

Enforcing Commercial Guaranties In And Out Of Bankruptcy Court

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By John R. Ruhl¹

He that is surety for a stranger shall smart for it:
and he that hateth suretyship is sure.
(Proverbs, 11:15)

εγγυα παρα δ' ατα (Give surety, get ruin)
(Inscription on the Temple at Delphi)

A guarantor is a fool with a pen.
(anonymous)

If you want a guaranty, buy a toaster.
(Clint Eastwood (*The Rookie*, 1990))

1. Introduction

A guaranty is an important tool used in many commercial loan transactions. By allowing the creditor to transfer risk to a third party (the guarantor), guaranties enable many borrowers to access credit for which they would not otherwise qualify.

The concept of a guaranty is simple – a promise to pay the debt of another. But guaranties never have been favored by courts, and over centuries imaginative guarantors – who never expected to have to pay in the first place – understandably have asserted numerous equitable defenses, which in turn have resulted in lenders adding new layers of waivers, warranties, exceptions and other protective clauses. The results of this process are the lengthy boilerplate commercial guaranties commonly used today.

Despite all of the protective language in most commercial guaranties, lenders still must be vigilant to preserve their rights. This paper will explore some of the issues that bank officers need to be aware of when a guaranteed loan goes into default, and especially when the principal borrower and/or the guarantor seeks protection under the federal bankruptcy laws.

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2. Be Aware of Commercial Guarantors' Rights Pursuant to Washington's Nonjudicial Foreclosure Statute

2.1. Commercial Guarantor's Right to Challenge Nonjudicial Foreclosure Sale Price

If a creditor files suit against a commercial guarantor for a deficiency judgment following the nonjudicial sale of the principal debtor's real property, the guarantor is entitled to challenge the foreclosure sale price as having been too low. The guarantor can request the court to eliminate or reduce the deficiency judgment by the amount of the difference between the unreasonably low purchase price and the actual fair value of the real property.² The creditor has the burden of proving that the sale price at the nonjudicial foreclosure sale was reasonable.

The foreclosure statute provides that this right "is in lieu of any right any guarantor would otherwise have to establish an upset price... prior to a trustee sale."³ The guarantor can exercise this statutory right regardless of whether the guaranty contains a waiver of the guarantor's rights to assert impairment of the collateral as a defense.

One way for a lender to anticipate and meet its burden of proof is to obtain an appraisal of the property immediately before the foreclosure sale, and then make sure that the sale price (including any credit bid) is at least as high as the appraised value.

2.2. Commercial Guarantor's Homestead Rights

A principal debtor generally waives and is not entitled to assert the homestead exemption on the foreclosure sale of the debtor's homestead property.

By contrast, if a commercial guarantor grants a deed of trust to secure its guaranty, and if the lender forecloses nonjudicially on the guarantor's deed of trust, the guarantor is entitled to receive "an amount up to the [\$125,000] homestead exemption ... from the bid at the foreclosure or trustee's sale ... prior to the application of the bid to the guarantor's obligation."⁴

In other words, even if the bank is the only bidder at the foreclosure sale of the guarantor's homestead property, the bank first must pay in cash to the guarantor an amount equal to the guarantor's \$125,000 homestead exemption (or an amount equal to the value of the real property if the property is worth less than \$125,000).

² RCW 61.24.100(5).

³ RCW 61.24.100(5).

⁴ RCW 61.24.100(6).

2.3. Anti-Deficiency Rule Applicable to Foreclosure Against Commercial Guarantor's Real Property

If a commercial guarantor has granted a deed of trust against its own real property to secure its guaranty, the creditor should weigh carefully whether to foreclose nonjudicially against the guarantor's real property. The reason is that the creditor's recovery generally will be limited to whatever amount is recovered at the nonjudicial foreclosure sale, and the creditor will not be able to sue the guarantor for a deficiency judgment in such a situation.⁵

The only exception is that the creditor will be allowed to sue for a deficiency judgment against the guarantor to recover for any waste that the guarantor caused to the property after the deed of trust was granted; and also for the guarantor's wrongful retention of any "rents, insurance proceeds, or condemnation awards."⁶

3. Guarantor's Nonwaivable Right Under UCC to Require Reasonable Disposition of Personal Property Collateral

In the case of a foreclosure against personal property, Washington's version of the Uniform Commercial Code requires that:

Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable.⁷

This requirement cannot be waived by the primary obligor or by the guarantor.⁸ In one Washington case, the court held that a guarantor who signed a guaranty purporting to waive the defense of "unjustified impairment" of collateral nevertheless was entitled to rely on the above-quoted statute and raise "impairment of collateral" as a defense to the creditor's claim to collect a deficiency.⁹

In another case, the court ruled that a creditor's disposition of the personal property collateral was unreasonable, and that the guarantor therefore was entitled to a presumption that the value of the collateral was equal to the amount of the outstanding debt.¹⁰

⁵ RCW 61.24.100(6).

⁶ *Id.*; See also RCW 61.24.100(3)(a)(i).

⁷ RCW 62A.9A-610(b) (formerly RCW 62A.9-504(3)).

⁸ RCW 62A.9A-602(7).

⁹ *Security State Bank v. Burk*, 100 Wn.App. 94, 99, 995 P.2d 1272 (2002).

¹⁰ *U.S. v. Cawley*, 464 F.Supp. 189 (E.D. Wash. 1979).

4. Tips and Traps for Dealing With Guarantors in Bankruptcy Court

4.1. Obtaining Relief From Stay Against Bankrupt Guarantor Before Foreclosing on Principal Debtor's Deed of Trust

The Washington foreclosure statute allows a creditor to seek a deficiency judgment against a commercial guarantor after foreclosing nonjudicially against a principal debtor's property, but only if the creditor has given the guarantor certain pre-foreclosure notices.¹¹

When the guarantor is in bankruptcy, however, and the principal debtor is not in bankruptcy, the creditor should obtain an order granting it relief from stay in the guarantor's bankruptcy before it commences the nonjudicial foreclosure against the nonbankrupt principal debtor's property and serves the statutory notices upon the bankrupt guarantor.

Otherwise, the creditor's notices to the bankrupt guarantor will have been served in violation of the automatic bankruptcy stay and thus be void, which in turn will disqualify the creditor from pursuing a deficiency judgment against the guarantor.

4.2. Defending Preference Claims Involving Affiliated Corporations

Where a principal debtor is a corporation and the guarantor is an affiliated corporation, payments made by one corporation generally are not considered to have been made by the affiliated corporation for preference purposes. Thus, a payment made by a nonbankrupt subsidiary guarantor corporation will not be treated as a preferential payment in the bankrupt parent corporation's bankruptcy; and vice versa.¹²

Preferences are covered under § 547(b) of the Bankruptcy Code. Basically, a trustee may recover certain transfers to a creditor made by the debtor within 90 days before the bankruptcy petition was filed. A transfer by the debtor constitutes an avoidable preference if six elements are shown: (1) a transfer of an interest of the debtor in property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt; (4) made while the debtor was insolvent; (5) made on or within 90 days before the date of the filing of the petition; and (6) which enables the creditor to receive more than the creditor would receive in a Chapter 7 liquidation of the estate.¹³

In each case it must be shown, as a threshold matter, that the challenged payment is a transfer of the bankrupt entity's property (Item 1, above). As a general rule, bankruptcy courts treat related corporations as separate entities, with separate

¹¹ RCW 61.24.100(3)(c); see also RCW 61.24.042.

¹² *Hansen v. MacDonald Meat Co. (In re Kemp Pacific Fisheries Inc.)*, 16 F.3d 313, 316 n. 6 (9th Cir.1994).

¹³ See 11 U.S.C. § 547(b).

assets and liabilities, unless there are clear grounds for piercing the corporate veil or “substantively consolidating” the two companies for purposes of the bankruptcy proceeding.¹⁴

For example, a bankrupt parent corporation’s property interest as a shareholder of a nonbankrupt subsidiary corporation generally is limited to the rights represented by the stock certificates, and the specific assets of the subsidiary are the property of the subsidiary only.¹⁵ If prepetition transfers of the subsidiary corporation’s assets may be recovered for the benefit of anyone, it is for the benefit of creditors of the subsidiary itself, not the creditors of the parent.¹⁶ As a result, the trustee of the estate of a bankrupt corporate principal debtor generally has no standing to seek to avoid prepetition transfers of the property of a nonbankrupt related guarantor corporation.

4.3. Defending Guaranties Against Fraudulent Transfer Claims

Although a bankruptcy trustee may challenge a bankrupt guarantor’s particular payment as a preferential payment, the trustee also may be able to challenge and undo the entire guaranty itself as a “fraudulent transfer” in certain situations, even if there is no actual fraud involved.

Section 548 of the Bankruptcy Code allows the trustee (or debtor-in-possession) to avoid all “fraudulent transfers” made within the two years before the filing of a bankruptcy case. The trustee (or debtor-in-possession) must show that the transfer was made with “actual intent to hinder, delay, or defraud” any creditor;¹⁷ or else that it was constructively fraudulent.

To prove a transfer to be constructively fraudulent, it must be shown that (1) the debtor made the transfer without receiving “a reasonably equivalent value” in exchange; and (2) the debtor was insolvent at the time (or was rendered insolvent as a result of the transfer).¹⁸

A bankruptcy trustee may claim that an intercorporate guaranty is constructively fraudulent if the guarantor corporation did not receive a “reasonably equivalent value” in return for its guaranty.¹⁹

In a “downstream guaranty” (i.e., parent guaranties subsidiary’s obligation), the creditor generally can demonstrate that the parent received some direct economic

¹⁴ *In re Regency Holdings (Cayman), Inc.*, 216 B.R. 371, 375 (S.D. NY 1998).

¹⁵ *In re Cassis*, 220 B.R. 979, 983 (N.D. Iowa 1998).

¹⁶ *In re Regency Holdings*, 216 B.R. at 376.

¹⁷ 11 U.S.C. § 548(a)(1)(A).

¹⁸ 11 U.S.C. § 548(a)(1)(B).

¹⁹ 11 U.S.C. § 548(d)(2).

benefit from the guaranty (such as the improved financial condition of the subsidiary).²⁰ But if the subsidiary is insolvent, a downstream guaranty by its parent may be vulnerable to attack as a fraudulent transfer on grounds that the guaranty did not increase the value of the parent's equity in the subsidiary.

In an "upstream guaranty" (i.e., subsidiary guaranties parent's obligation) or a "cross stream guaranty" (i.e., one between subsidiary companies), it may be difficult for the creditor to identify the "reasonably equivalent value" received by the guarantor. The creditor may seek to defend the transfer by pointing to the lower interest rate that the guaranty made possible for the guaranteed loan transaction; or that there is some other indirect benefit, such as allowing the corporate group to qualify for an otherwise "optimal financing arrangement" from the creditor which would not have been available to either company separately.²¹

In sum, if the parties involved are genuinely interdependent or if the guaranty will allow the guarantor and its affiliate to achieve synergistic gains, the guaranty will be more likely to withstand the trustee's challenge. But where "no viable enterprise exists, so that the ultimate effect of the guaranty is simply to shift assets from creditors of the guarantor to creditors of the principal debtor,"²² then the guaranty, and any security interest granted to secure the guaranty, are likely to be held to be constructively fraudulent and thus void.

There are several tips that may help insulate intercorporate guaranties from challenges as fraudulent transfers, including:

- Requiring a guarantor to warrant that it is not insolvent (and will not be rendered insolvent) as a result of entering into the guaranty.
- Adding a contribution agreement among related guarantors and/or the guarantor and the principal obligor to the effect that a guarantor is entitled to reimbursement or contribution from the other parties if it makes payment on the guaranty (which will allow the guarantor to argue that it obtained a tangible benefit in exchange for its guaranty).²³
- Adding a "savings clause" providing that the guaranty is to be limited to an amount that would not be avoidable under fraudulent transfer law; or else

²⁰ *In re Royal Crown Bottlers of North Alabama, Inc.*, 23 B.R. 28, 29 (Bankr. N.D. Ala. 1982).

²¹ *Tryit Enters., et al. v. Gen. Elec. Capital Corp. (In re Tryit Enters. et al.)*, 121 B.R. 217, 223-24 (Bankr. S.D. Tex. 1990); *Rubin v. Mfrs. Hanover Trust Co.*, 661 F.2d 979, 991 (8th Bankr. Ct. Dec. (CRR) 297 (2nd Cir. 1981); *United States v. Tabor Court Realty Corp.*, 803 F.2d 1228 (3rd Cir. 1986).

²² *In re Fairchild Aircraft Corp.*, 6 F.3d 1119, 24 Bankr. Ct. Dec. (CRR) 1569, 30 Collier Bankr. Cas. 2d (MB) 211, Bankr. L. Rep. (CCH) ¶ 75603 (5th Cir. 1993).

²³ See Godshall & Klyman, Wading "Upstream" in Leveraged Transactions: Traditional Guarantees v. Net Worth Guarantees, 46 Bus. Law. 391, 396 (Feb. 1991).

adding a “net worth limit” which limits the guaranty by its terms to an amount that is slightly greater than the guarantor’s net worth. One commentator, however, notes that neither of these types of provisions has been tested in any court.²⁴

4.4. Monitoring A Principal Debtor’s Proposed Chapter 11 Plan for Possible Release of Guarantors

The Bankruptcy Code provides that a bankruptcy discharge of the principal debtor does not release the surety.²⁵

However, in at least two cases, federal appellate courts have held that a nondebtor guarantor was released where the creditor had failed to file a timely appeal of the bankruptcy court’s order confirming the principal debtor’s reorganization plan that provided for the release of the nondebtor guarantor.²⁶ In each case the appellate court held that the creditor had lost its right to object to the reorganization plan notwithstanding the fact that the bankruptcy statutes would have provided the creditor with legal grounds to object to the release of the guarantor.

In light of these cases, a bank should take care to monitor carefully the principal debtor’s bankruptcy case and object to any proposed plan (and timely appeal from any court order) that adversely affects the bank’s rights, including the bank’s rights with respect to guarantors.

4.5. Avoiding the “Sham Guarantor” Defense

The so-called “sham guaranty” defense is a potential defense that could surface in Washington – and that might be expected to be asserted in deficiency suits and in bankruptcies by individual real property developers who have guaranteed loans for their single-purpose entities that were the primary borrowers in acquisition and development loans.

In a line of recent California cases, guarantors have claimed that their guaranties were sham, that they were not really guarantors but actually primary obligors on the

²⁴ See Greer and Moss, Guaranties in Bankruptcy: A Primer, 16 Norton Journal of Bankruptcy Law and Practice 309, at p. 335-336 (2007); Maglio, The Promise, Part II, *Business Law Today* (Jan./Feb. 2005).

²⁵ 11 U.S.C.A. §524(e); 11 U.S.C.A. § 727 (Chapter 7); 11 U.S.C.A. § 1141(d)(1)(A) (Chapter 11); 11 U.S.C.A. § 1328 (Chapter 13).

²⁶ *Republic Supply Co. v. Schoaf*, 815 F.2d 1046 (5th Cir. 1987); *Stoll v. Gottlieb*, 305 U.S. 165, 59 S.Ct. 134, 168-69, 83 L.Ed. 104 (1938).

debt, and that they therefore should have no liability for any deficiency judgment following the creditor's nonjudicial foreclosure.²⁷

In one case involving a real property development loan, the court allowed the sham guarantor defense to be asserted by the individual guarantors, who contended that:

(1) the entire transaction [was] structured to avoid the anti-deficiency preclusion of [California statutes similar to Washington's statutes], (2) the lender intended from the outset to look to the real property security for collection of the debt, released the purported "principal obligor" [a limited partnership whose general partner allegedly was a shell corporation] from any personal liability by virtue of the nonrecourse provisions of the loan instruments, and intended to look to the purported "guarantors" exclusively for collection of any deficiency after foreclosure, and (3) the general partner of the purported "principal obligor" was an undercapitalized corporation, entirely owned by defendants, whose financial wherewithal plaintiff never investigated.²⁸

Although there are no reported Washington cases to date in which courts have recognized the "sham guaranty" defense, lenders should be careful not to deal with borrowers and guarantors in such a way as to allow the guarantors to argue that the lender "required" the guarantor to form a single-purpose entity and then also guaranty that entity's debt, thus wrongfully compelling the "true borrower" (the guarantor) to waive the benefits of the one-action and anti-deficiency rules that protect primary obligors.

5. Conclusion

Although the basic purpose of a guaranty is simple, and although most commercial guaranties are full of language intended to make sure that the guarantor will pay if the borrower does not, there can be no absolute assurance that every guaranty will be fully enforceable in every situation. In order to more fully preserve their own rights lenders must be aware of guarantors' rights under state laws and also under the bankruptcy laws.

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²⁷ *Union Bank v. Dorn*, 254 Cal. App. 2d 157, 158 (1967); *River Bank America v. Diller*, 38 Cal.App.4th 1400, 45 Cal.Rptr.2d 790 (1995); *MKA Capital Group, Inc. v. Darling*, 2005 WL 289023 (Cal.App. 4 Dist.).

²⁸ *River Bank America v. Diller*, 38 Cal.App.4th 1400, 1420, 45 Cal.Rptr.2d 790, 801 (1995);