 (N.D. Ill. 1988), on reconsideration in part, 1989 WL 18112 (N.D. Ill. 1989) (collapsing a series of LBO transfers into a single integrated transaction and denying motion to dismiss fraudulent conveyance claims as to LBO lenders and controlling shareholders of debtor where both lenders and controlling shareholders were aware at the time of transaction that the debtor intended to use proceeds of the loan to fund the LBO and that the debtor was insolvent).

[189] Metro Communication, 945 F.2d at 645 (emphasis in original).

corporation.[190] However, courts have rejected the argument that the mere opportunity to remain in business is a benefit in the LBO context because the interests of shareholders and creditors sharply diverge after consummation of an LBO.[191] Given that the "reasonable equivalent value"/"fair consideration" inquiry is one of fact, whether an LBO may be protected from avoidance as a fraudulent transfer/fraudulent conveyance depends upon what the court accepts as "reasonably equivalent value" for the guarantor target under the particular facts with which a court is presented.

A leading case on voidability of a guaranty contracted for in connection with an LBO is *United States v. Gleneagles Inv. Corp*.[192] *Gleneagles* involved an LBO by Great American Coal Company of the stock of four affiliated corporations. Institutional Investors Trust (IIT) loaned approximately $8.5 million to the four affiliates. Each affiliate granted IIT a security interest in its own assets. Each of the four borrowers also executed a guaranty of its affiliates' obligations to the lender, secured by a second lien on its assets. The affiliates, when considered as a whole, were insolvent at the time the loans were made.[193] Each affiliate loaned a portion of its borrowed funds to Great American. Great American gave each affiliate an unsecured note in exchange for the loans and used the loan proceeds to buy the stock of the four affiliates.[194]

The court found that as between the affiliates and the lender, the loans were supported by fair consideration.[195] However, the court disregarded the formal structure of the stock acquisition plan and treated the transaction as though the funds had been loaned directly to Great American in exchange for the security interests and guaranties of the borrowing affiliates. The court stated:[196]

> [T]he issue of whether fair consideration was received by the [four affiliates] must be examined from the point of view of [their] creditors . . .. Because Great American could not and in fact did not

---

[190] *See Norberg*, *supra* note 160, at 1118.

[191] *See In re Jolly's Inc.*, 188 B.R. 832, 843–44, Bankr. L. Rep. (CCH) P 76803 (Bankr. D. Minn. 1995).

[192] *U.S. v. Gleneagles Inv. Co., Inc.*, 565 F. Supp. 556 (M.D. Pa. 1983), judgment aff'd, 803 F.2d 1288, 2 U.C.C. Rep. Serv. 2d 1140 (3d Cir. 1986).

[193] Gleneagles, 565 F. Supp. at 563–72.

[194] Gleneagles, 565 F. Supp. at 563–72.

[195] Gleneagles, 565 F. Supp. at 574.

[196] Gleneagles, 565 F. Supp. at 574–575

> repay the notes to the borrowing companies in accordance with their terms, those notes cannot be considered as valuable assets obtained by the borrowing companies from the IIT loan proceeds. The . . . IIT loan proceeds which were lent immediately by the borrowing companies to Great American were merely passed through the borrowers to Great American and ultimately to the selling stockholders and cannot be deemed consideration received by the borrowing companies.

The court concluded that the borrowing affiliates did not receive fair consideration from IIT in exchange for the security interests granted in their assets and their guarantees of obligations and held that the security interests and guarantees were avoidable.

Although it has been argued that *Gleneagles* should be narrowly construed because of the presence of intentionally fraudulent activity in the case,[197] courts have routinely indicated that fraudulent transfer principles apply to LBOs as a general matter and have focused on whether the elements of the fraudulent transfer cause of action apply to the facts and circumstances of a particular transaction.[198]

Parties have attempted to defeat fraudulent transfer claims in connection with LBOs by asserting that guaranties in connection with the LBO and related liens securing the guaranteed obligations are protected by the safe harbor of section 546(e) of the Bankruptcy Code.[199]

While courts have, with divergent results, analyzed whether

---

[197] As stated by one commentator:

> Indeed, it can be argued that *Gleneagles* is a case with an egregious set of facts and that, given the intentional fraud found there, normal LBO transactions negotiated at arm's length in a normal commercial environment are distinguishable from *Gleneagles*. Lenders and Sellers should agree, and courts should hold, in normal commercial transactions conducted at arm's length, that *Gleneagles* should be narrowly construed and limited to its own facts. Absent a showing of intentional fraud, the courts should not be quick to apply the constructive fraud provisions of the UFCA or the UVTA, which are designed to protect creditors, to a Lender that extends new credit in the ordinary course of business for a leveraged buyout.

David A. Murdoch et al., Fraudulent Conveyances and Leveraged Buyouts, 43 Bus. Law. 1, 26 (1987).

[198] *See, e.g.*, *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056, 1062, 23 Bankr. Ct. Dec. (CRR) 467, Bankr. L. Rep. (CCH) P 74792 (3d Cir. 1992); Metro Communication, 945 F.2d at 644–46; *Zahn v. Yucaipa Capital Fund*, 218 B.R. 656, 671–72 (D.R.I. 1998); Wieboldt Stores, 94 B.R. at 488.

[199] In relevant part, 11 U.S.C.A. § 546(e) provides:

> Notwithstanding Sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in Section 101, 741, or 761 of this title, or settlement payment, as defined in Section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clear-

the section 546(e) safe harbor is applicable to payments made in connection with LBOs,[200] few decisions have assessed whether section 546(e) insulates guarantees and related liens from avoidance in connection with an LBO that is otherwise a fraudulent transfer. The distinction between payments and the incurrence of a guaranty is relevant because the safe harbor of section 546(e) protects "transfers," while fraudulent conveyance and fraudulent transfer law allow for the avoidance of the "incurrence of obligations" as well as the avoidance of "transfers." Parties seeking to defeat the safe harbor defense have argued that the making of a guaranty is not a transfer but is simply the incurrence of an obligation, which is not protected by the plain language of section 546(e). In *In re MacMenamin's Grill,*[201] the Bankruptcy Court for the Southern District of New York refused to extend the protections of section 546(e) of the Bankruptcy Code to a private LBO, finding that application of the safe harbor had "little if anything to do with Congress' stated purpose in enacting section 546(e): reducing systemic risk to the financial market."[202] While resting its holding on the foregoing basis, the Court addressed in dicta whether guaranties could be protected by the section 546(e) safe harbor.[203] In addressing whether a guarantee could be exempted from avoidance, the Court found that sections 544(a) and 548(a)(1) of the Bankruptcy Code allow a trustee or debtor in possession to avoid both transfers and "any obligation incurred by the debtor."[204] The Court found that guarantees are not transfers but are instead "obligations incurred by the debtor" and therefore

---

ing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in Section 741(7), commodity contract, as defined in Section 761(4), or forward contract, that is made before the commencement of the case, except under Section 548(a)(1)(A) of this title.

[200]*Compare In re Plassein Intern. Corp.*, 590 F.3d 252, 258–59, 52 Bankr. Ct. Dec. (CRR) 145, Bankr. L. Rep. (CCH) P 81653 (3d Cir. 2009) (holding that section 546(e) insulates from avoidance payments made to shareholders in connection with a leveraged buyout involving privately held securities) *with In re MacMenamin's Grill Ltd.*, 450 B.R. 414, 420-21 (Bankr. S.D. N.Y. 2011) (holding that transfers made and obligations incurred in connection with private LBO could not be protected from avoidance by section 546(e) because application of the safe harbor had "little if anything to do with Congress' stated purpose in enacting section 546(e): reducing systemic risk to the financial market.").

[201]*In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (Bankr. S.D. N.Y. 2011).

[202]McMenamin's Grill, 450 B.R. at 419–20.

[203]McMenamin's Grill, 450 B.R. at 428–31.

[204]McMenamin's Grill, 450 B.R. at 428–29.

not protected by the section 546(e) safe harbor.[205] However, the court also noted that actual transfers such as payments or the grant of liens in connection with an otherwise voided guaranty could nonetheless potentially be protected by section 546(e)'s safe harbor, to the extent it applied.[206]

In a case outside the LBO context, Judge Peck in *In re Lehman Bros. Holding Inc.*,[207] addressed the distinction between transfers and obligations, holding that the section 546(e) safe harbor only protected transfers made by the debtor and not the obligations that the debtor incurred. Judge Peck analyzed whether guarantees granted by the debtor and related liens and payments could be avoided notwithstanding section 546(e).[208] In granting the Defendant's summary judgment motion in part, Judge Peck held that section 546(e) protected liens incurred and payments made in connection with guaranties, notwithstanding that the guaranties were not themselves transfers protected by section 546(e).[209] Judge Peck reasoned that while the debtors' guaranty obligations were "hypothetically exposed" to avoidance, this was irrelevant, "because the liens and other transfers made in connection with these obligations remained exempt from such claims" under section 546(e), because they were "transfers."[210]

It remains to be seen whether other courts will adopt the approach of Judge Peck in *Lehman* regarding the applicability of section 546(e) (and other financial contract safe harbors) to guaranties.

7. Cross-Stream Guaranties

In analyzing whether "reasonably equivalent value" or "fair consideration" exists when there is a cross-stream guaranty by a company of an affiliate's debt, courts often focus on whether the obligations were incurred pursuant to arm's length transactions and enhance the financial strength of the entire corporate family.[211] If the result of such guaranties is that the creditors of a solvent entity are put at increased risk to help an affiliated entity

---

[205]McMenamin's Grill, 450 B.R. at 431.

[206]McMenamin's Grill, 450 B.R. at 430.

[207]*In re Lehman Bros. Holdings Inc.*, 469 B.R. 415, 56 Bankr. Ct. Dec. (CRR) 94, 67 Collier Bankr. Cas. 2d (MB) 1077 (Bankr. S.D. N.Y. 2012).

[208]Lehman Bros., 469 B.R. at 420, 435–446.

[209]Lehman Bros., 469 B.R. at 420, 435–446.

[210]Lehman Bros., 469 B.R. at 423.

[211]4 Collier on Bankruptcy ¶ 548.05 (16th ed. 2010); *see also* Telefest, Inc., 591 F.Supp. at 1378–79; Tryit, 121 B.R. 223–24.

that is insolvent or about to become insolvent, courts are more likely to find that the transfer was made for less than reasonably equivalent value or fair consideration.[212] Where affiliated entities are of varying financial strength, creditors of a stronger entity may be put at an increased and unreasonable risk as a result of the cross-stream guaranty. As such, courts must examine whether the cross-stream guaranty results in a true benefit to the debtor, such as greater synergy with the group of companies or increased credit availability, and whether the corporate group as a whole was a viable enterprise at the time the guaranty was made.[213]

The Fifth Circuit refused to avoid a cross-stream financing in *In re Fairchild Aircraft Corp*.[214] In *Fairchild*, an aviation company (Fairchild) became a guarantor for an airline's fuel supply, which it could only secure by making monthly cash payments. Fairchild and the airline were owned indirectly by the same parent corporation, but the two companies had entered into business arrangements before the airline was acquired by the parent. Initially, the airline was an important client for Fairchild but was not able to raise sufficient credit to purchase aircraft. Fairchild became a guarantor for the airline, hoping that the airline might be returned to financial health and become a profitable customer. All ensuing arrangements were entered into in protection both of the airline and Fairchild.[215] Following Fairchild's insolvency, the Fifth Circuit concluded that the trustee could not avoid the fuel payments made by Fairchild to keep the airline afloat while the airline was operating but declined to shelter payments from avoidance made after the airline ceased operations.[216]

Fairchild thus provides an example of a successful cross-stream financing: despite the fact that the familial relationship between the two corporations was fairly attenuated, the shared identity of interests and fiscal interdependence of the corporations gave substance to the cross-stream financing, protecting it from avoid-

---

[212]Jack F. Williams, The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System, 15 Cardozo L. Rev. 1403, 1432–37 (1994).

[213]Jack F. Williams, The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System, 15 Cardozo L. Rev. 1403, 1432–37 (1994).

[214]*Matter of Fairchild Aircraft Corp.*, 6 F.3d 1119, 24 Bankr. Ct. Dec. (CRR) 1569, 30 Collier Bankr. Cas. 2d (MB) 211, Bankr. L. Rep. (CCH) P 75603 (5th Cir. 1993).

[215]Fairchild Aircraft, 6 F.3d at 1124.

[216]Fairchild Aircraft, 6 F.3d at 1129.

ance as a fraudulent transfer. Intercorporate guaranties can be protected from avoidance as fraudulent transfers where the transaction supports a true identity of interests. This includes situations where the guaranty "conferred an economic benefit on the debtor," including the benefit of "the synergy realized from joining two enterprises."[217]

However, where the interrelation between the corporations is tenuous and dictated only by a common parent, the form alone cannot save the transfer, particularly if no viable enterprise exists. Where the parties involved are genuinely interdependent in some form or where the guaranty will enable the guarantor and affiliate for which it has provided a guaranty to realize genuinely synergistic gains (e.g., through an LBO), the courts should protect the transfer, notwithstanding the fact that the estate may have been somewhat diminished by the transaction.

8. Drafting Strategies

To mitigate against the fraudulent transfer risk associated with intercorporate guaranties, certificates and/or representations are often required from a guarantor to the effect that the guarantor is not insolvent (and will not be rendered insolvent) as a result of entering into the guaranty. Additionally, many intercorporate guaranties include so-called "savings" language. The purpose of the "savings" language is to limit the amount of the guaranty to an amount that would not be avoidable under fraudulent transfer law.[218]

The effectiveness of a savings clause has generally not been tested in the courts.[219] However, in *TOUSA*, as discussed above, the Eleventh Circuit affirmed the bankruptcy court's refusal to enforce a savings clause on the basis that it constituted an impermissible ipso facto clause. While, at least prior to *TOUSA*, some had taken the view that a savings clause is preferable to a so-called "net worth guaranty" as a means of attempting to protect an intercorporate guaranty from avoidance as a fraudulent transfer,[220] it would seem that a "net worth guaranty" may perhaps be less vulnerable to attack under *TOUSA*'s rationale. A

---

[217]Fairchild Aircraft, 6 F.3d at 1127.

[218]Michael F. Maglio, The Promise, Part II, 14 Bus. L. Today 25 (Jan./Feb. 2005).

[219]Michael F. Maglio, The Promise, Part II, 14 Bus. L. Today 25 (Jan./Feb. 2005).

[220]Michael F. Maglio, The Promise, Part II, 14 Bus. L. Today 25 (Jan./Feb. 2005).

"net worth guaranty" is a guaranty that is limited by its terms to an amount that is slightly greater than the guarantor's net worth.[221]

Prior to the *TOUSA* decision, the savings clause was seen by some as preferable to a "net worth guaranty" for several reasons, namely:[222]

(1) The "net worth guaranty" may unnecessarily limit the amount of a guaranty in situations where such guaranty is not found to be constructively fraudulent,

(2) "Net worth guaranties" can be very difficult to draft,

(3) A guarantor may still fail the cash flow or capitalization tests under fraudulent transfer law, despite being solvent on a balance sheet basis, and

(4) "Net worth guaranties" have not been tested by the courts as a device to insulate guaranties from attack as a fraudulent transfer.

An additional tool utilized by lenders to insulate a guaranty from attack as a fraudulent transfer might be a contribution agreement among related guarantors and/or the guarantor and the principal obligor, which provides that the guarantor is entitled to reimbursement or contribution from the other parties to the agreement if it makes payment on the guaranty.[223] Although these contribution rights are not usually factored into a guarantor's balance sheet for purposes of calculating the guarantor's net worth, they constitute off balance sheet assets of the guarantor that can be asserted if the guaranty is ever challenged.[224]

VIII. "Bad Boy" or Springing Guaranties and Non-Recourse Carve Outs

In the commercial real estate context, many loans originated at the height of the market were non-recourse (i.e., there was no guaranty from the owner and no recourse against the borrower beyond the lien on the property). Where loans are completely

---

[221]Michael F. Maglio, The Promise, Part II, 14 Bus. L. Today 25 (Jan./Feb. 2005).

[222]Michael F. Maglio, The Promise, Part II, 14 Bus. L. Today 25 (Jan./Feb. 2005); *see also* Brad R. Godshall & Robert A. Klyman, *Wading 'Upstream' in Leveraged Transactions: Traditional Guarantees v. Net Worth Guarantees*, 46 Bus. Law. 391 (Feb. 1991) (describing bankruptcy issues associated with obtaining a net worth guaranty as opposed to a traditional guaranty).

[223]*See* Godshall & Klyman, *supra* note 213, at 396.

[224]*See* Godshall & Klyman, *supra* note 213, at 396 (*citing Matter of Ollag Const. Equipment Corp.*, 578 F.2d 904, 908–09, 17 C.B.C. 612 (2d Cir. 1978)).

non-recourse, existing equity has more of an incentive to put a distressed real estate borrower into bankruptcy to buy time for the real estate market to recover so that equity may potentially retain an interest in the property. In certain instances, lenders knew that the loans were in distress long before the bankruptcy filings by their borrowers but were unable to expedite foreclosures to protect the underlying collateral, which was their sole source for recovery on their loans. In other instances, lenders only realized the true nature of their losses after they foreclosed on their collateral. So, together with carve-outs in the primary borrowers' loan documentation allowing for recourse in certain circumstances, so-called "bad-boy" or springing guaranties were developed to address lenders' painful lessons from these experiences.

"Bad boy" or springing guaranties allow lenders to continue to offer "optically" non-recourse loans while discouraging borrowers and their equity holders from taking certain actions (*e.g.*, filing for bankruptcy) by enumerating events that will (i) trigger recourse on the primary obligation and (ii) cause the guaranty to "spring" into life, making the guarantor fully liable for the underlying debt. The detail and complexity of the triggers for liability on guaranties vary. Typical carve-outs to recourse liability include fraud, intentional and willful misconduct, the commission of waste with respect to the property, misappropriation of loan proceeds and income, additional encumbrances or liens on the property, breach of the covenant to maintain the borrower as a special purpose entity and observe certain corporate formalities, interference with the lender's enforcement rights and insolvency or bankruptcy of the borrower.

"Bad-boy" guaranties are now a standard part of the suite of commercial mortgage documentation. Until the most recent downturn in the real estate market, the enforceability of such guaranties had generally not been tested in the courts. Recent decisions indicate that courts will generally enforce these guaranties.

In *UBS Commercial Mortgage Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*,[225] a New York court enforced the "bad-boy" guaranty at issue. UBS Real Estate Securities Inc. had loaned $107 million to a group of investors in connection with its acquisition of certain property in Reston, Virginia. The first lien loan was subsequently certificated. Once the initial

[225] *UBS Commercial Mortg. Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, 33 Misc. 3d 1204(A), 938 N.Y.S.2d 230 (Sup 2011).

financing proved insufficient, the borrowers' equity owner obtained a mezzanine loan, secured by a pledge of 100% of its membership interests in the borrowers. The mezzanine loan was subsequently assigned to Garrison Special Opportunities Fund LP ("Garrison").

The borrowers defaulted on the first lien loan. In exchange for the promise of the first lien lenders ("First Lien Lenders") not to foreclose on the property, Garrison unconditionally guarantied the "payment and performance of obligations or liabilities of borrower to lender . . . to the extent such obligations and liabilities arose after acquisition of all or any part of the ownership interest in borrowers by Garrison." Under the guaranty, full recourse and liability under the guaranty would also be triggered by a voluntary bankruptcy filing by the borrowers.

Garrison subsequently foreclosed on the pledged membership interests due to a default on the mezzanine loan and then, once in control of the borrowers, placed each one into bankruptcy. In response, the First Lien Lenders promptly demanded payment from Garrison under the guaranty. When Garrison refused to make payment on the guaranty, the First Lien Lenders invoked Section 3213 of the New York Civil Practice Law and Rules ("NYCPLR"), summary judgment in lieu of complaint, which allows for expedited judgment on an instrument for the payment of money only.

Garrison argued that the guaranty, by its nature, was not susceptible to summary judgment in lieu of complaint under NYCPLR § 3213. The court rejected the argument and held that the guaranty contained "a straightforward unconditional promise to pay," and the reference in the guaranty "to other documents did not prevent the guaranty from being enforceable as an instrument for the payment of money only."[226] The court also found the "bad-boy" guaranty that Garrison had signed was a "common feature in commercial mortgage loans" and that such guaranties routinely include waivers of certain defenses.[227]

While concluding that the waivers were effective, the court continued to address Garrison's defenses. First, Garrison argued that the guaranty was an unenforceable penalty. The court noted,

---

[226]*UBS Commercial Mortg. Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, 33 Misc. 3d 1204(A), 938 N.Y.S.2d 230, 2011 WL 4552404, *4 (Sup 2011).

[227]*UBS Commercial Mortg. Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, 33 Misc. 3d 1204(A), 938 N.Y.S.2d 230, 2011 WL 4552404, *5 (Sup 2011).

however, that Garrison was "familiar with the Guaranty's mechanics and purpose," and it had "made a decision to take a calculated risk that it could arrange a refinancing of the Properties before being forced by an aggressive lender to initiate a bankruptcy proceeding to protect its economic interest."[228] As such, the guaranty was not an unenforceable penalty. Second, Garrison urged the court to conclude that the guaranty should be held void as against public policy. The court rebuffed this argument as well, likening the situation to a typical scenario where a parent guarantees the debt of its subsidiary.[229] Having addressed Garrison's arguments, the court enforced the "bad-boy" guaranty and granted the plaintiffs' motion for summary judgment in lieu of a complaint.

A similar result was reached in *Bank of America N.A. v. Lightstone Holdings LLC*.[230] David Lichtenstein, a residential and commercial real estate developer, through his investment vehicle, Lightstone Holdings LLC, purchased the Extended Stay Hotels ("ESH") hotel chain for approximately $8 billion. In connection with the purchase, there were five mezzanine loans to various companies that indirectly owned ESH. Notes were issued in connection with these loans, and the loans were secured by the membership interests in each of the respective ESH entities to which a mezzanine loan had been made. While generally nonrecourse, the mezzanine loans specified that, upon the occurrence of certain events, they would become fully recourse. As additional credit support, the defendants guaranteed the mezzanine loans. In relevant part, each guaranty agreement (i) provided that the "Guarantor . . . irrevocably and unconditionally covenants and agrees that it is liable for the Guaranteed Obligations as a primary obligor" and (ii) defined "Guaranteed Obligations" to include "the obligations or liabilities of Borrower to Lender under Section

---

[228] *UBS Commercial Mortg. Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, 33 Misc. 3d 1204(A), 938 N.Y.S.2d 230, 2011 WL 4552404, *5 (Sup 2011).

[229] *UBS Commercial Mortg. Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, 33 Misc. 3d 1204(A), 938 N.Y.S.2d 230, 2011 WL 4552404, *6 (Sup 2011).

[230] *Bank of America N.A. v. Lightstone Holdings LLC*, 32 Misc. 3d 1244(A), 2011 WL 4357491 (Sup. Ct. N.Y. Cty. Jul. 4, 2011); *see also In re Extended Stay Inc.*, 418 B.R. 49, 52 Bankr. Ct. Dec. (CRR) 47 (Bankr. S.D. N.Y. 2009), aff'd in part, 435 B.R. 139 (S.D. N.Y. 2010).

9.4 of the Loan Agreement."[231] Section 9.4(b) of each of the mezzanine loan agreements stated that, if the "Mortgage Borrower, an Operating Lessee, a Mortgage Principal, the Borrower, a Senior Mezzanine Borrower or the Property Owner (as the terms are defined in the mezzanine loan agreements) files a voluntary petition under the Bankruptcy Code, the debt due under the mezzanine loans becomes fully recourse to the Borrower as well as immediately due and payable."[232]

Two years later, the mezzanine loan borrowers, the mortgage borrower and the property owner filed voluntary bankruptcy petitions. The indebtedness under the mezzanine loans became fully recourse, but, per the terms of the guaranty, the defendants' exposure was capped at $100 million. The day after the debtors filed their Chapter 11 petitions, the plaintiffs notified the defendants of their obligations under the guaranties.

Like the plaintiffs in *Garrison*, the plaintiffs in *Lightstone* moved for summary judgment on the guarantees pursuant to NYCPLR § 3213. However, the defendants removed the action to the bankruptcy court. Although no debtor had been named in the action, the defendants argued that the bankruptcy court had core jurisdiction because the guarantees and the underlying liabilities of the debtors were penalties tied to the bankruptcy filing.[233] The "trigger" in each debtor's documentation, the defendants argued, constituted an ipso facto clause that, if not specifically barred by the Bankruptcy Code, should be rendered unenforceable as a matter of public policy. The defendants further argued that because the defendants' liability under guarantees "sprang" into effect upon the debtors' bankruptcy filings, the respective triggers created a disincentive significant enough to impair the defendants' exercise of their rights under the Bankruptcy Code. This type of forced waiver was prohibited by the Bankruptcy Code and, therefore, the guarantees were unenforceable.

Rejecting the defendants' ipso facto clause argument as the basis for core jurisdiction, the bankruptcy court concluded that the case presented standard contract claims. The bankruptcy court held that it did not have jurisdiction to hear the case because the state law claims to enforce the nonrecourse carve-out guarantees did not "arise under" the Bankruptcy Code. Finally,

---

[231] *Bank of America, N.A. v. Lightstone Holdings, LLC*, 32 Misc. 3d 1244(A), 938 N.Y.S.2d 225, 2011 WL 4357491, *1 (Sup 2011).

[232] *Bank of America, N.A. v. Lightstone Holdings, LLC*, 32 Misc. 3d 1244(A), 938 N.Y.S.2d 225, 2011 WL 4357491, *1 (Sup 2011).

[233] Extended Stay Inc., 418 B.R. at 57–58.

as the debtors alone had filed bankruptcy petitions, the bankruptcy court found the defendants' ipso facto clause and public policy arguments had "minimal relevance" and rejected the same.[234]

On appeal, the district court affirmed but concluded that the bankruptcy court did have "related to" jurisdiction. Nevertheless, because nothing in the record otherwise required the retention of federal jurisdiction, mandatory abstention was applied to remand the case back to the state court.[235]

Before the New York state court, the defendants argued that the guarantees were not subject to a NYCPLR § 3213 motion, but the court (the same court that decided *Garrison*) rejected the defendants' arguments and granted judgment to the plaintiffs. The court found no conflict or ambiguity in the bankruptcy filing triggering full recourse liability under the guaranties.[236]

In *G3-Purves Street, LLC v. Thomson Purves, LLC*, the court concluded that the terms of a loan agreement and guaranty were "unambiguous," holding that the "springing recourse event . . . merely affixe[d] liability and [was] not, in effect, a liquidated damages provision that impose[d] an unenforceable penalty."[237] In *G3-Purves*, the defendants had executed a mortgage and a "Guaranty of Recourse Obligations." One of the covenants provided that the property was to remain unencumbered. Failure to maintain this unencumbered status was a "springing recourse event."[238] Sixteen months after the loan had been funded, the lender accelerated the loan and moved to foreclose and to obtain a deficiency judgment from the guarantors alleging that "springing recourse events" had occurred, including the filing of certain of liens against the property. While the defendants did not dispute the default, they argued that to seek the remaining balance on the loan under the guarantee was "grossly disproportionate to the amounts of the liens that had been filed against the property."[239]

On appeal, the Appellate Division affirmed the trial court's de-

---

[234]Extended Stay Inc., 418 B.R. at 59.

[235]*In re Extended Stay Inc.*, 435 B.R. 139, 150–51 (S.D. N.Y. 2010).

[236]*Bank of America, N.A. v. Lightstone Holdings, LLC*, 32 Misc. 3d 1244(A), 938 N.Y.S.2d 225, 2011 WL 4357491, *4 (Sup 2011).

[237]*G3-Purves Street, LLC v. Thomson Purves, LLC*, 101 A.D.3d 37, 38, 953 N.Y.S.2d 109 (2d Dep't 2012).

[238]G3-Purves Street, 101 A.D. 3d at 38–39.

[239]G3-Purves Street, 101 A.D. 3d at 39.

termination that the guarantee, by its terms, allowed for full recourse liability. In reviewing the terms of the agreements, the Appellate Division concluded that the carve-out provisions had been bargained for, the guarantors had benefited from the fact that the loan had been provided, and from the outset, the lenders had been looking beyond the mortgaged property to the guaranty for full repayment on the loan. As a result, contrary to the defendants' contention, the springing recourse event in the guaranty was not a liquidated damages clause but instead "only provide[d] for the recovery of the actual damages incurred by the lender" (i.e., it was a mechanism for recovering the amount initially loaned).

Finally, in *172 Madison (N.Y.) LLC v. NMP Group LLC*,[240] the borrower filed for bankruptcy on the day that a court appointed referee was set to publicly auction the property. In response, the lender moved for summary judgment on the guaranty on the basis that the bankruptcy petition had triggered the defendant's liability under the guaranty for the entire amount owed. The guarantor objected, arguing that the pleadings failed to include a cause of action covering the guaranty and that under applicable New York law,[241] the plaintiff could only maintain one action, and because the plaintiff had chosen to proceed with foreclosure, it should be barred from pursuing its remedy against the guarantor while the foreclosure action was pending.

The court refused to "allow the guarantor to put off her day of reckoning by insisting in a pointless supplemental pleading to formally bring the complaint up to date where there was no purpose and the underlying facts are not in dispute."[242] The court acknowledged the applicability of NYRPAPL § 1301, but held that, because the triggering event had not occurred at the time the foreclosure had commenced, there was no election to be made. When the borrower chose not to respect the covenant that it made not to file bankruptcy and then filed, the liability under the guaranty sprang into effect and NYRPAPL § 1301, at that point, could not be used to preclude the lender from pursuing the guaranty. Granting summary judgment in favor of the lender, the court concluded that it would not upend the "widespread and

---

[240] *172 Madison (NY) LLC v. NMP Group, LLC*, 41 Misc. 3d 1208(A), 977 N.Y.S.2d 668, 2013 WL 5509141, *1 (Sup 2013).

[241] New York Real Property and Procedures Law ("NYRPAPL") § 1301.

[242] *172 Madison (NY) LLC v. NMP Group, LLC*, 41 Misc. 3d 1208(A), 977 N.Y.S.2d 668, 2013 WL 5509141, *2 (Sup 2013).

settled use of nonrecourse loans subject to guaranties triggered by certain spring[ing] recourse events."[243]

Likewise, courts in California, Georgia, Illinois, Massachusetts, Michigan and New Jersey, when confronted with "bad-boy" guaranties, have also analyzed the triggering events, matched them to the circumstances and, when appropriate, enforced the guaranty in accordance with its terms, rebuffing various penalty, public policy and textual arguments.[244]

In Michigan, however, after *Cherryland* and *Chesterfield*,[245] which had, in each instance, enforced the "bad-boy" guaranties that had been triggered when the SPE borrowers had become insolvent (but had not filed for bankruptcy), the Michigan legislature enacted the Nonrecourse Mortgage Loan Act,[246] which overturned both *Chesterfield* and *Cherryland*, each then on appeal. Under the Act, a borrower's breach of a covenant to remain solvent or adequately capitalized may no longer be used to trigger recourse under a "bad-boy" guaranty. While the impact

---

[243] *172 Madison (NY) LLC v. NMP Group, LLC*, 41 Misc. 3d 1208(A), 977 N.Y.S.2d 668, 2013 WL 5509141, *3 (Sup 2013).

[244] *See Bank of America, N.A. v. Freed*, 2012 IL App (1st) 110749, 368 Ill. Dec. 96, 983 N.E.2d 509, 521 (App. Ct. 1st Dist. 2012), appeal pending, (May 1, 2013); *Wells Fargo Bank, N.A. v. Mitchell's Park, LLC*, 2012 WL 4899888 (N.D. Ga. 2012); *Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership*, 295 Mich. App. 99, 812 N.W.2d 799 (2011) (noting that the case has been legislatively overruled); *51382 Gratiot Ave. Holdings, LLC v. Chesterfield Development Co., LLC*, 835 F. Supp. 2d 384 (E.D. Mich. 2011) (legislatively overruled); *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, 410 N.J. Super. 114, 980 A.2d 1 (App. Div. 2009); *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 2d 366 (D. Mass. 2007); *but see GECCMC 2005-C1 Plummer Street Office Ltd. Partnership v. NRFC NNN Holdings, LLC*, 204 Cal. App. 4th 998, 140 Cal. Rptr. 3d 251 (2d Dist. 2012), as modified on denial of reh'g, (Apr. 30, 2012) and review denied, (July 11, 2012) (court strictly construed terms of agreement and when applied to the facts at hand, there had been no termination of the lease and, therefore, no liability under the guaranty); *Heller Financial, Inc. v. Lee*, 2002 WL 1888591 (N.D. Ill. 2002).

[245] Chesterfield Development, 835 F. Supp. 2d at 384; Cherryland Mall, 812 N.W.2d at 799.

[246] Nonrecourse Mortgage Loan Act, Mich. Comp. Laws § 445.1591, et seq. (Mich.) (the "Act"). The Act became effective March 29, 2012. The Act states, in relevant part, that:

> (1) A post closing solvency covenant shall not be used, directly or indirectly, as a non-recourse carve-out or as the basis for any claim or action against a borrower or any guarantor or other surety on a non-recourse loan; and
>
> (2) A provision in the documents for a non-recourse loan that does not comply with subsection (1) is invalid and unenforceable.

Mich. Comp. Laws § 445.1593.

is now localized to Michigan, the Act, which was upheld as constitutional in 2013, has potentially significant implications for all parties in the real estate market if other states enact similar legislation.[247]

IX. Third-Party Release of Nondebtor Guarantors Under a Chapter 11 Plan

Courts are split over whether a debtor's Chapter 11 plan can ever release nondebtor guarantors from liability to third parties. The point of contention is the proper interpretation of section 524(e) of the Bankruptcy Code, which provides that "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.A. § 524(e). The Courts of Appeals are split over whether third-party releases are ever allowable in a Chapter 11 plan given the language of section 524(e). Certain courts of appeal hold that third-party releases may be included in a Chapter 11 plan, but only in limited circumstances.[248] A few circuits have held that third-party releases are never permissible on the basis that they are contrary to section 524(e) and the purposes of the Bankruptcy Code. The Ninth Circuit, for example, has repeatedly stated that section 524(e) prevents bankruptcy courts from discharging any debts but those of the debtor, and that to do otherwise would be contrary to the bankruptcy policy of providing a fresh start only to those parties that file for bankruptcy.[249] The Fifth and Tenth

---

[247] Perhaps the most significant aspect of the Act is that, with respect to current loans governed by Michigan law, it is retroactive. Mich. Comp. Laws § 445.1595. The Act does not prohibit solvency triggers in recourse loans. Mich. Comp. Laws § 445.1594.

[248] *See, e.g*, Airadigm Communications, 519 F.3d at 657; *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142–43, 44 Bankr. Ct. Dec. (CRR) 276, 54 Collier Bankr. Cas. 2d (MB) 1033, Bankr. L. Rep. (CCH) P 80397 (2d Cir. 2005); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 94, 17 Bankr. Ct. Dec. (CRR) 293, 18 Collier Bankr. Cas. 2d (MB) 316, Bankr. L. Rep. (CCH) P 72180 (2d Cir. 1988); *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293, 26 Collier Bankr. Cas. 2d (MB) 1413, 22 Fed. R. Serv. 3d 1091 (2d Cir. 1992); *In re A.H. Robins Co., Inc.*, 880 F.2d 694, 702, 19 Bankr. Ct. Dec. (CRR) 997, Bankr. L. Rep. (CCH) P 72955 (4th Cir. 1989); *In re Dow Corning Corp.*, 280 F.3d 648, 658, 39 Bankr. Ct. Dec. (CRR) 9, 47 Collier Bankr. Cas. 2d (MB) 1158, Bankr. L. Rep. (CCH) P 78582, 2002 FED App. 0043P (6th Cir. 2002).

[249] *See In re American Hardwoods, Inc.*, 885 F.2d 621, 625–27, 19 Bankr. Ct. Dec. (CRR) 1354, Bankr. L. Rep. (CCH) P 73130 (9th Cir. 1989); *In re Lowenschuss*, 67 F.3d 1394, 1401–02, 34 Collier Bankr. Cas. 2d (MB) 544, Bankr. L. Rep. (CCH) P 76673, 33 Fed. R. Serv. 3d 249 (9th Cir. 1995).

Circuits have similarly held that bankruptcy courts may not grant third-party releases.[250]

In the circuits that allow third-party releases, plans where the debtor seeks to release its nondebtor guarantors are analyzed within the same framework as other third-party releases. Each circuit has adopted its own test for allowing a third-party release, which include common factors such as whether there is an identity of interest between the debtor and the third party, whether the third party has contributed adequate consideration in exchange for the release, whether the release is necessary or important to the reorganization, and whether affected creditors have consented to the plan.[251] Special considerations may arise due to the nature of the guarantor relationship. For example, when determining whether there was an identity of interest between a debtor and guarantor, a court recently noted that when a creditor seeks payment from a guarantor, that may give rise to a claim (for contribution or reimbursement) by the guarantor against the debtor, and thus the court held that there was an

---

[250] *See, e.g.*, *Matter of Zale Corp.*, 62 F.3d 746, 754, Bankr. L. Rep. (CCH) P 76617 (5th Cir. 1995); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 600–601, 21 Bankr. Ct. Dec. (CRR) 320, 24 Collier Bankr. Cas. 2d (MB) 1012, Bankr. L. Rep. (CCH) P 73754 (10th Cir. 1990), opinion modified, 932 F.2d 898 (10th Cir. 1991).

[251] *See, e.g.*, Metromedia, 416 F.3d at 142–43 (concluding that a "non-debtor release in a plan should not be approved absent the finding that truly unusual circumstances render the release terms important to the success of the plan," such as where "the estate received substantial consideration," where "the enjoined claims were channeled to a settlement fund rather than extinguished," where "the enjoined claims would indirectly impact the debtor's reorganization by way of indemnity or contribution," or where "the affected creditors consent"); Dow Corning, 280 F.3d at 658 (concluding that a third party non-debtor release should only be approved when the following seven factors are met: "(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").

identity of interest between the parties that could affect the debtor's estate.[252]

In cases where a secured claim is restructured and any unsecured deficiency claim eliminated under a Chapter 11 plan, courts have disagreed as to whether barring suit against guarantors on account of the discharged unsecured deficiency claim is permissible. One bankruptcy court recently held that it was permissible for a plan to enjoin a secured creditor from pursuing guarantors where the plan restructured the secured obligation and eliminated any deficiency judgment on the secured claim.[253] However, another bankruptcy court recently refused to authorize a third party release, noting that although the secured claim would be paid in full, the creditor should be allowed to increase its recovery by pursuing the guaranty outside of bankruptcy.[254]

The Court of Appeals for the Fifth Circuit has addressed this question in the context of a Chapter 15 proceeding where the debtor, Vitro S.A.B. de C.V., sought recognition of a Mexican *concurso* (which is similar to a Chapter 11 plan), which was approved by the Mexican court solely due to the votes of insiders voting intercompany claims, and the *concurso* proposed to eliminate the U.S. nondebtors' guaranty obligations to the objecting noteholders.[255] In *Vitro*, the Fifth Circuit noted that even though third party releases—such as the releases the Mexican court proposed to grant to the nondebtor guarantors—were not allowed under Fifth Circuit law, other circuits have allowed third party releases under very limited circumstances. However, the Fifth Circuit found that the circumstances in *Vitro* would not support the granting of third party releases in the circuits that do allow such releases in the United States. Accordingly, the Fifth Circuit affirmed the bankruptcy court's decision not to recognize the Mexican *concurso*, because the relief sought was neither available under U.S. law nor were the facts substantially in accor-

---

[252]*In re Charles Street African Methodist Episcopal Church of Boston*, 499 B.R. 66, 100–101 (Bankr. D. Mass. 2013).

[253]*See In re J.C. Householder Land Trust #1*, 501 B.R. 441, 457 (Bankr. M.D. Fla. 2013) (reasoning that the guaranty was chiefly meant to protect against an unsatisfied deficiency judgment, the court barred suit against a guarantor as long as the debtor was current on its payments).

[254]Charles Street, 499 B.R. at 102–103.

[255]*In re Vitro S.A.B. de CV*, 701 F.3d 1031, 1037–42, 57 Bankr. Ct. Dec. (CRR) 79, Bankr. L. Rep. (CCH) P 82386 (5th Cir. 2012), cert. dismissed, 133 S. Ct. 1862, 185 L. Ed. 2d 862 (2013).

dance with the circumstances under which such relief might be granted under U.S. law.[256]

X. Section 1129(a)(10) and Guaranty Claims Against Special Purpose Debtors

It is not uncommon for financial lenders, as part of their lending arrangements, to receive guaranties from affiliates of the principal obligor that are special purpose entities. Special purpose entities, in this context, will be prohibited from incurring any debt other than the obligations under the guaranty. This type of arrangement provides additional protection for the lender, who is ensured that the assets of those special purpose guarantor entities will be fully available to satisfy the guaranteed obligations, and thus allows principal obligors to obtain credit on more favorable terms. If the principal obligor and the guarantors under such a lending arrangement file for bankruptcy, so long as the special purpose requirements were not breached, the lender will be the only creditor of the special purpose guarantors. This may put the lender in a unique position in the context of Chapter 11 confirmation in light of the specific requirements of section 1129(a)(10) of the Bankruptcy Code.

Section 1129 of the Bankruptcy Code establishes the requirements for confirmation of a Chapter 11 plan. In order to confirm a plan over the objection of creditors, section 1129(b) requires, among other things, the affirmative vote of at least one consenting impaired class of claims. 11 U.S.C.A. §§ 1129(a)(10); 1129(b).[257] Only a handful of cases have addressed the question of what this code section requires in the context of Chapter 11 cases involving multiple debtors that are jointly administered but not substantively consolidated. These cases are split, with certain cases holding that in confirming a joint Chapter 11 plan, a single impaired accepting class among all of the debtors will satisfy the section

---

[256] Vitro S.A.B. de C.V., 701 F.3d at 1053–69.

[257] Section 1129(a)(10) states: "If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider." *See Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 441, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 34 Bankr. Ct. Dec. (CRR) 329, 41 Collier Bankr. Cas. 2d (MB) 526, Bankr. L. Rep. (CCH) P 77924 (1999) ("Critical among [the conditions of cramdown] are the conditions that the plan be accepted by at least one class of impaired creditors, *see* § 1129(a)(10), and satisfy the 'best-interests-of-creditors' test, *see* § 1129(a)(7).").

1129(a)(10) requirement (the "per plan" view),[258] and other cases holding that the impaired accepting class requirement must be satisfied for each and every one of the debtors/plans under a joint plan (the "per debtor" view).[259]

So long as courts adopt a "per debtor" view of the section 1129(a)(10) requirement, a creditor holding the only claim against a special purpose debtor is in a strong negotiating position with respect to the debtors. If the special purpose debtor has only one creditor, it also has only one class of claims, and the lender holding the guaranty will be the only creditor in that one class. If the plan for the special purpose debtor would impair the claims in that one class, no plan for the special purpose debtor could be

---

[258] *See* In re Transwest Resort Properties Inc., Case No. 10-37134, Order Confirming Debtors' Third Amended and Restated Joint Plan [Docket No. 752] & Tr. of Confirmation Hrg. Dec., 16, 2011 [Docket No. 741] (Bankr. D. Az. Jan. 3, 2012) (confirming a Chapter 11 plan where the section 1129(a)(10) requirement was met on a per-plan basis), *appeal dismissed as moot by* No. 12-00024, Order, Docket No. 80 (D. Az. Aug. 29, 2012) (further appeal pending before the Ninth Circuit); *In re Station Casinos, Inc.*, 2010 Bankr. LEXIS 5380 (Bankr. D. Nev. Aug. 27, 2010) ("The bankruptcy courts that have expressly considered the matter have uniformly held [at that time] that compliance with Section 1129(a)(10) is tested on a per-plan basis, not on a per-debtor basis, and that Section 1129(a)(10) therefore does not require an accepting impaired class for each debtor under a joint plan"); *In re Charter Communications*, 419 B.R. 221, 270–71, 52 Bankr. Ct. Dec. (CRR) 114 (Bankr. S.D. N.Y. 2009) (stating that the confirmation requirements could have been satisfied even if the court had not ruled the debtors' classification scheme permissible, because section 1129(a)(10) can be satisfied on a per-plan basis); *In re Enron Corp., No. 01-16034*, 2004 Bankr. LEXIS 2549, at *234–36 (Bankr. S.D.N.Y. July 15, 2004) (in a case involving settlement of substantive consolidation issues, stating that the section 1129(a)(10) requirement could be met on a per-plan basis); *see also In re SGPA, Inc., No. 01-2609*, 2001 Bankr. LEXIS 2291, at *13 (Bankr. M.D. Pa. Sept. 28, 2001) (confirming a plan where the section 1129(a)(10) requirement was met on a per-plan basis and noting that the objecting creditors were not adversely affected and that the same result could have been reached through substantive consolidation).

[259] *In re Tribune Co.*, 464 B.R. 126, 180–83, 55 Bankr. Ct. Dec. (CRR) 179, Bankr. L. Rep. (CCH) P 82100 (Bankr. D. Del. 2011), on reconsideration, 464 B.R. 208, 55 Bankr. Ct. Dec. (CRR) 259 (Bankr. D. Del. 2011) ("I find nothing ambiguous in the language of § 1129(a)(10), which, absent substantive consolidation or consent, must be satisfied by each debtor in a joint plan"); *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293, 301–08 (Bankr. D. Del. 2011) (dismissing with prejudice the Chapter 11 case of one of many affiliated debtors where there was only one creditor of that particular debtor and no plan could be confirmed without that creditor's consent under section 1129(a)(10)); *see also In re TOUSA, Inc.*, 2013 Bankr. LEXIS 3169, at *54–55 (Bankr. S.D. Fla. Aug. 5, 2013) (applying section 1129(a)(10) on a per-debtor basis in concluding that the plan confirmation requirement had been met).

confirmed without the consenting vote of that creditor. However, outcomes cannot be certain, as the caselaw is still developing in this area.

Conclusion

Guaranties raise a number of complex issues in the context of a bankruptcy of a guarantor or primary obligor. Practitioners should take care in both drafting and negotiating the terms of any guaranty and should be aware that, in the bankruptcy context, the rights and remedies of the primary obligor, the guarantor, and the creditor may be significantly affected. While this article has been prepared to offer guidance on these issues, the application of the principles discussed above to a particular case will in all likelihood depend heavily on the facts pertaining to that case.